



DECISION ON SCARCE CAPACITY ALLOCATION CERTIFICATES

SCAC1/12

Applications BA/SCAC/3 by British Airways Plc, EJ/SCAC/3 by easyJet Airline Company Limited and VN/SCAC/3 by Virgin Atlantic Airways Limited in respect of the route London–Moscow heard on 1 & 2 October 2012

Panel

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Mr Richard Jackson
Mr Roger Mountford

Adviser: Mr James Wiltshire

Secretary: Mr David Kendrick

Applicants

Applicant: British Airways Plc, represented by Mr Robert Lawson,
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Witness: Mr Jerry Foran, Head of Product Delivery Revenue
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Applicant: Virgin Atlantic Airways Limited, represented by Mr Michael
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Witnesses: Mr Steve Ridgeway, Chief Executive Officer
Mr Edmond Rose, Director Commercial & Revenue Planning

Applicant: easyJet Airline Company Ltd, represented by Mr Akhil Shah,
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Witnesses: Ms Carolyn McCall, Chief Executive Officer
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BACKGROUND

1. In accordance with the Civil Aviation (Allocation of Scarce Capacity) Regulations 2007 ('the Regulations') the Secretary of State for Transport notified the Civil Aviation Authority ('CAA') in July 2012 of her belief that there would be scarce capacity on the London to Moscow route within six months. Under the Regulations, it is the duty of CAA to allocate the available capacity between the qualifying air carriers¹ and to grant Scarce Capacity Allocation Certificates² reflecting its decision.
2. The number of carriers (airlines) that can be designated to operate between London and Moscow, as well as the number of services (return flights) that can be operated by each designated carrier is regulated by an Air Services Agreement between the Governments of the United Kingdom and Russia.
3. British Airways currently operates twenty-one services per week between London Heathrow and Moscow Domodedovo. Up until 12 October 2012, British Midland Airways Limited t/a bmi ('bmi') operated fourteen services per week between London Heathrow and Moscow Domodedovo.
4. In accordance with the Regulations, the CAA invited formal applications from qualifying carriers for a Scarce Capacity Allocation Certificate ('SCAC') in order to operate on the route from 1 January 2013. The CAA received applications (detailed at paragraphs 13 to 15) from British Airways Plc ('BA'), easyJet Airline Company Ltd ('easyJet') and Virgin Atlantic Airways Ltd ('Virgin').
5. The CAA received written evidence from these air carriers and conducted a hearing on 1 and 2 October 2012 at which the three air carriers made oral representations. This document sets out the decision of the CAA following that hearing.
6. The scarce capacity allocation process to which this decision applies does not arise from any restrictions imposed by the CAA, but as a result of the restrictive nature of the Air Services Agreement. The CAA's position is that it would prefer no such restrictions.

The notification by the Secretary of State

7. On 9 July 2012 the Secretary of State notified the CAA that, in her belief, a situation of scarce capacity would exist within six months with regard to the traffic rights available on the route between London and Moscow and that she therefore wished the CAA to allocate the capacity available on the route between qualifying carriers in accordance with the provisions of the Regulations.

Terms of the UK–Russia Air Services Agreement

8. The Secretary of State's notification to the CAA in this case was based on information made available to the Department for Transport by three qualifying airlines - BA, easyJet and Virgin - about their plans to operate scheduled services on this route during the Winter 2012/13 IATA operating season.

¹ A qualifying air carrier means a UK air carrier or an EU air carrier established in the UK.

² A qualifying air carrier may only operate on a route notified as having scarce capacity if it has a Scarce Capacity Allocation Certificate granted by the CAA authorising the services it operates.

9. The Department for Transport held talks with the Russian Government on 2 and 3 July 2012 to discuss, amongst other things, the possibility of relaxing restrictions on air services between the two countries and on the London to Moscow route in particular. However, no agreement on the relaxation of the present restrictions, in terms of designations or services, was reached.

10. The bilateral arrangements between the UK and Russian Governments permit the UK and the Russian Federation to each designate up to two airlines to operate scheduled services on the London-Moscow (and vice versa) route. One designated airline of each side may each operate up to 21 services per week using any type of subsonic aircraft smaller than 500 seats capacity; and a second designated airline of each side may each operate up to 14 services per week using any type of subsonic aircraft smaller than 500 seats capacity. Under the terms of the bilateral arrangements each UK designated airline has to reach a commercial agreement with one of the airlines designated by Russia. The bilateral arrangements do not specify what such commercial agreements should comprise.

The notice

11. Following the notification from the Secretary of State, qualifying carriers wishing to operate services on the route from 1 January 2013, were invited to submit applications for a Scarce Capacity Allocation Certificate. The notice containing this invitation was published in the CAA's Official Record Series 2 on 10 July 2012. The notice stated that the CAA considered that it would be necessary to allocate the available capacity on the route between qualifying carriers that applied for a Scarce Capacity Allocation Certificate. The CAA would allocate scarce capacity in accordance with regulation 9 of the Regulations.

Applications

12. The CAA received three applications from qualifying carriers for a Scarce Capacity Allocation Certificate for operation on the route.

13. British Airways Plc (BA) applied to operate 21 services each week in each direction from London Heathrow to Moscow Domodedovo.

14. easyJet Airline Company Ltd (easyJet) applied to operate 14 services each week in each direction from London Gatwick to Moscow.

15. Virgin Atlantic Airways Ltd (Virgin) applied to operate 14 services each week in each direction from London Heathrow to Moscow Domodedovo.

16. In accordance with regulation 10, the CAA published these applications in its Official Record Series 2 on 24 July 2012 and invited objections or representations.

Objections, representations and right to be heard

17. No objections or representations were received from any party other than the applicants.

18. Each applicant exercised its right to be heard under regulation 13.

Preliminary meeting and Panel Brief

19. The CAA held a preliminary meeting with applicants on 31 July 2012 at which it outlined the timeline for submission of evidence and rebuttal evidence and outlined the hearing process.

20. On 24 September 2012, the CAA issued a Panel Brief and Statement of Key Issues in order to inform the parties of what appeared to the Panel to be the key issues that they should address at the hearing and to set out its initial thinking in a number of areas.

Public hearing

21. Pursuant to regulation 13, the CAA held a public hearing on 1 and 2 October 2012.

CAA APPROACH TO THIS DECISION

Purpose of this decision document

22. This document sets out the CAA's reasoning for its decision, in accordance with regulation 17(3) of the Regulations. Regulation 9 sets out the objectives of the CAA for the purposes of allocating scarce capacity, and the CAA's assessment of the proposals against these objectives is set out in this reasoning.

The CAA's Statutory Duties

23. Section 7(1) of the Civil Aviation Act 1982 ('the Act') allows regulations to be made which require specified decisions to be made only by Members of the CAA. In accordance with Section 7(1) of the Act, the Regulations specify that the function of deciding to grant, refuse, revoke or vary a SCAC may only be made by Members of the CAA. The quorum for this purpose is normally two Members. In this case, a panel of three Members was appointed by the Board of the CAA to determine these applications.

24. Regulation 9(2) of the Regulations provides that Section 4 of the Civil Aviation Act 1982, which sets out the general objectives of the CAA, does not apply to the allocation of scarce capacity. Instead, regulation 9 sets out the objectives of the CAA for the purposes of allocating scarce capacity.

25. Regulation 9(3) of the Regulations sets out that the CAA must allocate scarce capacity in a manner which it considers is best calculated:

- (a) to secure that qualifying carriers provide air transport services which satisfy all substantial categories of public demand at the lowest charges consistent with a high standard of safety in operating the services, whilst giving an economic return to efficient qualifying carriers on the sums invested in providing the services;
- (b) to further the reasonable interests of users of air transport services;
- (c) to secure the effective provision of civil air transport to and from the United Kingdom;
- (d) to ensure that qualifying carriers compete as effectively as possible with other airlines in providing air transport services on international routes; and
- (e) to ensure the most effective use of airports within the United Kingdom.

26. Regulation 9(4) states that when allocating scarce capacity the CAA must have regard:

- (a) to the effect on existing air transport services provided by qualifying carriers; and
- (b) in any case:
 - i.) where the existing services are similar (in terms of route) to the proposed new service; or
 - ii.) where two or more applicants have applied for a scarce capacity allocation certificate, indicating that they propose to provide a new but similar service, to any benefits which may arise from enabling two or more airlines to provide the service in question.

27. Regulation 9(5) states that, in exercising its functions under paragraphs (3) and (4), the CAA must have regard to the need to minimise so far as reasonably practicable:

- (a) any adverse effects on the environment; and
- (b) any disturbance to the public; from noise, vibration, atmospheric pollution or any other cause attributable to the use of the aircraft for the purposes of civil aviation.

Advice from the Secretary of State

28. Regulation 9(6) of the Regulations sets out that the CAA must have regard to any advice received from the Secretary of State. In relation to this case, advice from the Secretary of State was received on 23 July 2012. This set out that the UK side had made it clear in the July 2012 talks that it would prefer the significant relaxation of designation and frequency restrictions on scheduled passenger services operated by the designated airlines of both sides. The Russian side had explained that it was not able to agree to this proposal at that time. The two sides did agree to review the possibility of increasing the number of designations on the London to Moscow route at a further round of talks. Whilst the Department intends to follow up on this commitment, it is the Department's belief that no such increase or relaxation of the current restrictions on the London to Moscow route is likely before the end of the Winter 2012/13 IATA operating season at the earliest.

Analytical Framework

29. Part 4 and Annex 9 of the Official Record Series 1 set out the manner in which the CAA will allocate scarce capacity in accordance with regulation 9, and this is referred to where appropriate. Annex 8 sets out the related CAA procedures. The balance drawn between arguments and the conclusions set out here have been reached in relation to this specific case; different considerations may apply in other cases.

30. Paragraph 9 of Official Record Series 1 Part 4 states that the CAA will assess how best to maximise economic efficiency in allocating scarce capacity, noting that the most comprehensive approach would be to conduct a full economic analysis of the costs and benefits that would accrue to airlines and users, with capacity being awarded to the airline that provided the highest level of net benefit. In conducting its analysis, the CAA would take into account the effect on competition of the proposed services, with any detrimental impact on competition weighed against the benefits that would arise³ from awarding the scarce capacity to the relevant carrier.

31. Whilst the CAA has used the techniques of competition analysis where possible and appropriate, the scope of CAA's remit under the Regulations, as set out in paragraphs 23 to 25, is much broader than would be the case under competition law, where the primary focus would be on maximising the competitive constraint imposed on incumbent carriers.

32. Two of the parties, easyJet and Virgin, would be new entrants to the London-Moscow route³. The CAA notes that easyJet has limited experience of operating in bilaterally constrained markets while Virgin currently does not operate any route as short as London-Moscow. The evidence presented by these parties in terms of fares,

³ The CAA notes that Virgin operated a weekly service between London and Moscow for a period of approximately 18 months when it first launched its London-Tokyo services in 1989.

load factors and profitability is therefore necessarily based on forecasts that are subject to significant uncertainty. Furthermore, not all of the parties submitted full data on all of the areas requested by the CAA, in particular in relation to fares and costs⁴.

33. In view of the uncertainties inherent in forecasts and the incomplete nature of the quantitative evidence submitted to it, the CAA has not sought to prepare a full analysis of the costs and benefits that would accrue to airlines and consumers. Instead, the CAA has undertaken a comprehensive assessment of the arguments and evidence brought forward by the applicants, based on a qualitative evaluation of the likely alternative outcomes.

34. The CAA's duties under regulation 9 of the Regulations require it to allocate scarce capacity in a manner which best meets a number of objectives. The CAA is therefore required to make a balanced assessment of the merits of the proposals presented by each party and in doing so may be required to attach more or less weight to different arguments in reaching its decision. This is particularly so in the present case, where many aspects of the proposals presented by easyJet and Virgin differ significantly.

35. The present case is unlike previous scarce capacity allocation decisions in that the CAA's decision is based on allocation of existing traffic rights following the exit of an incumbent carrier rather than the allocation of newly created capacity. However, this distinction does not change the nature of the task facing the CAA in terms of its obligations under the Regulations. Consequently, the approach that the CAA has adopted is consistent with previous cases that have been heard under the current Regulations.

Case No COMP/M.6447-IAG / bmi

36. In their evidence, both easyJet and Virgin made reference to the decision of the European Commission in Case No COMP/M.6447-IAG / bmi. The approval of the merger between International Consolidated Airlines Group S.A. ('IAG') and bmi, resulting in bmi's withdrawal from the London-Moscow route and the applications from easyJet and Virgin to take up the second UK designation, was one of the catalysts that led to scarce capacity being declared on the route.

37. In its decision, the Commission examined the evidence available to it on substitutability between Heathrow and other London airports. It expressed the view that the market investigation was inconclusive on this issue. It therefore took the approach that it would assess the market by reference to origin-destination routes and in doing so would look the effects of the proposed merger on Heathrow alone, on Heathrow, Gatwick and London City ('London 3') and also on the five London airports taken together ('London 5').

38. As regards Moscow, at the time of the Commission's assessment, the only services to that destination were operated out of Heathrow, and the Commission could only assess by reference to that airport. It therefore did not attempt to reach a view on what the position would be if there were also services from Gatwick (or indeed any other airport). Its conclusion was that bmi's likely exit (absent the merger) would have created an opportunity for market entry and consequent competition.

⁴ In accordance with the position set out at paragraph 9 of Annex 9 of the Official Record Series 1, the CAA made clear to all parties that it would exclude from consideration any evidence presented by any party on a confidential basis.

Accordingly, the merger created a risk of a lessening of competition. The Commission did not attempt to examine precisely what form that likely competition would take.

39. Had there been other services in existence from other London airports it might have reached a different conclusion on the route-as it did in relation to London-Berlin (which it evaluated against all three markets: Heathrow, London 3, London 5), where it reached the conclusion that the merger posed no risk of a lessening of competition. When the Commission examined commitments, it focussed on what would address the lessening of competition by reference to Heathrow alone and it considered the main barrier to entry revealed by its market investigation was access to slots at Heathrow.

40. The Panel therefore considers that the Commission's decision is of limited assistance to the CAA in reaching a decision on allocation of scarce capacity on the London-Moscow route. (see the discussion at paragraph 92). The CAA is tasked with looking at different scenarios of market entry and it must assess these by reference to the tests set out in regulation 9, which is a much broader set of tests than those that the Commission considered in reaching its decision.

SUMMARY OF EVIDENCE AND ARGUMENTS PRESENTED

41. This section of the decision document summarises the evidence and arguments put forward by the parties in relation to what the CAA has identified as the key issues. The CAA's views on the evidence and arguments put forward, in terms of what is material to the decision, are detailed later in this document.

British Airways' case

42. BA states that it is the only applicant for the first designation on the Moscow route. It already holds the UK's first designation and currently operates on the route. It is the only applicant to propose 21 services per week (the maximum permitted to the first designated carrier). It has a commercial agreement with Aeroflot. Neither of the other two applicants objected to BA's application in their main or rebuttal evidence.

43. BA has chosen not to address all the points made by the other applicants in their cases, since it does not believe that these points are material to whether BA should be granted the first designation on the route. However, BA has made it clear that this should not be taken to mean that BA concurs with these points.

easyJet's case

Relevant counter-factual

44. easyJet argues that the relevant counterfactual in this case would be the award of the second designation to the other applicant.

Market definition

45. easyJet believes the market to be considered in this case is London-Moscow. However, even if the CAA decides that Heathrow and Gatwick are separate markets, then easyJet would be the only applicant proposing to serve the Gatwick market, whereas the Heathrow market is already served by the first designated UK carrier (BA) and the two Russian designated carriers.

Categories of demand

46. easyJet argues that awarding the designation to it would satisfy all categories of demand and, moreover, that the CAA has the opportunity to introduce a low-cost product into the sort of bilaterally constrained route which it could not normally enter freely. In comparison, awarding the designation to Virgin would provide 'more of the same'.

47. easyJet believes that no distinction needs to be made between time-sensitive and non-time sensitive passengers. However, should the CAA disagree, then easyJet argues that its evidence demonstrates that it also serves both types of passengers currently, that its on-time performance and add-ons such as speedy boarding, speedy check-in and the planned introduction of allocated seating are attractive to time-sensitive passengers, and therefore that it would meet such demand with its proposed Moscow services.

48. easyJet will not provide cargo capacity on the London-Moscow route, but believes that the route is already well served by the incumbent direct carriers and indirect options. easyJet will not provide business or first class cabins on its flights, but believes there is sufficient competition from Heathrow carriers' premium cabins and its own economy cabin to meet this segment of demand. easyJet also notes that its add-on services will be sufficient to attract some passengers that currently travel in premium cabins. easyJet will not provide a domestic connecting service at Gatwick (although passengers will be able to 'self connect' on its services), but believes that this market too is already well served with connecting options at Heathrow as well as, often cheaper and more convenient, options at other European hubs.

Fare benefits

49. easyJet claims that its proposal would provide lower fares than those that are currently available on the route and those that Virgin would offer. easyJet states that its lowest fare on the route, set on the basis of marginal avoidable cost, would be £125 return. easyJet claims it is able to offer such low fares because it will generate higher load factors and have lower costs than any of the other airlines⁵, and easyJet's brand is based upon offering the lowest fares on every route it serves. easyJet will therefore stimulate the market.

50. easyJet states that it will not impose the types of fare restriction currently common in the market, in particular it will not impose fare restrictions which require passengers to stay at the destination over a Saturday night in order to access the cheapest fares⁶ or which charge a large premium for one-way bookings. Moreover, easyJet believes that its entry into the market will cause other carriers to relax or remove these restrictions, based on the response of full service carriers to low cost entry into European and other mid-haul markets.

Sustainability

51. easyJet already has experience of operating on routes with a flight duration of between 3 and 5 hours. It cites the example of the London-Tel Aviv route, which it serves from Luton and on which it competes with, amongst others, BA from Heathrow. It has introduced a low cost fare structure to the route, offers lower fares than the incumbents which, following easyJet's entry, have abandoned fare restrictions on midweek travel.

52. easyJet argues that it is seeking to attract a significant share of business demand on the route and that it is necessary to operate at least a double-daily service in order to attract business travellers. easyJet stated that its network includes a number of other 'UK-outbound' routes that demonstrate significant seasonality, such as London-Berlin, and that it operates multiple daily services on these routes on a year-round basis.

53. easyJet acknowledges that, unlike most routes on its network, passengers between the UK and Moscow require visas, but does not think that this will affect its predictions, since all applicants agree that demand for both leisure and business

⁵ easyJet states that its cost per seat would be £106. Based on the evidence presented to the Panel, easyJet calculates that this compares with £150 for Virgin's proposed service.

⁶ The 'Saturday night rule' relates to the practice of charging higher fares for a return journey made within the working week, i.e. without a Saturday night stay, in order to price discriminate between business passengers (who typically do not wish to stay over a weekend) and leisure passengers (who may not mind doing so).

travel on the route is likely to increase. easyJet argues that its London-Moscow services would primarily serve an outbound market and that 70% of its passengers would originate in the UK. However, easyJet notes that there is a significant Russian expatriate community that is resident in London and which does not require visas to travel on the route. easyJet also intends to grow its market presence and brand awareness in Russia.

Other considerations

54. easyJet intends to commence operations in January or February 2013. easyJet is confident that it will be able to access sufficient airport slots at both ends of the route to operate its proposed services. easyJet is confident that, should it be granted the designation for the Moscow route, it will be able to secure a commercial agreement with Transaero, as required by the terms of the ASA.

55. easyJet argues that by introducing services from Gatwick airport, its proposal would ensure most effective use of capacity across London's airports. easyJet also argues that, by utilising modern, fuel-efficient aircraft on the route, its proposal would deliver environmental benefits.

Opposition to Virgin's application

56. easyJet rejects Virgin's fare comparisons, which suggest that the average economy fare will be similar under the two airlines' proposals, since they only relate to operations in year 1 and Virgin average fares will have increased by year 3, whereas easyJet's will not. The Virgin calculation also includes fares paid by international connectors and easyJet has doubts both over the way these fares have been pro-rated and whether the proportion of international connecting passengers Virgin will carry will be as low as Virgin claims. easyJet argues that no extra benefit to UK passengers would arise from Virgin's proposal to utilise larger aircraft on the route since Virgin's services would operate with lower load factors than easyJet's proposal and carry a proportion of international connecting passengers.

57. easyJet argues that the European Commission's decision on IAG-bmi is more equivocal than Virgin suggests on the issue of whether Gatwick and Heathrow services should be considered in the same market. easyJet also rejects the idea that an overnight flight would be beneficial to passengers, since the flight time was only four hours.

Virgin's case

Relevant counter-factual

58. Virgin argues that the relevant counterfactual in this case is not the situation prior to the current scarce capacity allocation process as the second-designated UK carrier, bmi, is withdrawing from the market. Virgin proposes, instead, that the relevant counterfactual would be the award of the second UK designation to a hypothetical carrier, which would satisfy the conditions set out under regulation 9 of the Regulations. However, Virgin argues that, when it was operating on the route, bmi had many of the features of the hypothetical carrier.

Market definition

59. Virgin argues that the relevant market is Heathrow-Moscow, especially for time-sensitive passengers, connecting passengers and cargo services. Time-sensitive passengers would not consider Gatwick as a substitute airport because it does not offer the same level of connectivity, accessibility or frequency of services as Heathrow-supported by the fact that all three incumbents operate from Heathrow. There was no finding by the European Commission in relation to IAG that divestment of Gatwick slots would provide sufficient competitive constraint on IAG, and, in the case of Glasgow, the Commission's assessment was that easyJet's Gatwick service would not provide an effective constraint on BA's pricing at Heathrow.

60. Virgin argues that there are separate markets for time-sensitive, connecting (to/from both UK and international services at Heathrow) and corporate passengers and for cargo. Both the European Commission and the OFT have drawn the distinction between time-sensitive and non-time-sensitive passengers as they have very different characteristics and preferences. Such a distinction is particularly relevant in this case because of the high proportion of business (time-sensitive) passengers. Air cargo customers who need to transport high value and time-sensitive goods prefer air over other modes of transport. The distances to Moscow are too great for surface transport to be an adequate alternative and indirect flights raise transshipment risks for high value cargo.

Traffic growth

61. Russia is one of the BRIC⁷ countries, which are forecast to have above average economic growth. UK originating cargo traffic and business travel on the route is expected to show strong and continued growth. Significant passenger growth of 5-7% pa over the coming years is projected. Virgin argues that it would be able to respond to traffic growth by deploying larger aircraft on the route, but that easyJet would not have the capacity to accommodate demand growth because it operates smaller aircraft and the number of services cannot be increased.

Categories of demand

62. Virgin argues that it can satisfy all substantial categories of demand, including premium class travellers, connecting passengers and air cargo customers, and exert effective competitive constraint on BA in all the relevant markets. Thus, Virgin argues that its bid satisfies all of the regulation 9 criteria.

63. Virgin will launch UK domestic services in 2013, which would benefit UK passengers connecting at Heathrow to Moscow services, and it already has an interline agreement with Transaero, which will benefit passengers travelling beyond Moscow to points in Russia.

64. Virgin argues that its proposal, using wide-bodied aircraft, would represent an increase in cargo capacity on the route. Virgin argued that cargo is a substantial and growing category of demand and that BA has growing dominance on the route as it offers substantially more capacity than other carriers given that it is the only existing carrier to operate wide-bodied aircraft on the route.

⁷ The BRIC countries are: Brazil, Russia, India and China.

Fares and scheduling

65. Virgin claims that its track record shows that its entry into new markets always drives down fares. Further, it argues that there is no material difference between Virgin's calculated average economy fares per passenger per sector for Moscow (£142.20) and easyJet's (£129.40)⁸.

66. In addition, Virgin argues that its economy class customers will benefit from a number of enhanced product features including complimentary meals and drinks, reclining seats, more leg room and in-flight entertainment. Four out of five of Virgin's current passengers pay lead-in fares, whilst only a small number of passengers get the lowest lead-in fares on easyJet. Some of the fares that Virgin offers to corporate clients do not impose a 'Saturday night rule'.

67. Virgin's proposal will offer schedule and frequency benefits, with a morning arrival allowing a day of business in Moscow and avoiding an expensive night in a hotel. Passengers will also have a greater choice of flights with Virgin since it already has a code-sharing agreement in place with Transaero.

Consumer benefits

68. Virgin asserts that its proposal would deliver a substantial increase in capacity (even after discounting international connecting passengers) across all cabins and for cargo (particularly since it would use wide-body aircraft to serve the route), relative to either bmi (the previous incumbent) or easyJet's proposal, and hence significant static fare benefits. easyJet's bid offers no dynamic fare benefits for business/premium class passengers as they only cater to those at the bottom end of the fare structure which will not provide sufficient competitive constraint on BA at Heathrow. Amongst UK consumers booking business class there is an overwhelming preference for UK airlines. Virgin's proposal would also deliver other non-fare benefits from a more convenient schedule, seamless connection and superior products both in-flight and on the ground.

Sustainability

69. Virgin notes that the Panel Brief acknowledged that international connecting passengers are relevant to the CAA's decision if they contribute to UK consumer benefit by enhancing the sustainability of services on the route. Virgin argues that connecting passengers comprise 26% of the total market and that 56% of these passengers connect at Heathrow. Virgin argues that international connecting passengers are vital to achieving the viability and sustainability of the route.

70. The CAA Passenger Survey shows that, in 2011, 42% of passengers on the route originated in the UK whilst 45% originated in Russia—a significant proportion of demand which Virgin is in a better position to serve due to its arrangements with Russian travel agents and the relatively small share of bookings that are made by Russian-originating passengers using the internet.

⁸ These figures are for Year 1 and include all taxes and charges, administrative fees and one standard item of hold baggage. Virgin's average fares calculation on the London-Moscow route includes connecting passengers on multi-sector flights.

Other considerations

71. Virgin expects to take delivery of the A330 aircraft it intends to use on the route by March 2013. Virgin argues that by utilising modern, fuel-efficient aircraft on the route, its proposal would deliver environmental benefits.

72. Virgin is confident that it will be able to access sufficient airport slots at both ends of the route to operate its proposed services. However, the timing of the launch of Virgin's operations is linked to securing slots at Heathrow⁹ and that this could limit Virgin's ability to start operating on the route before the start of the summer 2013 scheduling season. Virgin argues that the scarce capacity decision should focus on long-term consumer benefits and that the CAA should not attach importance to the specific start-up date.

73. Virgin argues that the deployment of wide-bodied aircraft on the route and the high-load factors it forecasts would represent effective use of scarce take-off and landing slots at Heathrow.

Opposition to easyJet's application

74. Virgin expressed serious doubts about the sustainability of easyJet's proposed low fare offering, which Virgin suggests is premised on achieving a high load factor (89%) based on speculative assumptions of stimulated demand from the Gatwick catchment area. Given the high seasonality and business characteristic of this route, easyJet's application would not satisfy all substantial categories of demand or exert an effective competitive constraint on BA. Virgin also doubts that easyJet's average revenue per passenger would remain constant through the first three years of operation on the route, claiming that easyJet's average revenue per passenger has increased in recent years by approximately 5% per annum.

⁹ As a result of slot remedy commitments made by BA as a condition of the IAG-bmi merger.

ANALYSIS

75. As set out in paragraphs 25 to 27, the CAA must allocate scarce capacity in a manner which it considers is best calculated to achieve the objectives set out in regulation 9 of the Regulations. It has considered the evidence and arguments presented by the applicants in writing and at the hearing and under cross-examination from the other parties.

Relevant counter-factual

76. Virgin argued that the relevant counterfactual in this case would be the award of the second UK designation to a hypothetical carrier, which would fully satisfy the conditions set out under regulation 9 of the Regulations. Virgin also argued that the services previously operated by bmi have many of the features of this hypothetical carrier. easyJet argued that the relevant counterfactual would be the award of the second designation to the other applicant.

77. The CAA considers that in allocating scarce capacity, the conditions set out in regulation 9(3) should be satisfied by all the qualifying carriers to which it awards a SCAC taken together and need not necessarily be served by each individual carrier. Accordingly, the CAA does not accept Virgin's argument that the relevant counter-factual is a single airline that satisfies all the conditions set out in regulation 9(3). Similarly, the CAA does not accept that its task is to allocate scarce capacity to the carrier whose proposal most closely resembles the services previously operated by bmi.

78. On the basis of the applications submitted by the parties, the CAA considers that the choice before it in the current case is whether to allocate the scarce capacity to a combination of BA and easyJet or to a combination of BA and Virgin. The CAA does not consider that there are any other credible choices, as in this case the bilateral agreement precludes the CAA from splitting the capacity between applicants as envisaged under regulation 9(4)(b)(i). Therefore the CAA determines that the relevant counterfactual in assessing each combination is the alternative outcome.

79. BA was the only airline to apply to operate the 21 services per week allowed under the first designation. Neither easyJet nor Virgin objected to BA's application, nor did they propose that services currently operated by BA be reallocated. Therefore, allocating a SCAC to BA, to operate as the first-designated carrier with 21 services per week, is evidently best calculated to achieve the regulation 9 objectives, and this is the decision set out at paragraph 187 below.

80. In practice, therefore, the rest of this section discusses the relative merits of the proposals presented by easyJet and Virgin to operate the 14 weekly services permitted for the second designated carrier.

Market definition

81. Consideration of market definition is usually the first step in identifying the competitive constraints faced by a supplier and assessing market power. It allows for an assessment of how the behaviour of a commercial entity will affect its competitors and ultimately consumers. In the context of scarce capacity allocation it is important in assessing the likely effects of the different proposals under consideration, for example, the extent to which benefits will flow to the consumer. This is particularly

pertinent where one applicant may be contending that acquiring the scarce capacity will influence the prices of its competitors.

82. The CAA has used the concept of relevant market to identify relevant categories of demand. The CAA is not bound to this approach, since the Regulations do not define 'relevant'. Equally, however, the CAA is free to adopt this approach since the Regulations give discretion on this matter. The reason that the CAA has adopted this approach is that market definition is a framework which not only separates demand into different classes, but also enables a rational assessment of expected dynamics and distribution of benefits within each market, and so enables evaluation of issues like how well demand is served, the overall interests of passengers and how effective is the overall provision of aviation services.

83. In line with OFT guidelines¹⁰, the CAA has in this case decided that it is not necessary to define the market exhaustively. Instead, it has concluded that it is sufficient to focus on the features of the market most relevant to the case; in particular to identify the most significant categories of demand.

84. Data available to the CAA and the parties for the purposes of considering the relevant market(s) included: the origin/destination and journey purpose of passengers travelling on the route; the proportion of traffic travelling indirectly; and the cargo traffic on the route.

Geographic dimension of the market

85. In the Panel Brief, the Panel set out its provisional view that London-Moscow is the most appropriate geographic dimension for consideration as the relevant market and did not consider the different London airports chosen by the applicants to be a key issue.

86. In its evidence Virgin challenged the Panel's provisional view. It argued that only services operated from Heathrow would be able to satisfy all substantial categories of demand, in particular time-sensitive passengers and cargo. Virgin argued that Gatwick does not represent a credible substitute because it does not offer the same level of connectivity, accessibility or frequency of services as Heathrow and noted that all three incumbents operate from Heathrow.

87. In its argument, Virgin relied on the Commission's assessment in the IAG-bmi merger case of the lack of effective restraint imposed by easyJet's Gatwick-Glasgow services on the fares charged by BA on its Heathrow-Glasgow services. Virgin also noted that there was no finding by the Commission in relation to the IAG-bmi merger that divestment of Gatwick slots would be sufficient to correct the lessening of competition resulting from the merger.

88. easyJet argued that the Commission's merger decision is equivocal on this point and consequently there is no compelling evidence that Heathrow constitutes a separate market. easyJet also cited the example of the London-Tel Aviv route, where easyJet's services from Gatwick have imposed competitive restraint on BA's behaviour in respect of its Heathrow-Tel Aviv, for example by stimulating the removal of the 'Saturday night rule'.

89. The CAA notes that demand in the London-Moscow market is predominantly for direct travel between the city-pair. CAA survey data suggests that in 2011 about 4%

¹⁰ Market Definition: Understanding Competition Law, OFT 403, 2004.

of passengers travelling between London and Moscow did so indirectly. No evidence was presented that indirect flights represent a close substitute for passenger travel in spite of the capacity constraint on the route.

90. The CAA accepts easyJet's arguments in respect of the potential relevant market for UK originating connecting passengers and air cargo, and recognises that a broader market definition may be relevant in relation to assessing competitive constraints on the route. These cases will be considered in the following section where each relevant category of demand is reviewed individually.

91. As noted in paragraphs 36 to 40, the CAA considers that the Commission's decision on market definition in the IAG-bmi merger case is not directly comparable to the current case. However, both Virgin and easyJet made reference to the Commission's assessment and so the CAA has given careful consideration to that decision.

92. In that decision, the Commission discussed a working paper of the CAA¹¹ analysing the catchment areas of Heathrow, Gatwick, Luton and Stansted. As noted by the Commission, that paper concluded that there was a considerable extent of catchment area overlap between Heathrow, Gatwick, Luton and Stansted, although the Commission was unable to conclude whether or not flights offered from these various airports are substitutable for passengers travelling on specific routes. In its decision, the Commission also considered the CAA's initial view on airport market power, which was published in January 2012¹² and which is subject to revision on the basis of comments received. This suggests that there is a degree of substitutability between Gatwick and Heathrow. The CAA notes that easyJet's argument that many passengers would be willing and able to travel through either Heathrow or Gatwick is consistent with these assessments.¹³

93. Having considered all the evidence presented by the parties, the Panel therefore confirms its view, as set out in the Panel Brief, that the relevant geographic definition of the market is London-Moscow.

Product Market - Relevant categories of demand

94. In accordance with regulation 9(3)(a), the CAA must allocate scarce capacity in the manner that it considers is best calculated to ensure that 'all substantial categories of public demand' are met. In relation to this duty, the CAA considers that this condition should be satisfied by all the qualifying carriers to which it awards a SCAC taken together and not necessarily by each individual carrier.

95. In the Panel Brief, the CAA set out the view that under the Regulations, the consumers whose public demand is to be satisfied and the users whose reasonable interests are to be furthered are those consumers and users originating in the UK. As well as UK-originating passengers, these consumers may also include those who,

¹¹ "Civil Aviation Authority, " Catchment area analysis", Working Paper, October 2011..

¹² "Heathrow, Gatwick and Stansted – market power assessments", summary of the CAA's initial views, January 2012.

¹³ Civil Aviation Authority, "Passenger's airport preferences: Results from the Passenger Survey", Working Paper, November 2011

directly or indirectly, are involved in related markets, for instance cargo shippers. This view was not challenged by any of the parties at the hearing.

96. The Panel Brief invited the parties to provide further evidence on the relevant categories of demand at the hearing.

Time-sensitive and non-time-sensitive passengers

97. The CAA considers that the arguments presented with regard to time-sensitive passengers tended to conflate three concepts, namely time-sensitive passengers, passengers travelling for business purposes and, in the case of Virgin, passengers travelling in premium cabins. In certain places, the parties' arguments made reference to these different segments of demand as if they were interchangeable.

98. The CAA does not accept that these concepts can invariably be taken as alternative definitions of the same group of consumers.

99. In its evidence, Virgin argued that time-sensitive passengers and non-time-sensitive passengers should be treated as separate categories of demand. Virgin argued that time-sensitive passengers represent a proxy for business passengers (including, but not limited to, those passengers travelling in premium cabins) and vice-versa.

100. Virgin noted that London-Moscow has a relatively high share of passengers travelling on business and argued that its proposal would meet the requirements of time-sensitive passengers better as a result of offering premium cabins and a convenient schedule. Virgin further argued that business passengers demonstrate a strong preference for Heathrow airport.

101. easyJet argued that its proposal would also be well-placed to meet the demands of time-sensitive passengers. easyJet stated that across its network as a whole 21% of passengers carried are travelling on business and cited routes including London-Amsterdam on which in excess of 40% of passengers are travelling on business. easyJet argued that its on-time performance record and add-ons, such as speedy boarding, speedy check-in and the introduction of allocated seating, would all be attractive to time-sensitive passengers.

102. easyJet did not accept Virgin's assertion that all passengers travelling on business have a strong preference for Heathrow and proposed that its low fare offering and proposed schedules were capable of attracting some business travellers that currently travel in premium cabins.

103. In addition, easyJet argued that the low fares associated with its proposal would stimulate demand on the route including from non time-sensitive passengers. easyJet argued that this case presented an opportunity to introduce a low-cost offering into a route to which carriers such as easyJet would not normally have access due to bilateral constraints.

104. In line with previous decisions of the CAA, OFT and others, the CAA feels that in this case the most relevant distinction is between time-sensitive and non-time-sensitive passengers and that for most purposes these are well represented by business and leisure journey purposes respectively. The CAA takes the view that the evidence presented by the parties indicates that a large share of demand, both time-sensitive and non time-sensitive, would be well served by either proposal.

105. The CAA accepts that the Virgin proposal would satisfy the demands of one subset of passengers more fully than the easyJet proposal, in particular: those passengers that currently travel in premium cabins; those based near west London with a strong preference for travelling from Heathrow and those corporate customers that make deals at network rather than route level. However, the CAA notes that

these passengers are currently served by the existing services operated by a qualifying carrier, as well as those services operated by Russian carriers.

106. The CAA considers that there is another subset of passengers that would benefit as a result of the easyJet proposal, in particular: those based closer to Gatwick (or those having no preference as between Gatwick and Heathrow), price sensitive business passengers (including potential passengers who do not currently travel on the route) and non-time-sensitive passengers (again, including potential passengers who do not currently travel on the route and existing passengers who do not travel on the route as frequently as they would like).

UK originating passengers from outside London connecting in London and/or Moscow

107. Virgin argued that its proposal would best satisfy demand from UK connecting passengers, in particular through the domestic services it will launch in 2013 from Manchester, and potentially Scotland, to Heathrow.

108. easyJet argued that UK connecting passengers represent a very small share (4%) of passengers on the route. In its evidence, easyJet argued that UK passenger travelling from other UK points have a range of alternative routeings to choose from, many of which it argues are quicker and cheaper than routeing through Heathrow. Furthermore, while easyJet recognised that connecting passengers are not central to its operation and that it does not offer 'on-line' connections, it noted that a small but growing proportion of its passengers choose to 'self-connect' between its services.

109. The Panel accepts that Virgin's proposal, as presented, would increase the choice available to UK connecting passengers. However, the Panel notes that Virgin does not currently operate the domestic services that would provide the connecting feed and considers that any assessment of benefits would therefore be speculative. As a result, the CAA has attached limited weight to this consideration in reaching its decision. The CAA also concludes from the evidence presented that passengers currently connecting in London from domestic services are likely to have access to a number of other European airports through which to connect to/from Moscow, in addition to the existing services operated on the route by qualifying carriers.

110. In its evidence, Virgin stated that it has an interline agreement in place with Transaero, which would expand the offering available to those UK passengers connecting in Moscow to points in Russia and beyond.

111. The CAA notes that the number of passengers on London-Moscow services travelling to points beyond Moscow comprised around 14% of the total on the route in 2011. However, around two in five of these passengers were travelling to points outside Russia and the ex-Soviet republics and are likely to have access to a number of other European airports through which to connect to their final destination. Of the remainder, CAA data indicates that in 2011 the majority were carried by BA or Aeroflot, with relatively few carried by bmi or Transaero. The CAA accepts that Virgin's proposal would increase the choice for those passengers connecting in Moscow that require a full interline service (such as through ticketing and baggage transfer) but notes that easyJet's proposal would also allow passengers to self-interline between services at Moscow. Therefore, the CAA concludes that the choice available to these passengers is unlikely to be affected significantly by the CAA's decision.

Passengers travelling in premium cabins

112. Virgin pointed to the fact that its proposal includes premium cabin products (both upper class and premium economy) unlike easyJet's single cabin proposition. At the hearing, Virgin presented market data as evidence of the preference of UK passengers to travel on UK carriers and noted that if easyJet were awarded the second designation, BA would be the only UK carrier offering premium classes of travel on the route.

113. easyJet accepted Virgin's argument that its product does not cater for the category of passengers who are willing to pay for premium class product, but noted that this category of demand would continue to be served by BA's services, as well as the Russian carriers operating on the route.

114. The CAA accepts that Virgin's proposal would provide a greater choice of carriers for UK originating premium travellers, in particular those that have a strong preference for UK carriers. However, the CAA notes that BA offers multiple cabin classes on its services. The CAA therefore concludes that this category of demand would be served by the existing services operated by a qualifying carrier under either proposal.

Cargo

115. Virgin argues that its proposal, using wide-bodied aircraft, would represent an increase in cargo capacity on the route, given that BA is the only other carrier to operate wide-bodied aircraft on the route.

116. In its evidence, Virgin argued that cargo is a substantial and growing category of demand and that BA has growing dominance on the route as it offers substantially more capacity than other carriers. Virgin also argued that the distance to Moscow is too great for surface transport to represent a credible alternative for time-sensitive shipments and that indirect routings raise transshipment risks for high-value cargo.

117. easyJet does not propose to carry cargo on the route. In its evidence, easyJet argued that indirect routeings (for example via other European hubs) are effective substitutes for direct London-Moscow services for cargo shipments.

118. The CAA accepts that Virgin's proposal would introduce additional cargo capacity onto the route and could be expected to lead to greater competition in the cargo market. However, the CAA notes that, in addition to BA, the Russian carriers operating on the route offer a limited amount of cargo capacity on the narrow-bodied aircraft used to operate their services on the route. The evidence made available to the CAA indicates that cargo load factors on the route are typically below 50%. On this basis, the CAA does not judge that cargo capacity is tightly constrained. The CAA concludes this category of demand would be served by the existing services provided by a qualifying carrier.

Conclusion on categories of demand

119. As set out in paragraph 77, the CAA interprets that its duty under regulation 9(3)(a) is to allocate scarce capacity so as to ensure that the qualifying carriers, taken together, are able to satisfy all substantial categories of demand on the route. The CAA accepts that the proposal presented by Virgin would serve some categories of demand that would not be served by easyJet's proposed services. However, the

CAA considers that those categories that would not be met by the easyJet proposal are satisfied by existing services operated by the other qualifying carrier.

120. In addition, the CAA considers that easyJet's proposal would cater for demand from consumer groups that are not currently well-served or who would welcome the additional choice of a low cost carrier service operated from Gatwick (as discussed in paragraph 101) by introducing a differentiated product onto the route. In reaching its decision, the CAA has given greater weight to the increase in consumer choice that easyJet would offer than to the ability of Virgin to meet demand from the sub-sets of consumers set out in paragraphs 100, 108 and 112.

Consumer Benefits

121. As noted at paragraph 30, the CAA's favoured approach to the allocation of scarce capacity is to assess how best to maximise economic efficiency, seeking to do that by balancing the respective costs and benefits that would accrue to airlines and consumers from each proposal. None of the parties offered a full quantification of the benefits its proposal was intended to achieve and as a consequence this decision is largely based on a qualitative assessment of the arguments and evidence presented by the parties.

Fare benefits

122. In the Panel Brief, the CAA stated that it was interested in establishing the extent to which consumers could be expected to benefit from: cheaper fares for existing users; satisfying unmet demand from users whose preferences are not currently met by the available services; and fare benefits resulting from an increase in the intensity of competition in the market.

123. In its evidence, easyJet presented the fare ladder, which it intends to apply on the London-Moscow route. The lowest return fare on the route, which easyJet stated is set on the basis of marginal avoidable cost, is £125. At the hearing, easyJet clarified that this fare included all taxes and charges, administrative fees and one standard item of hold baggage.

124. easyJet argued that it is the lowest-fare operator on all the routes it operates, and that it is able to charge lower fares than its competitors as a result of its lower cost base and a yield-management system that generates revenue by driving high load factors.

125. In the Panel Brief, the CAA calculated that easyJet's predicted revenue per passenger (per sector) was £129 (£258 return), remaining roughly constant over the first three years of operation. Virgin challenged easyJet's forecast that its fares would remain constant, noting that it had raised revenue per passenger by an average of 5% per annum across its network in recent years. easyJet argued that its challenging load factor targets would require it to maintain fares at a constant level and explicitly committed to doing so for three years.

126. Virgin also challenged the number of seats that easyJet would make available at the lead-in fare. easyJet argued that on average, an equal number of seats was available in each bucket on the fare ladder and that this equated to 16 seats per bucket for an A320. easyJet noted that this figure could rise or fall in line with

demand, with more seats being made available at the lead-in fare in periods of low demand such as winter and fewer seats available in peak periods.

127. Virgin presented limited evidence on its own fares. Virgin argued that its track record showed that its entry into new markets had always driven down fares. It argued that four out of five of its economy passengers paid the lead-in fare. Virgin also argued that its economy fare included more services than easyJet's, including complimentary food and drink, greater leg-room, reclining seats and in-flight entertainment.

128. In its rebuttal evidence Virgin stated that it expected its average economy class fares per passenger to be £142.20 in year 1. easyJet challenged the methodology used to derive this figure, in particular the approach to pro-rating yield from multiple-sector fares. easyJet also questioned whether the proportion of international connecting passengers that Virgin would carry would be as low as Virgin claims.

129. In the Panel Brief the CAA calculated that Virgin's predicted average revenue per passenger (across all classes) would rise from £193 in year 1 to £223 in year 3, although it was not possible to extract a year 3 average economy fare from the information provided as Virgin did not split its revenue estimates by cabin class. The CAA therefore attaches limited weight to the year 1 fare estimate as an indication of Virgin's pricing strategy in subsequent years.

Static fare benefits¹⁴

130. Virgin proposes to operate using an A330-300 with 266 seats split in three classes, which would provide a total weekly capacity of 7,448 seats. In its evidence, Virgin argues that it could potentially deploy a larger aircraft on the route at a future date in order to respond to demand.

131. Virgin forecasts that its load factor would increase over the first three years of operation, from 64% in year 1 to 73% in year 3. At the hearing, Virgin argued that even allowing for international connecting passengers, it would therefore carry more passengers originating in the UK or Russia than easyJet.

132. easyJet proposes to operate using an A320 with 180 seats in a single-class configuration, which would provide a total weekly capacity of 5,040 seats. easyJet forecasts that its load factor on the route would increase from 80% in year 1 to 89% in year 3. At the hearing, easyJet argued that it viewed London-Moscow as primarily an outbound market and that 70% of its passengers on the route would originate in the UK.

133. Virgin argued that its proposals would deliver the greater capacity and therefore greater static fare benefits than easyJet's proposals, in particular in premium cabins which would not be provided by easyJet. easyJet argued that not all of the capacity would be taken up by UK originating passengers, given Virgin's recognition that international connecting passengers are important to its business case. Accordingly, the static benefits would be limited to the additional capacity net of international connecting passengers.

¹⁴ Static fare benefits arise from a reduction in fares in response to an increase in supply in the market and the resulting shift in the balance between supply and demand.

134. Using the evidence presented by the parties, the CAA has constructed **Table 1** to illustrate the seats which the parties claim would be sold to passengers travelling to / from the UK.

Table 1: Claims regarding seats sold for travel to/from UK per week by class

	easyJet	Virgin	Economy and Premium Economy	Economy
	Economy	all cabins		
Seats	5040	7448	6524	5180
Load Factor	89%	73%	73%	73%
International connectors	0%	12%	12%	12%
Seats Sold to/from UK	4486	4788	4194	3330

Source: easyJet and Virgin evidence.

Notes: Virgin did not specify load factors nor the proportion of international connectors for each cabin for year 3, so it is assumed to be the same as for all cabins. easyJet did not estimate the proportion of international (self-)connectors, so it is assumed to be 0%.

135. **Table 1** suggests that easyJet would sell less weekly capacity than Virgin on the route in total, but would sell more than Virgin's Economy cabin or Economy and Premium Economy combined. It therefore appears to the CAA that the extent of static fare benefits might be similar for each parties' proposal.

136. However, as the notes to the tables indicate, the CAA was required to make some assumptions to assess the proportion of seats sold by cabin for Virgin. Moreover, the data in the table are based on projections by the applicants, and both parties have claimed that the other's estimates of relevant load factors may be overstated. (easyJet expected that more of Virgin's seats would be occupied by non-UK passengers, a claim that Virgin did not challenge. Similarly, Virgin doubted that easyJet could achieve an 89% load factor, although easyJet explained that it would reduce yield if necessary in order to achieve its load factor targets.) Uncertainty about actual seats sold is compounded by the fact that any difference in seats sold between the proposals must be taken in the context of those sold by BA and the Russian carriers also. Taking these factors together, the CAA feels unable to place much weight on an assessment of the extent of static fare benefits in reaching its decision.

*Dynamic fare benefits*¹⁵

137. easyJet argued that it would provide the greatest dynamic fare benefits by introducing innovation onto the route and encouraging the removal of fare restrictions on the route, for example the 'Saturday night rule' and pricing behaviour that deters the purchase of one-way tickets (either for a one-way trip or, for example, a return trip using different carriers for the outbound and return journeys). easyJet used the example of comparator routes, in particular London-Tel Aviv, in respect of which it argued that as a result of easyJet's entry on to the route, incumbent carriers had relaxed or removed these fare restrictions, leading to benefits for passengers on the route as a whole which were not necessarily confined to easyJet passengers. Virgin did not clarify whether it would impose fare restrictions on its proposed services; although it noted that some of the fares offered to corporate clients did not impose a 'Saturday night rule'.

138. Virgin argued that only its proposal would impose competitive constraint on existing carriers operating on the route, consistent with its position that services from Gatwick would not constrain the pricing of carriers operating at Heathrow. It also argued that only Virgin's proposal would benefit passengers travelling in premium cabins.

139. As set out in paragraphs 32 and 33, the CAA considers that both parties' fare estimates are subject to considerable uncertainty. easyJet explicitly committed to holding its fares constant for 3 years. However, the CAA notes that easyJet's business case depends on significant volumes of stimulated demand and high year-round load factors on a highly seasonal route for which visa requirements and accommodation costs present additional barriers to leisure demand. Virgin's forecasts rely on some element of cross-subsidy from premium cabins and would therefore be dependent on Virgin's ability to achieve its forecast load factors in these cabins.

140. Notwithstanding the uncertainty around fare estimates, the CAA considers that the key issue in relation to fare benefits is the likely impact that competition on the route will have on dynamic fare benefits. The CAA accepts Virgin's argument that its proposal would deliver greater choice and competition for passengers in premium cabins. However, Virgin did not present evidence on expected fare benefits for passengers in premium cabins as a result of this increased choice and competition.

141. The CAA considers that the evidence submitted by easyJet in respect of fare benefits is consistent with its business model and experience from other routes which it has entered. The CAA considers that easyJet's business model, focused on offering low fares and the removal of fare restrictions would be likely to exert greatest downward pressure on fares for the majority of passengers.

142. The CAA therefore concludes that easyJet's proposal would be likely to deliver significant fare benefits for consumers and has attached significant weight to these benefits in reaching its decision.

¹⁵ Dynamic fare benefits can be expected to result from changes in the extent of rivalry in a market that result an increase in the intensity of competition.

Schedules and connections

143. As set out in paragraph 10, the Air Services Agreement governing air traffic between the UK and Russia limits the second designated carrier of each side to 14 services per week on the London-Moscow route. Both easyJet and Virgin propose to operate all available services.

144. In its evidence, Virgin argued that its schedule offered a number of benefits over easyJet's proposal. In particular, Virgin stated that business passengers favoured both early morning arrivals and evening departures as these facilitate a full business day. In addition, Virgin argued that its proposed schedule facilitated connections for UK connecting passengers.

145. easyJet challenged Virgin's emphasis on the attractiveness of an overnight flight, suggesting that on a relatively short sector of just four hours duration, an overnight flight was not conducive to effective business the next day and so it could not be assumed that this was preferential for passengers. BA expressed its view that an overnight flight was not optimal, and stated that it only operated one of its services overnight as a condition of the commercial agreement with Aeroflot.

146. The CAA considers that both schedules represent equally credible propositions in terms of addressing customer preferences, within the frequency limitations imposed by the Air Services Agreement. The CAA has therefore not attached weight to the differences between the proposed schedules in reaching its decision.

Realisation and Sustainability of Consumer Benefits

147. Paragraph 3 of Official Record Series 1 Annex 9 states "The CAA's Statement of Policies indicates that it is concerned that scarce capacity be used in a way that *sustainably* produces the most benefit to passengers" (emphasis added)¹⁶. The sustainability of the proposals of each party is therefore considered important by the CAA in ensuring that additional capacity granted would be utilised. This issue is of particular relevance to determining the element of 'effective provision' within the meaning of regulation 9(3) (c) and therefore that benefits claimed by the applicants would be realised in practice.

148. In the Panel Brief, the CAA stated that it wished to explore further whether the services applied for by each party are likely to be implemented in full and sustained over time.

Commencement of operations

149. easyJet indicated that it intended to commence operations in January or February 2013.

150. Virgin stated that it expected to take delivery of the A330 aircraft it intends to use on the route by March 2013. Virgin explained that the launch of its operations would be linked to securing slots at Heathrow¹⁷ and that this could limit Virgin's

¹⁶ The Statement of Policies in respect of the allocation of scarce capacity now forms part of Part 4 of the CAA's Official Record Series 1.

¹⁷ As a result of slot remedy commitments made by BA as a condition of the IAG-bmi merger.

ability to start operating on the route before the start of the summer 2013 scheduling season.

151. Virgin argued that the scarce capacity decision should focus on long-term consumer benefits and that the CAA should not attach importance to the specific start-up date.

152. The CAA considers that both proposals are similar in this regard, and accepts Virgin's argument that relatively small differences in the proposed dates for commencement should not be a material issue. The CAA therefore does not consider the difference between the two parties' proposals to be a material factor which should influence its decision.

Financial sustainability of the proposed services

153. Virgin argued in its evidence that demand on the London-Moscow route is highly seasonal and questioned easyJet's ability to operate double daily services on a year-round basis from Gatwick based on a high-share of leisure demand and without significant international connecting traffic. Virgin speculated that easyJet would be expected to either deploy a smaller aircraft on the route or cancel some of its services.

154. Virgin argued that only 45% of demand on the route is made up of UK-originating passengers and hence both Russian originating and international connecting passengers are vital to route viability¹⁸. Virgin argued that its access to both UK and international connecting passengers, its codeshare agreement with Transaero and its greater penetration of the Russian sales market would enable it to access year-round demand. In contrast, Virgin questioned easyJet's ability to sell into the Russian market and stated that only 7% of Russian-originating passengers currently book air travel over the internet.

155. easyJet accepted Virgin's argument that demand on the route is highly seasonal. But easyJet reaffirmed its commitment to operating double-daily services and argued that its yield management systems would be sufficiently flexible to adjust fares in order to stimulate additional demand from UK-originating passengers, including Russian expatriates resident in London. easyJet also reaffirmed its intention to grow its presence and brand awareness in Russia. easyJet argued that it has successfully stimulated demand at the 'foreign-end' of the route in other markets and provided evidence at the hearing to indicate that Russian passengers would be willing to adopt easyJet's web-based direct sales model.

156. easyJet argued that it is seeking to attract a significant share of business demand on the route and that it is necessary to operate at least a double-daily service in order to attract business travellers. easyJet stated that its network includes a number of other 'UK-outbound' routes that demonstrate significant seasonality, such as London-Berlin, and that it operates multiple daily services on these routes on a year-round basis.

157. easyJet also argued that its cost base is lower than other carriers, including Virgin, and that as a consequence it would be able to offer consistently lower fares than Virgin. Based on the evidence provided by the parties to the Panel, easyJet

¹⁸ Virgin noted that in the Panel Brief, the CAA acknowledged that international connecting passengers would be relevant if they contribute to the realisation of consumer benefit by UK originating consumers by enhancing the sustainability of the route.

stated that its cost per seat would be £106 compared with £150 for Virgin's proposed service. Virgin challenged the comparability of the two cost figures, given that the Virgin cost estimate included the additional costs associated with offering premium cabins, which generate additional revenue.

158. Finally, as set out in paragraphs 128 and 129, all parties stated the expectation that demand on the London-Moscow route would continue to grow over the next three years.

159. On the basis of the evidence presented to it, the CAA does not consider that it has reason to question the financial sustainability of the parties' proposals. The CAA therefore concludes that both parties' proposals would be consistent with operating the route on a financially sustainable basis consistent with maintaining a high standard of safety.

Ability to accommodate growth

160. All parties agreed that they expected demand on the route to grow over time. Virgin stated that it expected demand to grow at between 5 and 7% per annum and argued that easyJet would not be able to accommodate such demand growth and would therefore be expected to raise fares after the initial three years of operation. In contrast, Virgin argued that it would be able to deploy a larger aircraft on the route if appropriate.

161. The CAA accepts the parties' view that demand on the route is likely to grow over time and acknowledges the risk that Virgin identifies. However, the CAA considers that demand forecasts are, by their nature, subject to significant uncertainty. Moreover, it is possible that market conditions could change in the intervening period. This may include partial or full liberalisation of the Air Services Agreement. It is also possible that easyJet could adapt its fleet to accommodate additional demand. Accordingly, in reaching its decision the CAA has not attached significant weight to predictions as to what might happen beyond the initial three years of operation.

Slots, Permissions and Commercial Agreement

162. Both easyJet and Virgin confirmed in their applications and evidence that they expect to have access to sufficient airport slots at both ends of the route to operate their proposed services, secure all relevant permissions from the Russian authorities and reach a commercial agreement with the second designated Russian carrier.

163. The CAA has not been provided with any evidence that leads it to doubt either of the applicants' ability to operate their proposed services. Accordingly, the CAA has taken its decision on the basis that either carrier would be able to operate their proposed services according to the plans stated in their applications.

Effect on existing services

164. Regulation 9(4) provides that the CAA must have regard: (a) to the effect on existing air transport services provided by qualifying carriers; and (b) in any case—(i) where the existing services are similar (in terms of route) to the proposed new service; or (ii) where two or more applicants have applied for a Scarce Capacity Allocation Certificate, indicating that they propose to provide a new but similar

service, to any benefits which may arise from enabling two or more airlines to provide the service in question.

165. The terms of the Air Services Agreement, as set out at paragraph 10, preclude the allocation of the services associated with the second designation to more than one carrier. The CAA considers that the services proposed by both applicants are similar to the existing services provided by qualifying carriers, in the sense that they are both for services to the same origin-destination pair. The consideration of the geographic dimension of the market set out at paragraphs 85 to 92 and the analysis of categories of demand and consumer benefits at paragraphs 93 to 145 make a number of references to the effect that the applicants' proposals would be expected to have on the existing services operated by a qualifying carrier. The CAA is satisfied that both applicants' proposals would be capable of delivering benefits based on their ability to compete effectively with the existing services.

Other considerations

Competition with other airlines

166. Regulation 9(3) (d) provides that the CAA must allocate scarce capacity in a manner which it considers is best calculated to ensure that qualifying carriers compete as effectively as possible with other airlines in providing air transport services on international routes. Qualifying carriers in this context includes EU carriers established in the UK¹⁹, which essentially means that it is non-EU carriers that are the 'other carriers' referred to: in the case of the London-Moscow route, Aeroflot and Transaero.

167. Both Aeroflot and Transaero currently operate the maximum number of services permitted under their respective designations. Aeroflot operates its 21 services per week between Heathrow and Shermetyevo airport in Moscow. Transaero has recently split its operations across two Moscow airports; it operates seven services per week between Heathrow and Domodedovo airport and seven services between Heathrow and Vnukovo airport. Both carriers operate services on the route using narrow-bodied aircraft in a short-haul configuration.

168. The evidence presented to the CAA on the extent of competition between the carriers already operating the route suggests that qualifying carriers are already competing effectively with other carriers, and the CAA has not been presented with any evidence to suggest that this would not be the case in the future under either easyJet's or Virgin's proposal. The CAA does not consider, therefore, that competition with other carriers is a significant factor in this case.

Effective use of airports

169. Regulation 9(3) (e) provides that the CAA must allocate scarce capacity in a manner which it considers is best calculated to ensure the most effective use of airports within the UK.

170. Virgin argued that the deployment of wide-bodied on the route and the high-load factors it forecast would represent effective use of scarce Heathrow slots. In contrast, easyJet countered that its proposal, by introducing services from Gatwick airport, which ensure most effective use of capacity across London's airports.

¹⁹ See The Civil Aviation (Allocation of Scarce Capacity) Regulations 2007 for a full definition.

171. The CAA is satisfied that the proposals presented by all parties satisfy the requirements of regulation 9(3) (e) and therefore the CAA has not relied on differences between the proposals in this respect in reaching its decision.

Environment

172. Regulation 9(5) provides that the CAA should have regard to the need to minimise so far as reasonably practicable: (a) any adverse effects on the environment; and (b) any disturbance to the public; from noise, vibration, atmospheric pollution or any other cause attributable to the use of the aircraft for the purposes of civil aviation.

173. easyJet and Virgin both made a case that their applications delivered environmental benefits by utilising modern, fuel efficient aircraft. The CAA concludes that both proposals would meet the requirements of regulation 9(5) and therefore does not consider the environment a distinguishing issue between the parties in this particular case, given the overall assessment of other benefits.

Advice from the Secretary of State

174. The CAA has had regard to the advice received from the Secretary of State (as provided for in regulation 9(6)) on 23 July 2012. This set out the context for the situation of scarce capacity that had arisen, through detailing the outcome of bilateral negotiations. There is nothing in this advice which would influence the CAA to allocate the scarce capacity to either easyJet or Virgin.

CONCLUSIONS

175. It is the view of the CAA that, on balance, granting the second designation to easyJet, with BA granted the first designation that it holds currently, would best meet the objectives set out in regulation 9 of the Regulations. The reasons for this decision are set out below.

176. BA was the only airline to apply to operate the 21 services per week allowed under the first designation. As noted in paragraph 79, neither easyJet nor Virgin objected to BA's application, nor did they propose that services currently operated by BA be reallocated. Therefore, the CAA determines that BA should be allocated a SCAC to operate as the first-designated carrier.

177. In practice, therefore, the CAA has proceeded on the basis that easyJet and Virgin are competing for the right to operate the 14 weekly services permitted for the second designated carrier.

178. The CAA has to determine which proposal would, in its opinion, better satisfy the requirements set out in regulation 9. As set out in paragraph 34, this requires the CAA to consider a number of issues, to determine their relative importance and to assess the applicants' evidence in relation to those issues.

179. It is the view of the CAA that, on balance, allocating scarce capacity to easyJet would be likely to deliver the greatest benefit to consumers. The CAA concludes that easyJet's proposal would introduce a new product into the market and would be more likely to stimulate innovation on the route as a whole. The CAA considers that easyJet's proposal would satisfy and stimulate categories of demand that are currently underserved on the route, in particular: those based closer to Gatwick (or those having no preference as between Gatwick and Heathrow and who would be willing to switch), price sensitive business passengers and non-time-sensitive passengers.

180. The CAA considers that easyJet's proposal, by introducing an innovative product into the market, has the potential to deliver the greatest dynamic fare benefits, in particular by encouraging the removal of fare restrictions applied by incumbent carriers. The CAA has attached significant weight to the expectation of dynamic fare benefits in reaching its decision.

181. Virgin argued that its proposal would impose the greatest competitive constraint on BA's operations from Heathrow. The CAA does not agree with Virgin's argument that easyJet's proposal will not stimulate competition with the existing Heathrow services because it is proposing to operate from Gatwick. Rather, the CAA considers that Gatwick and Heathrow can be considered to be in the same market, and therefore that there will be competition between services from the two airports. The CAA recognised the validity of comparisons between the Moscow route and Tel Aviv where there was evidence that a service operated from another London airport had posed a competitive constraint on a BA Heathrow service. Moreover, the CAA notes that its consideration is not limited to imposing the maximum constraint on other carriers on the route but a broader test of satisfying the conditions of regulation 9 of the Regulations.

182. The CAA accepts that the proposal presented by Virgin meets some categories of demand that would not be served by easyJet's proposed services, in particular air cargo, passengers wishing to travel in premium cabins and UK-originating connecting

passengers. The CAA acknowledges that Virgin's proposal would provide a greater choice of carriers for these categories of demand.

183. However, as set out in paragraph 77, the CAA interprets that its duty under regulation 9(3)(a) is to allocate scarce capacity in the best manner so as to ensure that the qualifying carriers, taken together, are able to satisfy all substantial categories of demand on the route.

184. The CAA considers that easyJet's proposal would cater for demand from consumer groups that are not currently well-served or who would welcome the additional choice of a low cost carrier service operated from Gatwick (as discussed in paragraph 101) by introducing a differentiated product onto the route.

185. The CAA considers that those categories that would not be served by the easyJet proposal are satisfied by the existing services operated by qualifying carriers. The CAA concludes that any detriment to these consumers resulting from lesser choice and competition is outweighed by the benefits generated by the easyJet proposal.

186. The CAA has reached its decision based on a careful assessment of the evidence and arguments presented to it. However, should the holders of Scarce Capacity Allocation Certificates fail to deliver the expected benefits within a reasonable period, the CAA considers that it may be appropriate to reconsider the allocation of scarce capacity on the route.

THE DECISION

187. Pursuant to the reasoning set out in this document, the CAA therefore decides to grant Scarce Capacity Allocation Certificates as follows:

- to British Airways plc for the operation of 21 services per week in each direction on the route London-Moscow;
- to easyJet Airline Company Ltd for the operation of 14 services per week in each direction on the route London-Moscow.

David Kendrick
For the Civil Aviation Authority
October 2012