



**UNITED KINGDOM
CIVIL AVIATION AUTHORITY**

DECISIONS ON AIR TRANSPORT LICENCES AND ROUTE LICENCES

2/98

Decision of the Authority on its proposal to vary licence 1B/13 held by British Midland Airways Limited and licence 1B/35 held by Virgin Atlantic Airways Limited heard on 25 August 1998.

Panel

Chairman: Mr D Andrew
Mr B Austin
Adviser: Mr D Batchelor
Secretary: Mr G J Elsbury

Objections to the Authority's proposal:

Objector: British Midland Airways Ltd represented by
Mr T Soames, Partner, Norton Rose

Witnesses: Mr A Reid, Group Managing Director,
British Midland Airways Ltd

Mr B Brett, General Manager Offline and Interline,
British Midland Airways Ltd

Mr A Davis, General Manager Industry Affairs &
Pricing, British Midland Airways Ltd

Objector: Virgin Atlantic Airways Ltd, represented by
Mr R Webb QC

Witness: Mr B Humphreys, Director of External Affairs and
Route Development, Virgin Atlantic Airways Ltd

SUMMARY

1. This hearing was convened to decide which of two UK airlines should be allowed to operate between London and Moscow in addition to British Airways, given that the UK/Russia bilateral air services agreement currently restricts to two the number of airlines of each country permitted to operate on the route. British Midland Airways and Virgin Atlantic Airways were each seeking the second UK designation on the route. The Authority has concluded that its decision should be based primarily on which of the two proposed services is likely to produce the greater benefits for users of air services. It does not believe that industry structure arguments are a significant factor in this case. On the basis of the evidence put to it, the Authority has decided that Virgin Atlantic's proposed service should be given preference over that of British Midland.

THE NOTICE

2. On 5 August 1998 the Secretary of State, in exercise of his powers under Regulation 3(5) of the Civil Aviation Authority Regulations 1991, gave notice to the Authority that in his opinion, by virtue of provision made by or under the terms of the Memorandum of Understanding concluded on 21 May 1998 between Russia and the United Kingdom, the United Kingdom's share of capacity on air transport services between the United Kingdom and Russia which may be provided by British airlines would, within 6 months of the date of that notice, be insufficient to enable both Virgin Atlantic Airways Ltd and British Midland Airways Ltd to make available all the capacity which they planned to provide. This notice was published in the Authority's Official Record Series 2 on 11 August 1998.

THE PROPOSAL

3. Following the notice from the Secretary of State, the Authority published its proposal to vary the licences of British Midland Airways (1B/13/64) and Virgin Atlantic Airways (1B/35/141) in its Official Record Series 2 on 11 August 1998. After reciting the notice, this proposal stated that:

"2. The Authority is advised by the Secretary of State that not more than two UK airlines may operate from London and stop at Moscow and vice versa. British Airways plc is currently designated and operates such services. The UK may therefore designate only one further airline to operate services on the route between London and Moscow, and both British Midland Airways and Virgin Atlantic Airways wish to be the UK's second designated airline on this route.

3. For these reasons, the Civil Aviation Authority, in exercise of its powers under Section 66 (2) of the Civil Aviation Act 1982, hereby proposes to vary route licence number 1B/13 held by BRITISH MIDLAND AIRWAYS LIMITED (BMA) and route licence number 1B/35 held by VIRGIN ATLANTIC AIRWAYS LIMITED (Virgin) so as to provide that should it not be possible under the terms of the bilateral air services agreement between the United Kingdom and Russia

for more than two British airlines to operate air services between London and Moscow, only one of BMA or Virgin may operate such services in addition to the existing services operated by British Airways plc pursuant to its designation by the UK Government with effect from 1 April 1984. Which of the two airlines may operate will be determined by the Authority in the light of its statutory duties and objectives and arguments advanced at the hearing.”

OBJECTIONS AND REPRESENTATIONS

4. British Midland Airways (“BMA”) exercised its right to be heard on the Authority’s proposal to vary its licence 1B/13 and made a representation in respect of the proposal to vary Virgin Atlantic Airways’ licence.

5. Virgin Atlantic Airways (“Virgin”) exercised its right to be heard on the Authority’s proposal to vary its licence 1B/35 and made a representation in respect of the proposal to vary British Midland Airways’ licence.

6. The Air Transport Users Council (“AUC”) made a written representation on the Authority’s proposal.

REPRESENTATION BY THE AIR TRANSPORT USERS COUNCIL

7. The AUC regretted that, because of the restrictive bilateral Air Services Agreement (ASA) between the UK and Russia, a choice had to be made between two UK airlines, both of whom were fully capable of mounting effective competition on this route. It saw consumer benefits in both airlines’ proposals. Virgin’s proposal to offer better in-flight service, particularly in business class, represented a real benefit to passengers, although it was felt this may be of less significance on this route than on the long haul routes which form most of Virgin’s network. Competition would also be enhanced and passengers would benefit from wider choice as a result of Virgin’s proposal to offer a daily service compared to BMA’s four flights a week. On the other hand, BMA was in a position to offer far more convenient timings, greatly enhancing the benefit of its service to passengers connecting to and from its domestic and short haul European routes. The AUC also attached considerable importance to the firm commitments contained in BMA’s written submissions to introduce lower fully flexible fares as soon as it became possible. In terms of wider competition, the AUC believed that the question of which carrier would provide the greatest benefit turned largely on whether London-Moscow was to be seen as part of the short/medium haul market or as a long haul route. In view of the distance and journey time involved, Moscow fell more comfortably into the short haul market, and moreover fitted into BMA’s coherent strategy of extending its European network eastward. The AUC concluded that wider competition with British Airways (“BA”) was likely to be reinforced by the addition of Moscow to BMA’s network, and the AUC’s view was therefore that BMA should be designated on the London-Moscow route.

BRITISH MIDLAND AIRWAYS' CASE

8. BMA had since 1986 followed a coherent strategy for the development of its European route network by seeking to provide competitive services between London Heathrow and all of Europe's major cities as well as convenient international connections to all major UK regional cities. Constraints on the availability of slots at Heathrow had prevented BMA from implementing this strategy to its full extent, and BMA had in recent years developed European routes where a lower level of slot utilisation was required, such as those between London and Palma, Bergen, Prague and Warsaw. It had a proven track record of developing and expanding competitive services on European routes to the benefit of users. Allowing BMA to serve Moscow as the second UK carrier would provide it with the opportunity to further develop this strategy enabling it to compete more effectively throughout Europe. Failure to award the second designation to BMA, on the other hand, would place it at a significant competitive disadvantage against BA, its main European competitor.

9. BMA proposed to operate four services a week between London Heathrow and Moscow, commencing in Winter 1998. It would use Boeing 737/300 equipment with a maximum seating capacity of 130, and would operate from Terminal 1 at Heathrow. BMA submitted two sets of forecasts for its Moscow service. The first, included in its written evidence-in-chief, was based on operating four services a week each calendar year through to 2001. In the first full year of operation, 1999, BMA forecast that it would carry some 22,100 passengers, rising to 28,200 and 34,900 in subsequent years. Load factors were forecast to rise steadily from 40% in the first full year to 51% and 63% thereafter. The route would lose £746,000 in 1999, but produce a profit of £229,000 in 2000. In the third full year, its profit was forecast to rise to £1.2m.

10. At the hearing, BMA submitted a second forecast based upon operating seven services a week. This was in response to the fact that Virgin's forecast was based on an assumption that it would operate seven services a week by virtue of an agreement with the second Russian designated carrier, Transaero. BMA argued that because of the obligation upon the second carriers from each side to conclude a commercial agreement with each other, whatever terms were available to Virgin would be similarly available to BMA. Its initial forecast was based on four services a week because that was the frequency entitlement under the bilateral. If it proved possible, however, its preference would be to operate seven services a week. Although load factors were forecast to be the same as in the four services a week scenario, the effect of operating seven services a week from the outset was to increase losses in the early stages. However, once the route moved into profit in the second full year, its ability to generate profits was greater, so that a profit of £975,000 was forecast in 2000 and £2.8m in 2001. This was based on passenger carryings of 38,700, 49,400 and 60,700 over the three consecutive years.

11. BMA argued that the user benefits to be derived from its proposal would be greater than those arising from the Virgin service. It had already acquired all the slots it needed at Heathrow to mount its proposed service without affecting any of its existing services. The timing of its service, departing London at 0900 and returning at 1645, would offer an attractive schedule to both point-to-point passengers and those making

connections at London. In particular BMA's services from the UK regions and short haul European destinations would offer same day and same terminal connections in both directions to passengers flying to Moscow. BMA's extensive range of code share partners at Heathrow would further provide users with connections to and from many key destinations world-wide. Its extensive European network and interline arrangements with other carriers would also enable it to offer an alternative to airlines such as BA in respect of two centre or "open-jaw" journeys within Europe where Moscow was one of two or more stops on a trip to Eastern or Central Europe.

12. The Authority's own recent report on the first five years of the single European aviation market¹ had highlighted BMA's achievements in spurring vigorous competition, in terms of quality of service and price. It had also been presented with numerous industry awards for all aspects of its service. BMA cited the results of the OAG Business Travel Lifestyle Survey (1997), as they appeared in a recent Consumers Association report on airline competition, in support of its contention that overall its product was superior to that of Virgin. According to the survey, of the factors influencing business travellers' choice of airline, an airline's schedule was often the top priority, followed by price and reliability. The quality of on-board service tended to come somewhere behind these factors. BMA did not dispute that Virgin's 2 x 2 business class seating was superior to its own 3 x 2 configuration, but it argued that Virgin's fixed business class cabin would constrain its ability to cater for the business market. BMA on the other hand offered a flexible seating arrangement which allowed it to expand the business class cabin to meet the demand for each flight. BMA's existing large short haul fleet and planned acquisition of further Airbus 321 aircraft with a maximum seating capacity of 195 meant that it would be able to upgrade the size of its aircraft once it was established on the route. It would also be much better placed than Virgin, which would have only two aircraft in its short haul fleet, to provide back-up aircraft in the event of operating difficulties.

13. BMA was also renowned for its competitive and innovative business tariff structure. Although under the UK/Russia ASA tariffs were currently subject to a double approval regime, with no freedom for airlines to innovate in respect of their published tariffs, BMA expected this to be revised within the next twelve months. As soon as it was given the opportunity to do so, BMA would introduce its usual competitive pricing structure. In addition to the standard full fare equivalent to BA's Club Europe fare, this would include an Executive fare at a discount of between 5 and 10%, a three-day Executive fare at a discount of between 10 and 15%, and a Eurobudget at a discount of about 20%, all of which would be for travel in BMA's EuroClass business cabin.

14. BMA's frequent flyer programme was the second largest programme in the UK, and it had an extensive sales presence throughout Europe to support the route. These elements, combined with its better schedule, its network for connecting passengers, its business cabin flexibility and its competitive tariffs, meant that BMA's proposal offered considerable consumer benefits compared to Virgin's.

¹ "The Single European Aviation Market: The First Five Years" (CAP685), Civil Aviation Authority 1998

VIRGIN ATLANTIC AIRWAYS' CASE

15. The task facing the Authority in this case was straightforward - to decide which of Virgin's or BMA's proposals were likely to benefit the consumer most. There was no issue relating to the structure of the UK industry, and there was little doubt that both airlines would be able to operate a London-Moscow route profitably.

16. A central feature of Virgin's case was its plans to co-operate with the second Russian designated carrier, Transaero, in order to provide a daily service. It had already concluded an "umbrella" agreement with Transaero which outlined the nature of the intended co-operation between the two airlines. This would involve Virgin borrowing some of Transaero's bilateral frequency entitlement in order to operate additional frequencies itself. Virgin believed that this arrangement would be acceptable to the Russian authorities. A precedent for such an arrangement had already been set by British Airways' and Virgin's use of Aeroflot's bilateral rights to operate additional trans-Siberian services.

17. Although discussions between Virgin and Transaero were ongoing, Virgin suggested that the most likely outcome was that Virgin would "borrow" three of Transaero's frequencies to operate a daily service itself. Transaero may in addition operate a single frequency in its own right. Alternatively, it was possible that Virgin would operate six frequencies and Transaero two. In either event, consumers would be provided with a minimum daily service, and this would increase to a double daily service from summer 2000 when additional frequencies became available under the bilateral agreement. A number of areas of possible co-operation had been identified, and it had already been agreed that Transaero would place its code on all Virgin's London-Moscow flights, probably involving the allocation of blocks of seats for sale in Transaero's name. This would mean that Transaero and Virgin would compete with each other for traffic, albeit on the same aircraft. Another important aspect of the two airlines' co-operation would be the ability of both carriers to feed each other's networks. Virgin's Moscow services would connect upon arrival at Heathrow with its own services to New York, Hong Kong, Athens and Johannesburg. While connecting times on to Transaero's services at Moscow would be longer than normal, Virgin hoped to be able to move the Heathrow departure and arrival times when the opportunity arose in order to improve connections at both ends of the route.

18. Virgin proposed to integrate its Moscow service with its existing Athens operation. It intended to acquire a second Airbus 320 aircraft to operate the route, and it would reconfigure its existing A320 so that both aircraft would have 22 Business and 120 Economy seats as an interim measure. In the medium term Virgin intended to investigate the feasibility of introducing business configuration flexibility. Virgin offered the largest business class seat of any European service, with a seat pitch of 36 inches in a 2 x 2 configuration. The quality of service in Virgin's European business class was more akin to its long haul product, including extensive in-flight entertainment. BMA meanwhile proposed only to match the quality of BA's product, whose standard European in-flight service Virgin considered to be at the margins of acceptability for a sector of this length. Virgin would undoubtedly surpass the quality of BA's product as it

already did on Athens. Indeed its service had already been recognised as the best business class in Europe by one national newspaper.

19. Virgin's proposed schedule was for an 0640 departure from Heathrow and a 1705 arrival upon return. It had acquired the necessary slots with the exception of one arrival slot. However, it did not foresee any problems in obtaining this slot, and expected to obtain similar slots for the summer 1999 season. Indeed, it hoped over time to be able to improve the timings of its Heathrow slots to improve connectivity. Virgin readily admitted that an 0640 departure from Heathrow effectively precluded any connections to the outbound Heathrow sector, but argued that it was certainly viable for point-to-point passengers who accounted for the bulk of the market.

20. Like BMA, Virgin submitted two sets of traffic and profitability forecasts. Its principal forecast was based on operating a daily service from the beginning of the winter 1998 season, and assumed that Transaero would operate daily from summer 2000. Its forecast was that it would carry some 55,300 passengers in the first year at a load factor of 53%. Traffic would grow in years two and three to 58,400 and 59,400 at load factors of 56% and 57% respectively. This was based on an initial market stimulation of 15% following Virgin's entry to the route. Thereafter the market was expected to grow at a rate of 5% a year, with a further stimulation of 11% in 2000 as a result of the second daily frequency. The forecast also relied on the diversion to direct services of many of the 39,000 passengers who, according to CAA data, currently travelled indirectly. While well over half of the traffic on the route was currently travelling on business, and 38% of BA's Heathrow-Moscow traffic travels in Business Class, Virgin's forecast assumed conservatively that 20% of its traffic would travel in business class. On this basis, the route was expected to return a profit of £1.7m in year one, growing to £2.7m by year three.

21. In response to BMA having submitted a forecast on the basis of operating four services a week, Virgin submitted a second forecast assuming an operation of four services a week in years one and two, rising to daily in the third year. Traffic was forecast to be 29,900 in year one, growing to 33,000 and 57,800 in subsequent years. The load factor was forecast to be 50% in the first year and 55% in years two and three. On this basis the service was expected to make a loss of £244,000 in year one and to be profitable in the second year.

22. Virgin also argued that failure to allow it to serve the London-Moscow route would deny it the legitimate fruits of its past endeavours. Virgin had been actively seeking rights to operate this route since 1995 and had engaged in extensive lobbying in Moscow. BMA, on the other hand, had sought rights only in 1997 and to Virgin's knowledge had carried out no lobbying in Moscow.

ANALYSIS AND REASONS

Introduction

23. As with each of the previous occasions on which the Authority has had to allocate scarce bilateral capacity, the circumstances of this case are unique. Most notably, perhaps, the case does not involve BA. Unusually, the capacity which became available as a result of the bilateral agreement between the UK and Russia in May this year is reserved for second carriers from each side. While BA is not therefore able to bid at present for all or a share of the additional capacity, nor under the terms of the May agreement is the UK free to allocate to BMA or Virgin a portion of the capacity currently being used by BA. Since the UK/Russia ASA limits each side to designating only two airlines, the Authority is required to make a straight choice between the two UK carriers it has licensed in addition to BA to operate services between London and Moscow. It is of course regrettable that the Authority is presented with this decision. The Authority's preference is that both BMA and Virgin, along with other airlines, should be able to choose to operate to Moscow in competition with BA, and that all three carriers should be free to mount the frequency and capacity they wish, subject only to safeguards against anti-competitive behaviour. The effect of government-imposed restrictions is inevitably to restrict airlines' output to the detriment of users and ultimately the economies of both the UK and Russia.

The Authority's Duties and Policies

24. Consistent with its duties under the Civil Aviation Act, the Authority's prime concern in licensing cases is to further the reasonable interests of users. It sees competition, both among British airlines and between British and foreign airlines, as the best available means of ensuring that users have the widest possible choice of products, services and airports, that quality of service is maintained and that fares are set at reasonable levels in relation to cost. It believes that the interests of users are best met by the existence of a number of efficient and profitable British airlines strong enough to compete with each other and with foreign airlines, directly or indirectly, when the opportunity arises or can usefully be created.

25. This is the second occasion on which the Authority has been required in a scarce bilateral capacity case to decide which of two UK carriers should take up one remaining designation opportunity. However, in Decision 2/97 the Authority was required to make a choice between two carriers seeking to operate two different routes. BA was seeking to take up the one remaining designation available under the UK/US bilateral agreement to operate from London to Denver while Virgin wished to operate from London to Las Vegas. Thus the choice facing the Authority in that case was not only between two carriers but between two routes. Indeed the Authority concluded that industry structure arguments were not a significant factor in that case, and the decision therefore revolved around the relative user benefits arising from the two route proposals. The respective user benefits clearly depended to a great extent on the different characteristics of the two markets concerned as well as the services being proposed by the respective airlines. Here, however, the decision facing the Authority is which of two carriers other than BA should operate on one route. In the absence of any industry structure arguments, therefore, the issue is on the face of it rather narrower than in the Denver/Las Vegas case.

26. However, BMA argued that the structure of competition between UK airlines and between route networks across Europe was one of the relevant factors which should be taken into account by the Authority. It argued that unless it was able to operate on routes such as Moscow, then it would be at a serious disadvantage in its ability to compete effectively with BA. It was aiming to build a comparable network to BA in respect of the major cities in Europe, and the lack of certain cities from its portfolio would make it less competitive. Virgin's presence in Europe was currently limited to the Athens route, and the same argument therefore did not apply to it. Virgin, on the other hand, argued that in this case the Authority did not have to concern itself with the structure of the UK's air transport industry.

27. The Authority does not dismiss BMA's contention out of hand. Although BMA did not expand on its argument in detail, it appears similar to that which Virgin deployed in the Denver/Las Vegas case, and which the Authority addressed at paragraphs 25 and 26 of Decision 2/97. Just as in that case, the Authority accepts that the addition of a profitable route to an airline's network would tend to strengthen its ability to compete effectively. However, this clearly applies to Virgin as well as to BMA. BMA certainly did not argue that failure to operate to Moscow would bring the viability of its services in general into question. The Authority therefore sees no basis for concluding, as the AUC seems to do, that wider competition with BA would necessarily be reinforced by the addition of Moscow to BMA's rather than Virgin's network. In view of this, the Authority is not convinced that great weight should be placed on industry structure arguments in this case.

Relationship with Transaero

28. There was considerable discussion at the hearing about the implications of the requirement upon the UK's second designated carrier to enter into a commercial agreement with Russia's second designated carrier, currently Transaero. Indeed Virgin argued that a central feature of its case was its proposed co-operation agreement with Transaero. It was on the basis of this proposed co-operation that Virgin would operate a daily service initially, moving to a double daily service when the additional capacity became available in 2000. Virgin submitted in evidence a copy of its "umbrella" agreement with Transaero, under which the two airlines declared their intent to enter into close commercial co-operation in a number of specified areas. Virgin stated that it had been in discussions with Transaero about possible co-operation since 1992, when Transaero had made its first approach to Virgin.

29. BMA had clearly adopted a different approach from Virgin. It was proposing to operate four services a week in its own right. Although it had held one very recent meeting with Transaero on 21 August to discuss possible co-operation on the route, it was quite apparent that BMA had approached Transaero in response to the evidence submitted by Virgin concerning its own proposed relationship with Transaero. BMA argued first that, given the obligation upon the second carriers of each side to enter into a commercial agreement, whatever the benefits of the proposed arrangement with Transaero may be they would apply equally to the service proposed by BMA. Second, it argued that Virgin's evidence was seriously misleading since Virgin and Transaero had not formally agreed on the details of the proposed co-operation as set out in

Virgin's evidence. There was a written agreement to discuss co-operation, but BMA had, albeit orally, also discussed co-operation with Transaero. In BMA's view, the Authority should take no account of Virgin's proposed co-operation with Transaero in the absence of substantive evidence that it would materialise.

30. It is clear to the Authority that its decision in this case cannot be pre-empted in any sense by agreements, whether written or otherwise, entered into by UK and foreign airlines. It is certainly not for Transaero to determine which UK airline should be awarded the second designation on the London-Moscow route. However, the Authority equally cannot disregard the evidence before it in relation to Transaero, particularly given the potential implications for the interests of users of BMA's and Virgin's different approaches to this issue.

31. It is of course inimical to competition that there should be a government-imposed requirement upon airlines to enter into commercial agreements. The nature of the agreement which might meet such an obligation can of course vary considerably. For example, it might conceivably involve only an interlining or pro-rate agreement, or it might involve a degree of revenue or profit sharing. Thus, in general the effect of such agreements may at best be to merely temper competition but at worst may result in entirely collusive behaviour to the detriment of users. It was clear from BMA's evidence that its own thinking about the nature of a possible relationship with Transaero was some way behind Virgin's. While BMA stated that a daily service would be commercially more viable and more beneficial to users than a service four times a week, and that given the opportunity its preferred option would therefore be to operate daily, its discussions with Transaero appeared to have established nothing other than that Transaero would be prepared to co-operate with BMA. No details of the proposed co-operation had been resolved.

32. In contrast, Virgin had a very clear vision of its proposed co-operation with Transaero. While its formal agreement with Transaero may only constitute a statement of intent, it was Virgin's evidence that it has entered into an understanding with Transaero as to the outline and many of the details of its proposed co-operation. Most importantly, it seems to the Authority, is the firm intention to operate a daily service from the outset, increasing to a double daily service from summer 2000. Given that BA currently operates a double daily service and Aeroflot operates near double daily, competition is clearly likely to be stronger and thus user benefits greater if the incumbents are faced with a competitor offering a level of frequency close to their own. Virgin said that it would provide this. BMA said that it might offer a daily service from the start if it proves possible, but beyond that it had no clear plans.

33. Since its operations would ultimately be subject to final agreement with Transaero and approval by the Russian authorities, there could be no guarantee that Virgin would in practice deliver the services it was proposing. Nevertheless, the Authority cannot avoid concluding that, in the absence of firmer proposals from BMA, there is a considerably greater degree of probability that Virgin will in practice be able to operate a daily service. The worst outcome for users would be a situation in which only four additional services a week were provided, and the UK airline operating them had also to make payments in some form to the second Russian carrier. The best

outcome, on the other hand, would be full utilisation of the rights available under the bilateral agreement, with a second UK airline providing a daily service without incurring the costs of a side payment to the second Russian carrier. On the basis of the evidence before it, it seems to the Authority that the better outcome is considerably more likely if Virgin were to be the UK's second designated carrier rather than BMA.

Viability

34. Neither party questioned the viability of the other's proposed services. Nevertheless it was clear that the two airlines had different views of their ability to penetrate this market in the short term. With a daily service, Virgin anticipated profits from year one despite higher unit costs than BMA. BMA forecast a more gradual growth in traffic and load factors, with services coming into profit only in year two and returning similar levels of profit to Virgin only in year three. Much of the difference arises from Virgin's assumption that it will stimulate the market by 15% in year one. Virgin accepted that it was unusual to enter a route and expect to return a profit in the first year but believed this route was crying out for competition. Virgin argued that, unlike BMA, its strong brand and marketing presence would enable it to make a significant impact from the outset of its operation.

35. BMA challenged in particular Virgin's forecast for its first year of operation which it regarded as extremely optimistic. Its own experience in entering new European routes suggested that it took some time to build up to anticipated load factors. Virgin, on the other hand, expressed confidence that its forecasts were achievable. It also raised the question of how robust each carrier might be to an aggressive competitive response from BA. Virgin argued that its product would stand up well against any upgrading, for example, of BA's business class to Club World standards instead of Club Europe. BMA was only matching BA's existing product, and would therefore be vulnerable to any such move as it could not easily respond.

36. The Authority sees no reason to seriously dispute either airline's forecasts. It does not doubt that either airline would be able to mount a viable service to Moscow. The Authority does however regard it as significant that Virgin anticipates better results from the route than BMA, particularly in the early years.

User Benefits

37. In considering the benefits to users which may result from the two proposals, there are clearly a number of factors to be taken into account. Each party argued that its service offered clearly superior consumer benefits to the other. The Authority refers in paragraph 9 of its Statement of Policies to a number of factors which constitute quality of service, albeit to be considered in the context of a proposal to substitute one carrier for another. This case clearly does not fall into that category, but nevertheless the elements which the Authority identified as comprising quality of service are of some relevance here. They are "capacity, seat availability, frequency, timings and price".

38. Clearly these elements are to some extent inter-related. In general, the level of prices in a market will ultimately be driven by the capacity which is made available and

the strength of demand. In bilaterally constrained air services markets, published tariffs are often subject to strict government regulation. This is the case here, and although the Authority shares BMA's hope that the tariffs regime under the ASA will be liberalised in the near future, this will depend upon securing agreement from Russia on which there can be no guarantee. Despite these constraints on published fares, there is clearly an active "grey" market for discount fares on this route, and it is here that prices will be determined largely by the capacity which is put into the market. Although the difference in the capacity of the equipment each airline is proposing to use may not appear large - 142 seats for Virgin against 130 seats for BMA - Virgin's capacity will nevertheless be almost 10% higher than BMA's. Other things being equal, one would expect this to feed through to some difference in the level of fares in the grey market, with the greater user benefit in terms of lower fares resulting from Virgin's proposal. When the potential difference in frequency of operation is also taken into account, as discussed in paragraphs 28 to 33 above, this conclusion is considerably reinforced.

39. BMA emphasised its track record of offering competitive and innovative business class fares. The Authority has on several occasions highlighted the competitive impact of BMA's entry to European routes, and does not doubt the user benefits which result from its pricing policy where it is given the opportunity to innovate. As Virgin pointed out, however, there is currently no freedom to innovate on published fares in the UK/Russia market. Virgin stated that if there were, it too would offer highly competitive business class fares. In these circumstances, the Authority finds it difficult to place great weight on any differences between the two airlines' strategies in respect of published fares.

40. BMA argued that its timings were far more attractive to both point-to-point and connecting passengers than Virgin's, particularly outbound from Heathrow. Virgin's departure time of 0640 clearly precluded users from benefiting from any connecting opportunities on the outbound journey, whereas BMA's 0900 departure would allow an extensive range of connections with its domestic and international network. Nevertheless it was clear that the numbers of passengers connecting over London in this market was currently very small relative to the total. BMA suggested that about 10,000 passengers currently transit London, out of a total market of some 300,000. Its own assumption for the purposes of its traffic forecast was that it would attract 1,488 of these passengers. It also pointed out that there were some 45,000 passengers who route from UK points via a hub other than Heathrow or Gatwick, such as Amsterdam. It would hope to attract a number of these passengers to its services, particularly given the attractiveness of its schedule, but it had made no assumptions about how many it would carry and was not relying on them to demonstrate the viability of its service.

41. The Authority does not dispute, and nor did Virgin, that BMA's proposed Heathrow departure time offers considerably better connectivity. However, given the relatively small numbers of passengers involved, even taking into account that BMA might attract indirect passengers currently not travelling over London, it seems to the Authority that the benefits to connecting passengers should not be overplayed. The Authority agrees with Virgin that this appears to be primarily a point-to-point market. While Virgin itself acknowledged that its departure time was not ideal, nor did it believe it to be outrageously early. It hoped over time to improve the timing of its service, to

offer a marginally more attractive departure time from Heathrow and better connecting times at Moscow. The Authority is aware that it often is possible for airlines to improve slot timings at Heathrow, and has no reason to believe that Virgin would find it impossible to do so. The Authority nevertheless agrees with BMA that its proposed timings offer users greater benefits than do Virgin's.

42. Because user choice is unlikely to be a relevant factor in a pure substitution case, it does not receive a specific mention in paragraph 9 of the Statement of Policies. However, in paragraph 3 of the Statement the Authority states that it sees active competition as the best available means of ensuring that users have the widest possible choice of products, services and airports. In paragraph 4 the Authority states that it will seek to encourage an environment in which competition between British carriers and with foreign airlines can flourish and user choice is enhanced. The degree to which each airline's proposal widens the choice available to users on the London-Moscow route is therefore a relevant factor in the Authority's decision. There was relatively little discussion of this aspect at the hearing. Virgin argued that its business class product was distinct from that of both BMA and BA, in terms of seating, in-flight service and ground services. BMA acknowledged that Virgin's business class configuration was superior, but countered that it had the benefit of a flexible cabin which would enable it to be more responsive to business demand. The Authority sees merit in both sides of this argument. It also has no doubt that either airline would offer a high quality and competitive service. However, if one is judging which proposal widens user choice to the greater extent, the Authority concludes that this points towards Virgin. Comparing the two airlines' products with that of BA, Virgin's business class product is clearly the more highly differentiated, offering a new option to users.

Other issues

43. BMA sought also to make an argument that users' interests might be put at risk if Virgin were to operate to Moscow because it would not be well placed to cope with disruptions to its services for technical or other reasons. The fact that it would have only two A320 aircraft in its fleet was bound to mean that Virgin's operation would be less reliable than that of BMA, with its much larger short haul fleet and availability of back-up aircraft. Virgin responded that it had experienced no problems on its Athens service, using just one aircraft. In the event that back-up aircraft were needed, it had the option of either using an A340 from its long haul fleet or of leasing in an aircraft at short notice. It appears to the Authority, therefore, that reliability should not be a significant factor in its decision.

44. One difference between the two carriers at the hearing was that while BMA had already acquired all of the Heathrow slots it needed to mount its proposed schedule, Virgin was still seeking one arrival slot. This placed something of a question mark over whether Virgin would in practice be able to operate a daily service. Virgin was confident that it would be able to obtain the slot it needed, and pointed out that the slot exchange process for the coming winter was still continuing. Even were Virgin to fail to obtain the arrival slot it needed for the coming winter season, it would still have the slots for six services a week. It was also confident that it would secure the slots it needed for a daily service in the summer season. While there may be a small element of doubt

over whether Virgin would be able to operate a daily service at the outset, therefore, it seems to the Authority that this is minor relative to the doubt over the level of operation which BMA might operate.

45. Virgin's argument about equity was put forward on the basis that should the Authority conclude that the proposals of the two applicants would produce similar user benefits, then the fact that Virgin had been actively seeking these rights for longer than BMA should be a decisive factor. The Authority has not reached this conclusion and therefore does not regard this argument as relevant to its decision in this case.

Conclusion

46. The decision in this case appears to the Authority to be particularly finely balanced. It does not accept that industry structure arguments are a significant factor here, and its decision therefore rests on where the greater user benefits lie. It has no doubt that both carriers would be able to offer viable competitive services offering significant benefits to users. It is clear that greater user benefits would result from a daily service as opposed to four flights a week, and that the benefits to the UK would be greater if a UK airline were able to offer a daily service itself. There can be no guarantee about the services either airline would be able to deliver in practice because of the need to enter into a commercial agreement with the second Russian carrier. However, Virgin's plans are significantly clearer than BMA's in this respect. In particular, it has a clear intention to move to a double daily service in conjunction with Transaero in 2000, whereas BMA is much less clear as to what level of service it would wish to operate at that time. There appears to the Authority, therefore, to be a much greater prospect of a daily service initially and double daily service from 2000, with the resulting user benefits, being delivered by Virgin than by BMA.

47. There are some aspects where the balance of advantage seems to the Authority to lie with BMA. The proposed timings of its services are better for users, especially outbound connecting passengers at Heathrow. However, the numbers of connecting passengers are relatively small. The flexibility of BMA's business class cabin means that BMA is better placed to accommodate the peaks of business class demand. BMA's slots are all in place, whereas Virgin is still seeking one arrival slot.

48. However, it seems to the Authority that these are outweighed by other benefits offered by Virgin. Most significant is the prospect of daily and then double daily services. This would result in greater capacity than BMA is proposing, perhaps substantially so, producing attendant benefits to users in terms of frequency and fares. Virgin's product offers a greater degree of choice to business class passengers than BMA's when the two are compared with the product on offer from the existing UK carrier. Virgin's service is also expected to be profitable from the first year.

49. The Authority therefore concludes that the reasonable interests of users will be better served by Virgin's proposed services from Heathrow to Moscow than by BMA's. This conclusion rests on an expectation that Virgin will substantially deliver the service it has proposed in its case to the Authority. In the absence of further opportunities for UK airlines to be designated to serve the London-Moscow route, any significant delay in the

implementation of Virgin's plans for services to Moscow or failure to operate to the level proposed might be regarded as grounds for the Authority to reach a different conclusion.

DECISION

50. The Authority withdraws its proposal to vary route licence number 1B/35 held by Virgin Atlantic Airways Ltd.

51. In accordance with its proposal, the Authority hereby varies the route licence number 1B/13 held by British Midland Airways Ltd by adding the following condition:

“British Midland Airways shall not operate between London and Moscow if to do so would restrict or inhibit the ability of either British Airways or Virgin Atlantic Airways to operate between London and Moscow.”

52. For the purposes of any appeal which may be made against this decision the 'decision date' (see Regulations 26(8)(a) and 27(4) of the Civil Aviation Authority Regulations 1991, as amended by the Licensing of Air Carriers Regulations 1992) is 17 September 1998.

G J Elsbury
For the Civil Aviation Authority
11 September 1998