5 Views of the main parties

Summary of BA's views

5.1. BA told us that the proposed merger was a natural consequence of changes in the civil aviation industry. In the new environment an airline needed to be large enough to enjoy economies of a scale or small enough to enjoy the advantages of being a specialised niche operator: BCAL with its present route network was neither. BA believed that, without diminishing either the competitiveness of the civil aviation market or the dynamics of the competitive process, the merger would strengthen its own position and enable it to cope better with the competitive pressures to which it would increasingly be subject as deregulation proceeded.

5.2. BCG could not survive alone (see Appendix 5.1). If a merger with BA was disallowed and BCG merged with a foreign airline the result would be detrimental to the United Kingdom and grossly unfair to BA. If it merged with one of the other United Kingdom airlines, all of which had smaller route networks than BCAL, nothing would be solved in the longer term; the problems facing BCG would still be there, and two airlines, rather than one, would be at risk. On the other hand a merger with BA would ensure that the United Kingdom airline industry included a major international carrier which would survive and be able to compete effectively with foreign airlines.

General changes in civil aviation

5.3. Change in the industry had come about in the first place because of changes in the international regulatory environment, which affected the number of airlines which could operate on routes, fares, frequency of service, and the sharing of capacity and revenue. The ASAs between governments increasingly allowed, and encouraged, competition; where agreements had not been liberalised, airlines were nevertheless finding ways of circumventing—or ignoring—the regulations; and there were now fewer revenue-pooling agreements between airlines.[1]

5.4. A second development was that large airlines increasingly tended to concentrate their activities on hub airports at the centre of a network of routes (the 'spokes'), not all of which would be profitable to operate on their own. By carefully co-ordinating arrival and departure times, airlines operating from the hub could attract considerable business from other airports. The hub principle had been developed and refined in the United States, where the vast domestic market lent itself to being organised in this way; the hubs were also used to feed domestic passengers on to international flights. Airlines all over the world had responded by developing their own hubs. BA's hub was at Heathrow, which had a large natural catchment area. But other airlines had grown by focusing their activities on airports which had no significant home market but were able to act as clearing houses for passengers travelling to and from other parts of the world; KLM, for example, treated the United Kingdom as part of the catchment area for Schiphol, which was marketed as London's third airport.

5.5. In a hub and spoke operation the complexities of fares, schedules and connections were such that airlines had needed sophisticated computer reservation systems to enable them to market the information to travel agents. These too had been developed principally in the United States, and were now being marketed to travel agents in Europe where they would inevitably replace less

[1] BA is terminating certain revenue-pooling agreements and commercial arrangements (see paragraphs 2.20 and 2.22).

sophisticated systems such as BA's Travicom. European airlines had responded by embarking upon two competing joint ventures to develop systems: Galileo (in which BA would be a partner), and Amadeus (see paragraph 2.86). In the United Kingdom the travel agency business, which would be invited to choose from among these systems, was also changing. Outlets were increasingly controlled by nationwide groups which were able to use their market power to obtain larger commissions from carriers, some of which they would be allowed to pass on as discounts to their customers if a recent decision of the CAA were not overturned on appeal to the Secretary of State. BA told us that 'bucket shops' also offered heavily discounted airline tickets.

5.6. Travel agents' discounts were not the only way in which consumers had benefited. Airlines themselves were offering a wide range of special tariffs and promotional fares (such as Apex); these were likely to become even more common once the European Commission's liberalising proposals became law.

Competition in specific markets

5.7. The United Kingdom scheduled domestic market had been substantially liberalised as regards fares, routes and capacity. The one effective constraint was that new domestic services were only allowed from Heathrow in exceptional circumstances. There were a number of carriers in the market besides BA and BCAL, including British Midland which carries two and a half times as many scheduled passengers as BCAL. Some of these were new entrants, and their market share had grown at the expense of BA and BCAL.

5.8. Scheduled services within Europe, inside and outside the Community, had become more open to competition, although some governments still imposed restrictions on capacity, on designation of carriers, and in particular on tariffs. The United Kingdom had re-negotiated more liberal ASAs with several countries, and had supported the European Commission's new air transport policy.

5.9. Scheduled long-haul services to many countries had become very competitive. Even where foreign governments sought to protect the interests of their national carrier by imposing restrictive bilateral agreements, there was a great deal of competition from direct services offered between the same points by fifth-freedom carriers (for example, Air Canada between London and Singapore), as well as from sixth-freedom carriers (that is, carriers operating services based on a hub outside the countries of origin and destination). The competitive opportunities for foreign carriers were further enlarged by the fact that many long-haul passengers had a choice of points from which to begin a visit to Europe, so that London had to compete with other European cities to be the initial destination.

5.10. International charter services were very competitive. The market was to all intents and purposes deregulated, and entry barriers were low. There were several large and successful United Kingdom charter airlines, as well as some foreign ones; these competed with scheduled services to leisure destinations, offering passengers the choice of paying for different degrees of comfort and convenience. There were a number of charter airlines and tour operators which belonged to the same parent company as did British Airtours and BA's several holiday businesses (but see paragraph 3.14); nevertheless charter airlines depended for their success on their ability to market their services to all tour operators. The number of charter passengers relative to scheduled passengers had grown; this was partly because of a natural expansion in the market, but there was little doubt that a significant part of the charter growth had been at the expense of scheduled services. Part-charter tickets on scheduled flights, and seat-only tickets on charter flights, added to the competitiveness of the market.

Plans and prospects for the merged airline

5.11. BA told us that it plans to integrate BCAL's operations with its own to the greatest extent allowed by licensing regulations as soon as possible after the merger. Through rationalisation, and through increased scale of operations, it expected to achieve gains in overall efficiency and cost competitiveness. These, in turn, would generate a growth in turnover and further economies of scale. The cycle would continue, to the benefit of the public as well as of BA.

5.12. Combining the two fleets of aircraft would offer many advantages, including significant economies of scale. The proportion of the fleet required for 'standby' cover, for unserviceable aircraft or to meet unexpected delays on flights, could be reduced without lowering the service provided to the customer. Maintenance could be spread more evenly over the year, and the matching of capacity to demand would come more easily with a wider range of aircraft sizes from which to choose. The enlarged fleet would also allow more flexible scheduling, with flight times better matched to passenger requirements.

5.13. There would also be scope for savings in the cost of crewing the aircraft by adopting the best practices of both airlines. Deployment from a single workforce would improve utilisation; the merged airline would require fewer crews than the two airlines separately. Benefits would also accrue if BCAL's aircraft and crews were included in BA's computer system which held, checked and tested the scheduling of aircraft and crews.

5.14. BA would also expect savings from a rationalisation of aircraft maintenance facilities and from reductions in the holding of spares. Calculations had shown that millions of pounds a year could be saved simply by using BA's advanced stock control system for BCAL's spares. The transfer of BCAL's passenger reservation arrangements to BA's own system and the integration of other computer facilities would yield savings in running costs, capital expenditure and staff. Substantial savings could also be made by avoiding duplication in ground-based customer services, sales and distribution, central management and other overhead activities. Aircraft procurement would also be cheaper—BA, through its position as an important customer, and its skills in negotiations, was able to obtain more attractive terms than could BCAL. This would be reflected in the cost of future replacements for the combined fleet.

5.15. BA stressed that savings were not the only benefits to arise from the merger. There would also be revenue gains through enhanced marketing opportunities and increased competitiveness. BA's reputation and higher profile in the market and its more efficient route network would enable it to increase traffic on the present BCAL services. Integration of the two networks would lead to even wider gains. The merged airline would also have greater influence in the development of CRS than BA alone.

5.16. More directly, a better and more competitive service could be offered on certain routes currently served by the two airlines, in particular on the London to Tokyo route where the division of carriage between BA and BCAL had, in BA's view, given a big advantage to the single Japanese competitor, JAL, to the detriment of the United Kingdom public interest. Furthermore, BCAL's existing services would benefit from the extra interconnecting flights that could be offered from within the merged airline and from interlining arrangements with other carriers. Studies had shown that BA connected well with BA at Heathrow, and BCAL connected well with BCAL at Gatwick, but cross-flow between the two was small. The merged airline would be able to offer a larger number of connecting services at Gatwick than was offered by the two separate airlines. On the basis of 1987 summer schedules, calculations had shown that an increase in intralining connecting services of nearly 50 per cent could be achieved and opportunities for the future were even greater. Following the merger, it would be BA's intention vigorously to develop the network of scheduled services at Gatwick, within the constraint on slots that might exist from time to time. BA argued that this was entirely consistent with Government policy for the airport. Nonetheless, BA intended—subject to licensing—to transfer certain BCAL services, such as those to Tokyo and Saudi Arabia, from Gatwick to Heathrow, whilst other scheduled services would be transferred from Heathrow to Gatwick.

5.17. BA provided us with an estimate that it had made of these likely savings and achievable benefits (see Appendix 5.2). The size of its bid for BCG had been pitched accordingly. Nothing had been included for any benefit arising from loss of competition. In its view there would be no such loss.

Effects of the merger

5.18. In support of its belief that there would be no loss of competition, BA pointed to the changes taking place in the market (see paragraphs 5.3 to 5.6). Increasing competitive pressure from airlines across the world would ensure that the merged airline kept down prices, increased its efficiency and maintained a good quality of service. By comparison with this pressure, the competition BCAL now offered to BA was insignificant. On many common routes the activities of the two airlines were in fact complementary to the extent that, from Gatwick and Heathrow respectively, they served different markets.

5.19. Opportunities for new entrants to domestic and European routes had been growing, and this would be unaffected by the merger. Nor would the removal of BCAL from intercontinental scheduled services noticeably reduce competition. The routes served by both BCAL and BA—to the USA, Middle East and Far East—were fiercely competitive and would continue to be so. Competition on international charter services was also intensive and there was scarcely any barrier to entry. Britannia and Dan-Air each carried more passengers than BA and BCAL and their subsidiaries combined. In all these areas the disappearance of BCAL as an independent airline, whether by natural demise or through the proposed merger, would not reduce the opportunities available to other airlines; indeed a merger with BA would actually increase opportunities for other British airlines to compete. BA also told us that the merger would not diminish BA's commitment to the continued development of its own regional services to Europe.

5.20. We asked BA about the effects of the merger on the provision to other airlines of BA's and BCAL's ancillary services such as flight simulation systems, hangar facilities and engineering services, and passenger handling. It told us that shared use of simulator systems was international and very widely practised. BA's own sales of simulator training probably represented well under 5 per cent of the world market. The merger would clearly have no effect on competition. Furthermore, BA was committed to continuing the services it provides. BA was also convinced that the merger would have no effect on the supply of hangar facilities and engineering services. Acquisition of BCAL's maintenance facilities at Gatwick would not reduce the availability of services there, since BA would make them available to United Kingdom airlines on the same basis as it currently makes its existing facilities available to third parties. The markets, again, were international and a substantial number of suppliers competed for available third party work. There was no risk that airlines would be deprived of these other sources of supply.

5.21. On the question of passenger-handling services, BA pointed out that these were controlled by Heathrow Airport Ltd at Heathrow and by Gatwick Airport Ltd at Gatwick. Their policies were to limit the provision of handling services by airlines. At Gatwick, where both BA and BCAL were handling agents, the third agent—Gatwick Handling—had a 60 per cent share of third party business. Another handling agent, not a part of any airline, has been appointed and will begin operations when the new terminal building opens in 1988. At that time there will thus be three agents as there are now.

5.22. BA acknowledged that the merger would lead in the short term to a substantial reduction in requirements for staff (see paragraphs 5.13 and 5.14), in the order of 2,000 employees, of whom approximately 500 would be based outside the United Kingdom. Subject to consultation with trade unions, it was intended that most reductions in the United Kingdom would be achieved by voluntary severance and to some extent by natural wastage (BA recruits around 3,000 employees a year). Most of the losses would take place in the South of England, which was an area of high employment and where there was a considerable demand for airline staff. In the longer term, the merged airline would be able to offer secure employment and secure career opportunities. Furthermore, employees in industries which supply BA and BCAL could only stand to benefit from the improved prospects offered by the merger.

BCG's views

Origins of the merger situation

5.23. BCG believed that the ultimate cause of its present situation was that the Government's airline policy had been inconsistently applied. BCAL became the United Kingdom's second-force airline as a result of the 1969 Edwards Report. Support of the concept of a second force had been an essential part of Government policy ever since; however, support for the carrier embodying that policy had been less than complete. In particular the route transfers recommended first in the Edwards Report, and later in the CAA's 1984 review of airline competition policy (CAP 500), had not been fully implemented. That review had in fact been a turning point in BCAL's fortunes. After its publication, and while waiting for the Government's response, BCG had said publicly that the Government had three options: to accept the CAA's advice, to allow BCAL to transfer all its services to Heathrow (from which it had been barred since 1977), or to allow a merger between BA and BCG.

5.24. BCAL had sought to develop profitable new routes but, because of what it saw as the Government's preferential treatment of BA and the generally restrictive nature of the international aviation market, it had never been permitted to acquire sufficient destinations. In particular it had lacked sufficient short-haul flights to feed its long-haul services. Its route network was therefore inherently weak; it was this, and not any lack of effort on its part or failure of management, that had led to the proposed merger. If BCG could not maintain a viable second-force airline, it was most unlikely that anyone else could.

5.25. BCAL had been unable to achieve sufficient economies of scale. It could not spread its fixed costs over sufficiently high volume; it could not use its aircraft, crew and other assets to the best advantage; and it lacked the financial resources to invest in advanced computer technology or to fund the development of new routes.

5.26. The weakness of BCAL's route structure and, in consequence, of its financial position (see Appendix 5.1) had meant that it was unable to survive the repeated shocks of external events—the Government's closure of the Gatwick-Heathrow airlink; the Falklands War; the loss of oil-related traffic; the United States' bombing of Libya; the Chernobyl disaster; and foreign currency problems in Nigeria—which had made these routes less profitable.

5.27. At the same time the airline world was changing. Deregulation in the United States since 1978 had created fierce competition between United States carriers, mostly for the domestic market; as a result many airlines had been forced to combine in order to survive, and the 'mega-carriers' had emerged. These were now the largest airlines in the world, and enjoyed immense economies of scale. They organised their entire network around a hub airport, feeding domestic traffic into their international flights; previously they had been willing to feed the transatlantic network of other carriers, such as BCAL.

5.28. Air transport in Europe was also moving towards deregulation. The European Commission's efforts to liberalise air transport within the Community, together with similar moves in Switzerland and the Scandinavian countries, would in BCG's view lead to a restructuring of the European airline industry similar to that which had taken place in the United States.

Alternatives to a merger with BA

5.29. BCG maintained that a reduction of BCAL's route network was not feasible. Competition in modern air transport was between airline 'systems' of short-haul spokes converging on a hub and feeding into long-haul or other short-haul flights. The routes depended on each other to generate business. Around 40 per cent of its passengers transferred from one BCAL flight to another and withdrawing the service on one of its routes, even one making a loss, actually brought more losses in its train. There remained the possibility that it could transform itself into a 'niche' carrier, serving particular segments of the market on a few chosen routes. This, apart from sacrificing BCAL's ambition to be a world-class carrier, would entail a complete reorganisation of its business with the expense of still more redundancies and other diseconomies of scale.

5.30. BA was not the only airline to have shown an interest in a merger. During 1986 and early 1987 BCG had been approached by a number of foreign airlines from Europe, Canada and the United States; it believed that it was worth even more to a United States airline than it was to BA. The problem here was that a full merger was ruled out because if BCAL passed into foreign ownership or control its licences could be revoked by the United Kingdom Government, and its designation under the ASAs under which it operated could be cancelled by foreign governments. The difficulty of defining 'control' in these circumstances, and of knowing how the United Kingdom and foreign governments would define it, discouraged foreign carriers from acquiring a minority shareholding; this would in any case probably not afford a lasting solution to BCG's problems.

5.31. During the same period BCG held discussions with two British airlines. Those with British Midland had been no more than tentative; British Midland had seemed to envisage moving all BCAL's services to Heathrow, which BCAL thought was not feasible. The discussions with the International Leisure Group (ILG), which owned Air Europe, lasted some months but had eventually been broken off; ILG had then made an offer (to 3i) which BCG's Board had rejected as derisory. BCAL and Air Europe were different types of airlines, and there was no synergy between them.

Effect on competition

5.32. On all those routes which were now served by both BA and BCAL there was already sufficient competition, or opportunity for new entrants to establish themselves, to outweigh the loss of BCAL as a separate operator. Several British carriers competed in the domestic market, where there were few barriers to entry, and often competed on short-haul international routes; foreign carriers competed on all international routes, both directly and through exercising fifth- and sixth-freedom rights. If it were to happen that there were insufficient competition on any route, or the other United Kingdom airlines wished to apply for additional licences in competition with the merged airline, BCAL believed that the ordinary licensing procedures of the CAA were adequate to deal with the situation; this was a highly regulated industry. Charter airlines were unlikely to be harmed by the combination of Cal Air and British Airtours, since their combined market share would still fall short of that of the market leaders.

5.33. If the ground-handling activities of BA and BCAL were combined the merged airline would have a large share of the market at Gatwick. Nevertheless there was already a third handling agent competing there for airlines' custom, and a fourth had recently been appointed to begin operations in 1988. This was a matter which Gatwick Airport Ltd was able to control. The effect of the merger on other airline services would be very slight.

Advantages of the proposed merger

5.34. BCG believed that the proposed merger with BA, far from threatening the public interest, offered positive benefits. Passenger carryings on BCAL's routes would be increased simply because they were operated by BA, with the advantage of BA's established reputation and more favourable listing in computer reservation systems; intralining between services at present operated separately by BA and BCAL would also strengthen the merged company.

5.35. Moreover the United Kingdom's public interest required an international flag carrier which was as strong as possible. It had become clear that the United Kingdom could only support one international airline of world class and that BA was the only airline with the network and resources to compete effectively with the powerful foreign carriers. A merger with BCG would make its position secure. BCG did not think BA's present management would be likely to repeat the mistakes of an earlier management which had merged BOAC and BEA without fundamentally integrating their businesses.

Remedies for possible adverse effects

5.36. We discussed separately with BA and BCG suggestions made by various parties of safeguards which might be attached to the merger. In particular we sought the opinions of BA and BCG on a proposal that the merged airline should surrender all, or some, of BCAL's route licences (and the associated slots at Gatwick), on the understanding that it could apply for them if it wished along with other airlines. We also asked for views on proposals that BA should surrender a number of its current domestic and/or short-haul international route licences, and that the merged airline should surrender some thousands of its slots at Gatwick spread proportionately throughout the year.

5.37. BA restated its view that the merger was not intended to be, and would not be, anti-competitive. BA could not agree to the wholesale surrender of BCAL's route licences. To do that would be to acquire BCAL's assets and liabilities without its business. BA could not count on achieving the cost savings and other benefits expected from the merger; it would not make a bid for BCG on those terms.

5.38. However, in the course of our inquiry BA told us that while it believed safeguards to be unnecessary, it had to recognise that others might hold a contradictory view. It had therefore looked to see how its plans might be adapted without undermining the basis for the merger. In the result, BA put forward the following points as part of its proposals for the merger:

(*a*) Within one month of acquiring a controlling interest in BCG, BA will return:[1]

(i) all BCAL's licences to operate domestic routes, including routes to the Channel Islands;

(ii) BCAL's licences to operate routes between Gatwick and the following places:

Paris
Brussels
Nice
Athens
Copenhagen
Hamburg
Oslo
Rome
Stockholm
Stuttgart

(Athens, Copenhagen, Hamburg, Oslo, Rome, Stockholm, Stuttgart:) Not at present operated by BCAL

(*b*) Within the same period of one month BA will withdraw BCAL's pending appeals against the grant by the CAA to Air Europe of licences to operate routes between Gatwick and the following places:

Amsterdam
Brussels
Copenhagen
Frankfurt
Geneva
Munich
Paris
Zurich

(*c*) BA will retain its right to apply to the CAA for the reissue of the licences returned under (*a*) above, but without relying on its rights as incumbent, so that BA's application is considered on the same basis as any other application for a licence to serve that route.

[1] The procedure used would be to apply to the CAA for revocation of the licences. This would enable BA to continue the services during the consideration by the CAA of applications for the routes.

(*d*) Subject to (*c*) BA will not oppose any application made at any time for a licence to operate in competition with the merged airline on any route on which the presently existing services of BA and/or BCAL would not be artificially constrained by inter-governmental agreements. BA told us that it believed that this proposal would apply at present to the following routes where dual or multiple designation is available:

all domestic routes;
all routes within western Europe, except Italy and possibly Portugal;
all routes to the USA and Canada; and
all routes to the UAE, Qatar and Bahrain.

This list will be extended as the Government succeed in negotiating more liberal arrangements with other countries.

(*e*) The merged airline will operate as one carrier for the purpose of designation by the United Kingdom on international routes.

(*f*) BA will submit to a review by the CAA of all routes at present operated by BCAL (other than those covered by (*a*) above), for the purpose of seeing whether further British competition would be desirable.

(*g*) BA will surrender a minimum of 5,000 slots at Gatwick, spread reasonably throughout the year. Slots associated with licences returned under (*a*) above and not reissued to BA will be surrendered and will count towards or replace this minimum.

(*h*) BA will continue after the merger to offer to other airlines without discrimination the maintenance and repair facilities at present made available to other airlines by BCAL.

(*j*) BA will merge the charter activities of British Airtours with the relatively small charter activities operated by BCAL under the BCAL name. BA will operate these merged charter activities using the BCAL name, and expects that in the short term they will be substantially on the same scale as the separate charter activities to be merged now are. In the longer term BA expects that these activities will expand, in the main probably in long-haul charter flights, in line with market growth. When scope for expansion is no longer available at Gatwick the merged airline, together with other operators, will make increasing use of other airports.

(*k*) BA would like also to merge the activities of Cal Air with the charter activities mentioned in (*j*), but the possibility of that will depend upon the attitude of whoever may be the owner of the half share of Cal Air now belonging to Rank, and upon any action which may be taken under the Fair Trading Act.

In respect of its proposal to return certain of BCAL's licences, BA explained that it would be its intention to apply to the CAA for the revocation of these licences. Such a procedure would enable any airline (including BA) to apply for the routes in question without the merged airline having the advantage of being an 'incumbent'. BA told us that pending the outcome of the licensing proceedings following an application to revoke the BCAL licences BA would continue to operate BCAL's services. If any licence thus returned was not re-allocated to BA, BA would surrender the slots associated with that licence.

5.39. BCG said it could not accept the proposal that safeguards were necessary, certainly not on the scale of surrendering BCAL's licences on all categories of route (domestic, short-haul international, and intercontinental). Such sweeping measures could only prevent the merger from proceeding. Re-allocation of licences would take a long time and neither party to the proposed merger would know in advance what was being transferred; nor what synergies, intraline benefits, or key staff would remain. In these circumstances it would be impossible for the Boards of BCG and BA to agree terms.

5.40. BCG said the same considerations would apply even if the proposal for the surrender of licences was restricted to any one of the three route categories. Decisions on investment in or development of routes, and on ordering new aircraft, could not be made against a background of uncertainty. It was doubtful if, in these circumstances, the merger would proceed; the opportunity to create a strong British competitor in all international markets would be lost.

5.41. BCG also pointed out that in its view the problem of insufficient slots at Gatwick was not a consequence of the merger. If the Government's policy to give preference to scheduled services at Gatwick was pursued (see paragraph 2.30), no scheduled carrier need be disadvantaged if BCAL's services were continued, nor would those charter carriers which operated from Gatwick throughout the year. The surrender of slots would not guarantee their availability to other British airlines; foreign airlines would also be able to claim them.