



UNITED KINGDOM
CIVIL AVIATION AUTHORITY

DECISIONS ON AIR TRANSPORT LICENCES AND ROUTE LICENCES

3/98

Decision of the Authority on its proposal to vary licence 1B/10 held by British Airways Plc and licence 1B/35 held by Virgin Atlantic Airways Limited heard on 14 September 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 Airways Plc represented by Mr C Allen,
Head of Competition and Industry Affairs, British
Airways Plc

Witness: Mr D Noyes, Director UK/Africa and Middle East,
British Airways Plc

Objector: Virgin Atlantic Airways Ltd, represented by
Mr R Lawson of Counsel

Witnesses: Mr R Branson, Chairman, Virgin Atlantic Airways
Ltd

Mr D James, General Manager, South Africa,
Virgin Atlantic Airways Ltd

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

SUMMARY

1. This hearing was convened to decide which of British Airways or Virgin Atlantic Airways should be allowed to operate a single additional weekly frequency available for UK airlines under the UK/South Africa bilateral air services agreement. From the winter 1998/99 season British Airways wished to add a sixth weekly frequency between London and Cape Town while Virgin Atlantic Airways wished to commence services on the same route with two services a week. However, the UK/South Africa bilateral agreement currently restricts the weekly frequencies which UK airlines may operate so that only one additional weekly frequency remains available. 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. On the basis of the evidence put to it, the Authority has decided that British Airways' proposed service should be given preference over that of Virgin Atlantic Airways.

THE NOTICE

2. On 13 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 in Pretoria on 31 October 1997 and the Agreed Record of 16 July 1998 between the Republic of South Africa and the United Kingdom, the United Kingdom's share of capacity on air transport services between the United Kingdom and the Republic of South Africa which may be provided by British airlines would, within 6 months of the date of that notice, be insufficient to enable British Airways plc and Virgin Atlantic 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 18 August 1998.

THE PROPOSAL

3. Following the notice from the Secretary of State, the Authority published its proposal to vary the licences of British Airways (1B/10/354) and Virgin Atlantic Airways (1B/35/142) in its Official Record Series 2 on 18 August 1998. After reciting the notice, this proposal stated that:

"2. The Authority is advised by the Secretary of State that from the Winter 1998 season British Airways would like to operate an additional Cape Town service and Virgin Atlantic Airways would like to enter the Cape Town route with a twice weekly service. Under the UK-South Africa bilateral arrangements UK airlines are currently permitted to operate a total of 25 services a week. BA currently operates 18, and Virgin 7, services a week between the UK and South Africa, thereby using all the available capacity. From the start of the Winter 1998 season, UK airlines will be permitted to operate 26 services a week. The single additional frequency which will become available is therefore insufficient to meet their planned expansion of operations.

“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/10 held by BRITISH AIRWAYS PLC (BA) and route licence number 1B/35 held by VIRGIN ATLANTIC AIRWAYS LIMITED (Virgin) so as to provide that the total number of flights operated between the UK and South Africa by BA and Virgin in any one week shall not exceed 26 in each direction. The maximum number of flights which may be operated by each airline 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 Airways (“BA”) exercised its right to be heard on the Authority’s proposal to vary its licence 1B/10 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 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), a choice had to be made between the immediate benefit to passengers on the London/Cape Town route and the longer term benefit to these and other air travellers. In its view, it was clear that consideration of the immediate benefits would favour BA in this case. Its proposal offered a wider choice of day of travel and apparently better timing, it made better use of the scarce capacity and was operationally more efficient. The AUC believed that these benefits outweighed the availability of Virgin’s superior in-flight service. The AUC also doubted whether a single service a week was likely to constitute significant competition with BA and South African Airways (SAA). Nonetheless, the AUC believed that competition offered such benefits to passengers that it would be willing to see the certainty of short term gains sacrificed for the possibility of future benefits. While it considered the issues to be very finely balanced, therefore, the AUC’s view was that the additional frequency should be awarded to Virgin.

BRITISH AIRWAYS' CASE

8. The primary issue before the Authority in this case was which of BA's or Virgin's proposals would better serve the reasonable interests of users. Allowing BA to add a sixth weekly service to Cape Town would, in BA's view, clearly represent the better utilisation of the scarce bilateral resource available. BA was offering significantly greater capacity than that proposed by Virgin. Considerations of industry structure were not an issue here. There was no indication that one additional BA frequency to South Africa would have a material impact on Virgin, either on routes to South Africa or more generally. BA was not arguing that there was no room for another operator on the Cape Town route, but that in the short term BA was able to make better use of the opportunity that was available to the UK.

9. BA proposed to use this opportunity to add a sixth weekly non-stop frequency to Cape Town from winter 1998/99. It would depart London on a Thursday at 1820 on the outbound leg, returning from Cape Town on a Friday at 2030. It would thus fill one of the two "gaps" in its current weekly schedule to Cape Town, and move BA closer to a daily operation. The service would be operated with a 401-seat Boeing 747-400 in BA's standard long haul configuration. The additional service was forecast to add 29,688 passengers to BA's non-stop Cape Town carryings in the year ending March 2000, its first full year of operation, returning a profit of £1.3m. Its effect would therefore be to increase the profitability of its Cape Town services overall. The service would provide extensive connecting opportunities in each direction at Heathrow.

10. BA had demonstrated a continuing willingness to invest in the development of its South African services. Since 1994, when it operated 8 services a week to Johannesburg and 2 a week to Cape Town, BA had grown its services to its current level of 13 services a week to Johannesburg and 5 a week to Cape Town. Its ability to make further investment in the market was now constrained by the bilateral agreement.

11. In the winter 1997/98 season, BA achieved an average passenger load factor of 85% on its Cape Town services, despite having increased capacity by 25% through the addition of a fifth weekly service. Growth in passenger volumes of 30% had outstripped the growth in capacity. For the coming winter season, BA was already turning traffic away. For the period from November 1998 to March 1999, BA's forward bookings were running at 62% of capacity. For the months of November and December its forward bookings were running at 91%, compared to a comparable figure at this time last year of 71%. There was clearly unsatisfied demand in the market.

12. While Cape Town has been primarily a leisure market, it is becoming of increasing importance to business travellers. The CAA's 1997 survey suggested that 24% of the traffic on the route was travelling on business. As far as BA was able to detect, this proportion was growing. The addition of BA's fifth weekly Cape Town flight in winter 1997/98, for example, produced a 28% growth in sales in the economy cabin, 34% growth in the Club World cabin and 40% growth in First Class. BA believed this reflected in part changes in the Cape Town area itself, with growing numbers of businesses setting up in the Cape. The addition of a sixth weekly

frequency would be moving BA closer to providing the business traveller with the daily service needed.

13. BA argued that awarding the additional frequency to Virgin would not significantly enhance competition on the route. To the extent that Virgin would have a competitive impact on the route, it was already exerting it by virtue either of its services from London to Johannesburg and associated code shared services with Sun Air or through Virgin Holidays' presence in the market. While it was true that Virgin offered some fares to Johannesburg at levels lower than those offered by BA, this was equally true of its fares to Cape Town. This, together with the fact that the main price innovator on Johannesburg had been BA, with Virgin following its lead on pricing, suggested that Virgin's entry to the Cape Town route with one service a week would have a negligible competitive impact. Indeed, Virgin's proposed schedule would result in three competing services operating on the same day. Its northbound service was proposed to be a daylight rather than overnight service, but BA's evidence was that there was a clear customer preference, particularly amongst time-sensitive passengers, for overnight services in this market. Given that schedule and frequency are critical to the business market, awarding the service to Virgin would not meet the needs of the market but would represent a lost opportunity in terms of the objective of a daily service.

VIRGIN ATLANTIC AIRWAYS' CASE

14. Virgin shared BA's view that this case should turn primarily on where the greater user benefit lay. Paragraphs 3 and 4 of the Authority's Statement of Policies implied that the reasonable interests of users were to be equated with widening consumer choice. The entry of Virgin to the London/Cape Town route would clearly introduce a real choice for the consumer which would be absent were the Authority to award the additional frequency to BA. Furthermore, if the Authority's policy was to promote competition, then here was a clear opportunity to introduce a competitor to a route badly in need of competition.

15. Virgin's entry to the London/Johannesburg route in October 1996 and subsequent expansion of services had generated, and continued to generate, substantial consumer benefits. The same benefits would be produced if Virgin were able to enter the Cape Town route to provide much needed competition against BA and SAA. Prior to Virgin entering the Johannesburg route, fares were high and quality of service less than impressive. Virgin's entry to the market resulted in reductions in both the published fares and particularly fares available in the "grey" market. Virgin offered a very different type of service from that of BA and SAA. Class for class, there could be no doubt that the quality and value for money of Virgin's product far exceeded those of the incumbents. Johannesburg had consequently proved to be a highly successful route for Virgin, with over 111,000 passengers carried in 1997 at an average seat factor of 71%.

16. In view of its success on Johannesburg, Virgin informed the Department of the Environment, Transport and the Regions (DETR) of its strong interest in commencing services to Cape Town in October 1997. Its preferred plan was to operate two services a week initially, rising to four services a week from summer

1999, five services a week from summer 2000, and moving to a daily service within four or five years. In anticipation of the bilateral rights becoming available, it had obtained suitable slots at Heathrow for a twice weekly service to commence in September 1998. If now, however, it was able to operate only one service a week it would depart London on a Friday at 1700. On the return leg it would depart Cape Town at 0830 on Saturday arriving back at Heathrow at 2000 the same day. For the coming winter season it had obtained confirmed slots at Cape Town. The precise timing of its Heathrow departure slot was not yet confirmed, but the Heathrow slot allocation process was not yet complete and Virgin remained confident that it would obtain the appropriate slots. In the unlikely event that it failed, it had confirmed slots for both Saturday and Sunday departures and Sunday and Monday arrivals, and would therefore be prepared to slip the service by a day. The service would operate using Airbus 340 equipment, with 255 seats (40 Upper Class, 28 Premium Economy and 187 Economy seats).

17. Virgin still anticipated that the bilateral restrictions would be relaxed so that it would in practice be able to increase frequency beyond one service a week in the near future. (Indeed, Virgin raised the possibility that it might be able to commence with two services a week even within the current bilateral arrangements, as discussed below.) It therefore submitted two sets of forecasts. The first was based on Virgin being held to one service a week for a period of three years. In this scenario, Virgin expected to carry 16,246 passengers in its first year at a seat factor of 61%, 18,618 passengers at a seat factor of 70% in the second year, and 22,507 passengers at a seat factor of 85% in the third year. On this basis, Virgin forecast that its service would make a loss of £1.8m in the first year, £1.1m in the second year, producing a marginal profit of £22,000 only in the third year. Virgin pointed out in its evidence that it would pay a financial penalty if it operated only one rather than two services a week. In particular, the effect of being held to one service a week would be that it would take longer for the route to become profitable. It was nevertheless prepared to incur this penalty in order to gain a foothold in the market.

18. Its second set of forecasts showed how the route would perform if it were able to operate four services a week from summer 1999, rising to five services a week a year later. The build-up in seat factor over the three years was broadly the same as in the first scenario, and although the loss in the first year was considerably greater at £3.3m, the profit in the third year was also considerably higher at over £5m.

19. Since the last round of bilateral negotiations between the UK and South Africa, Virgin had been actively lobbying in South Africa to persuade its authorities to allow UK airlines further additional services to their country. On the evening of Friday 11 September, the South African Minister of Transport had told Virgin's Chairman by telephone that he would be prepared to accept a UK airline operating two services a week operated with aircraft of capacities of no more than 250 seats instead of one service a week with unlimited capacity. Since Virgin's preferred plan was to operate two services a week with A340 aircraft, while BA was interested in adding only one frequency with a B747, Virgin argued that it was open to the Authority to take this offer from the South African authorities into account in reaching its decision. This proposal would have the effect of negating any capacity advantage which BA's proposal might have on the basis of only one service a week, and would enable Virgin to be a stronger competitor in the market than otherwise.

ANALYSIS AND REASONS

Introduction

20. This hearing would not have been necessary had the bilateral consultations between the UK and South Africa earlier this year succeeded in increasing the weekly frequencies available to UK airlines to 28 or more for the coming winter season. This would have enabled BA to add its fifth frequency to Cape Town and Virgin to enter the route with two services a week as planned. The Authority hopes that consultations will be resumed in the near future and that the current bilateral restrictions will be either removed completely or relaxed sufficiently so that UK airlines are able to mount the current and future services they plan without the need for regulatory intervention. It is clear that the UK/South Africa market in general, and the London/Cape Town market in particular, is currently growing strongly and may be expected to continue to do so, at least in the short term. If UK airlines are not permitted to respond to the needs of the market because of government-imposed restrictions, then the losers will be consumers and ultimately the economies of the two countries.

The Authority's Duties and Policies

21. The Authority's Statement of Policies makes clear that its prime concern in licensing cases will be for the reasonable interests of users. It sees active 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 also sees competition as a powerful incentive to efficient operation and the sound allocation of resources. 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.

22. Both parties argued that the primary issue before the Authority in this case was which proposed service offered users the greater benefit. BA argued that secondary weight should be placed on the need to facilitate competition by British airlines with others. Virgin did not believe that this should be a relevant consideration. BA was already competing effectively and successfully in the non-stop London/Cape Town market. It operated at a higher frequency than SAA and therefore did not need an additional frequency to enable it to compete effectively. While Virgin did not argue that this case was primarily one of industry structure, it nevertheless submitted that the issue could not be ignored. The Authority's Statement of Policies made clear that it supported competition, but in order for competition to take place there had to be competitors in the market. This case presented an opportunity for the Authority to enable a new competitor to enter the non-stop Cape Town route. If BA were permitted to increase to a daily service before Virgin were able to enter the route, it would be more difficult for Virgin to

compete and it may be more difficult for Virgin to obtain the necessary slots at Heathrow in the future. The AUC also voiced support for the principle of fostering competition, even where the short term interests of passengers might point in other directions.

The Interests of Users

23. The Authority agrees with BA and Virgin that its decision should turn primarily on the interests of users. The arguments about industry structure and competition are considered later below. As it stated in its recent decision on Moscow (Decision 2/98), the Authority regards the level of capacity to be offered, and its associated quality, as key elements in determining where the balance of user benefits might lie in a particular case. In general, the level of prices in a market will be driven by the interaction of supply and demand. Other things being equal, the greater the capacity being offered in the market, the lower prices are likely to be. There was much discussion at the hearing about the effect on fares of Virgin's entry to the Johannesburg market. While the Authority has no doubt that the increase in the number of competitors in that market will have played its part in prompting greater price competition, the fundamental factor was likely to have been the level of capacity offered. The difference in capacity being proposed by BA and Virgin in this case is large. BA's B747-400 contains 146 seats more than Virgin's A340, a difference of some 57%. Over a twelve month period this would represent over 7,500 more seats being put into the market in each direction under BA's proposal compared to Virgin's. Looked at in narrow short-term user interest terms, this is clearly a powerful argument in favour of BA.

24. A number of countervailing arguments were put to the Authority. Virgin suggested that its entry to the market would result in a greater choice of airlines on the busiest day of the week, and that the resulting user benefit would be greater than that to be derived from BA adding a service on what must by definition be one of the two weakest days of the week. Virgin produced no evidence to support its suggestion that Friday outbound and Saturday inbound were in fact the busiest days of the week, referring only to its experience on Johannesburg, but nor did BA produce any evidence to disprove it. Virgin also argued that consumer choice would be widened by its provision of a daylight service on the northbound leg as opposed to the overnight services offered by BA and SAA. BA produced evidence seeking to demonstrate that when it had operated daylight services in contrast to overnight services they had appeared significantly less popular with premium class passengers and had attracted a lower yield from economy class passengers. Virgin countered that the quality of its in-flight product was superior to that of BA and that it believed its daylight service would be attractive to passengers. Indeed the fact that its overall product, including the associated ground facilities, was distinctly different from that offered by BA also meant that consumers would benefit from a choice which would be absent if BA were to be awarded the additional frequency.

25. In considering these arguments, it seems to the Authority that any short term benefits to users arising from differences between the two service proposals would ultimately be reflected in the value that consumers are expected to attach to them. This in turn would feed through to the numbers of passengers expected to use the

respective services and the price they would be willing to pay for the service. Ultimately these factors would be reflected in the profitability of the two proposals.

26. Neither airline challenged the other's traffic or profitability forecasts, and the Authority has no reason to believe that they are unachievable. Whether or not Virgin's proposed service will operate on what are currently the busiest days of the week, it forecasts that it will carry significantly fewer passengers than BA forecasts for its sixth weekly service and at a lower seat factor. This is not what one might expect if the days of the week on which Virgin proposed to operate were suffering from significantly greater unsatisfied demand than those days on which BA proposed to operate.

27. Virgin's forecast average yield for its Cape Town service was rather lower than that forecast by BA for its sixth weekly frequency. Virgin argued that this demonstrated that Virgin would be offering lower fares than BA, to the benefit of users. As BA argued, however, it is possible that differences in traffic mix between the two carriers, with BA carrying a higher proportion of business traffic, might account for at least some of the difference. BA also pointed out that its own daylight services had attracted lower economy class yields than its overnight services. Ultimately, it seems to the Authority that the average yield forecast for a service does not necessarily help in identifying where relative user benefits lie. Virgin argued that its lower average yield implied lower average fares and thus greater user benefits, presumably on the basis that consumer surplus would be greater. On the other hand, a higher average yield might simply reflect a higher value being attached to the service. Alternatively, it might reflect the ability of an airline to exploit market power. In the absence of compelling evidence pointing in either direction, the Authority cannot place great weight on differences in average yield in determining where the balance of user benefit might lie.

28. The Authority also finds it difficult to conclude that the entry of Virgin to the non-stop London/Cape Town route would of itself necessarily result in a significant reduction in fares compared with the alternative, BA. The Authority agrees with Virgin that, in general, the entry of a third carrier to a route previously served by two carriers acting as a duopoly can often result in price competition to the benefit of users. This is in line with the Authority's observations and published views, particularly in respect of international routes within Europe. In order to provide effective competition, however, it is often important that the new entrant is able to mount a level of frequency which is at or close to that of the incumbents. In this case, however, there is only one additional frequency available. The Authority accepts BA's evidence that to the extent that published fares in the London/Johannesburg market have changed since Virgin's entry, these changes have generally been mirrored in the London/Cape Town market. This lends some weight to its argument that the impact of Virgin's entry to the Johannesburg market has already been felt in the Cape Town market, and that the scope for further impact may therefore be muted. While the Authority does not doubt that Virgin's entry to the Cape Town route would be likely to produce some new pricing initiatives, it cannot conclude that any user benefits arising therefrom would necessarily outweigh the benefits which would arise from the addition of BA's significantly greater capacity.

Industry Structure and Competition

29. The Authority does not regard this case as one where the structure of the UK industry is a significant issue. As it stated in its Decision on the Tokyo case in 1991 (Decision 1/91), the Authority's commitment to maintaining a multi-airline industry could not imply any presumption that smaller airlines would automatically be given preference over BA regardless of the merits or otherwise of doing so in individual cases. The Authority does not dismiss Virgin's contention that if the benefits of competition are to be realised, then competitors must be allowed to enter a market. But it is clear that the Authority must weigh the benefits to be derived from introducing competition per se against the merits of particular proposals in terms of users benefit. It cannot therefore agree with the AUC's apparent view that the short term interests of users should be sacrificed simply in order to introduce competition without regard to the merits of the particular case.

The Bilateral Position

30. The basis of the Authority's proposal to vary BA's and Virgin's licences was the notification from the Secretary of State that a situation of scarce bilateral capacity had arisen, and his accompanying advice as to the nature of the problem. This included advice on the current bilateral arrangements between the UK and South Africa to the effect that there was a single additional frequency available for allocation to one of the two UK airlines wishing to take it up. There has never previously arisen a circumstance in which the nature of the bilateral agreement has changed between the date of the Authority's proposal to vary licences pursuant to a notification of scarce bilateral capacity from the Secretary of State and the date of its decision. If the bilateral circumstances were to change materially at any point during that time, the Authority would expect to receive advice from the DETR to that effect.

31. In giving evidence at the hearing, Virgin reported to the Authority that the South African authorities had indicated a willingness to amend the bilateral arrangements so as to allow UK airlines in effect to operate two services for each single frequency permitted under the bilateral agreement provided that the aircraft used on those services had a maximum capacity of 250 seats. Virgin asked the Authority to take this offer into account in reaching its decision. However, the Authority does not see that it is able to do so. Although of course the Authority does not doubt the evidence put before it by Virgin, the responsibility for negotiating bilateral air services arrangements on behalf of the UK rests with the DETR. The Authority has received no advice concerning the bilateral position other than that on which its original proposal to vary licences was based. Indeed if it were to receive new advice which materially changed the nature of the scarce capacity which the Authority was required to allocate between UK airlines, then it would be difficult to see how the Authority could reach a decision on the matter without at least giving all parties to the hearing the opportunity to give fresh evidence and perhaps making a new licensing proposal. However, since the Authority has received no new advice from DETR concerning the bilateral arrangements, it sees no alternative to taking a decision based upon its existing proposal and the evidence before it.

Conclusion

32. The Authority agrees with BA and Virgin that the primary issue to be decided in this case is which of the two airlines' proposals offers users the greater benefit. It is clear that the UK/South Africa air services market is growing strongly and that either airline would be able to use the single additional frequency which is available to offer a high-quality and economically viable service. While the Authority accepts that there are likely to be benefits arising from the introduction of competition from Virgin on this route, the weight of evidence in this case appears to support the view that the greater user benefit would arise from allowing BA to add a sixth weekly frequency to Cape Town.

33. The Authority therefore concludes that the reasonable interests of users will be better served by BA taking up the single additional frequency available to serve South Africa in preference to Virgin. This conclusion rests on an expectation that BA will deliver the service it has proposed in its case to the Authority. It is of course hoped that further opportunities for UK airlines to serve the UK/South Africa market will become available in the near future. However, should these opportunities not materialise, then any significant delay in the implementation of BA's plans to take up the additional frequency might be regarded as grounds for the Authority to reach a different conclusion.

DECISION

34. The Authority withdraws its proposal to vary route licence number 1B/10 held by British Airways Plc.

35. In accordance with its proposal, the Authority hereby varies the route licence number 1B/35 held by Virgin Atlantic Airways Ltd by adding the following condition:

“Virgin Atlantic Airways shall not operate more than 7 flights a week in each direction between the UK and South Africa for so long as the total number of flights which may be operated between the UK and South Africa by UK airlines in any one week is limited to 26 in each direction.”

36. 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 24 September 1998.

G J Elsbury
For the Civil Aviation Authority
18 September 1998