



DECISION ON SCARCE CAPACITY ALLOCATION CERTIFICATES

**SCAC
1/09**

**Applications BA/SCAC/1 by British Airways Plc and BMI/SCAC/1
by British Midland Airways Ltd (trading as bmi) in respect of the
route London–Kiev heard on 18 December 2008**

Panel

Chairman: Dr H Bush CB
Mr R Mountford
Mr R Jackson

Adviser: Miss H Watson

Secretary: Mr G J Elsbury

Applicants

Applicant: British Airways Plc, represented by Mr Robert Lawson,
Counsel

Witnesses: Mr Colm Lacy, Manager Network Development

Applicant: British Midland Airways Ltd (trading as 'bmi'), represented by
Mr Richard Venables, Solicitor

Witnesses: Mr Nigel Turner, Chief Executive Officer
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SUMMARY

1. This hearing was convened to decide how to allocate the capacity available on the London–Kiev route between qualifying carriers from 29 March 2009. British Airways is already operating seven services per week on the route, and had applied to operate 12 services per week. bmi had applied to operate seven services per week, but in its written and oral evidence subsequently amended this to five services per week.

THE NOTIFICATION BY THE SECRETARY OF STATE

2. On 20 October 2008, the Secretary of State, in exercise of his powers and duties under regulation 4 of The Civil Aviation (Allocation of Scarce Capacity) Regulations 2007 (“the Regulations”), gave notice to the Civil Aviation Authority (CAA) that, in his belief, a situation of scarce capacity would exist within six months as regards the traffic rights available on the route between London and Kiev (London is defined in this case¹ as Heathrow, Gatwick and Stansted Airports). Accordingly, the Secretary of State asked the CAA to allocate the capacity available on the route between London and Kiev between qualifying carriers from 29 March 2009 in accordance with the Regulations.

THE NOTICE

3. Following the notification from the Secretary of State, qualifying carriers, as defined by regulation 2 of the Regulations, wishing to operate services on the route were invited to submit applications for a scarce capacity allocation certificate pursuant to regulation 10. This notice, published in the CAA’s Official Record Series 2 on 21 October 2008, 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 such that the number of services operated on the route from 29 March 2009 should not exceed 12 services each week in each direction. The maximum number of flights that may be operated by each carrier would be determined by the CAA in accordance with regulation 9 of the Regulations.

APPLICATIONS

4. British Airways Plc (“BA”) applied for a scarce capacity allocation certificate to allow it to operate 12 services each week in each direction on the route from 29 March 2009 (the start of the IATA summer season 2009).

5. British Midland Airways Ltd (trading as bmi) (“bmi”) applied for a scarce capacity allocation certificate to allow it to operate seven services each week in each direction on the route from the start of the IATA summer season 2009.

6. In accordance with regulation 10, the CAA published these applications in its Official Record Series 2 on 11 November 2008 and invited objections or representations.

¹ This definition derives from the most recent Memorandum of Understanding between the aeronautical authorities of the UK and Ukraine signed on 11 September 2008.

OBJECTIONS AND REPRESENTATIONS

7. BA objected to bmi's application and bmi objected to BA's application. No other objections or representations were received.

8. Both applicants exercised their right to be heard under regulation 13. Pursuant to this regulation the CAA held a hearing on 18 December 2008.

THE CAA'S STATUTORY DUTIES

9. Section 7 of the Civil Aviation Act 1982 allows the Secretary of State to establish certain functions as prescribed functions of the CAA and to make Regulations governing the conduct of the CAA in carrying out such functions. Regulation 8 of the Civil Aviation (Allocation of Scarce Capacity) Regulations 2007 provides that the function of allocating scarce capacity on a capacity constrained route is a prescribed function of the CAA for the purposes of Section 7(2) of the Act. Further, it provides that the function of deciding to grant, refusing to grant, revoking or varying (otherwise than on the application of the holder) a scarce capacity allocation certificate is also a prescribed function of the CAA.

10. 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 relevant objectives of the CAA for the purposes of allocating scarce capacity.

11. Part 4 and Annex 9 of the Official Record Series 1 set out the manner in which the CAA will set about allocating scarce capacity in accordance with regulation 9. Annex 8 sets out the related CAA procedures.

TERMS OF THE UK–UKRAINE AIR SERVICES AGREEMENT

12. The Secretary of State's notification to the CAA is triggered in this case by the terms of the Air Services Agreement (ASA) concluded between the UK and Ukrainian Governments in September 2008. With regard to the London–Kiev route it was agreed that airlines on each side may operate up to 12 services per week with effect from the IATA summer 2009 season (increased from 10 at present). The ASA also provides for up to seven services per week to be operated on each other route between the UK and the Ukraine (including routes that served either London or Kiev).

13. British Airways currently operates seven services per week between London (Heathrow) and Kiev.

14. Advice from the Secretary of State received on 20 November 2008 set out that the UK side made it clear in the talks leading to the conclusion of the ASA that it would prefer a more substantial relaxation of the current limits on the London–Kiev route. The Ukrainian side explained that it was not able to agree to this at the present time. The Memorandum of Understanding signed at the talks records that the two delegations agreed to consider an increase to 14 services per week or more on this and other routes during the next round of consultations, to be held within twelve months. The Department for Transport aims to follow up on this commitment. However, its expectation is that no further increases in capacity on the London–Kiev route will be achievable before 2010 at the earliest.

SUMMARY OF EVIDENCE PRESENTED

15. This section of the decision document provides brief factual summaries of the case presented to the CAA by each of the parties. These summaries are not exhaustive. Substantive points in relation to the CAA's views on the arguments put forward are not covered here, but later in this decision.

British Airways' case

16. The central case presented by BA was that it would be able to offer passengers the frequency benefits from operating a double daily service on five days of the week. BA submitted that it had 10 years' experience on this route and was therefore best placed to develop it further. BA stated that the introduction of an extra competitor on the route would generate no additional consumer benefit, since introducing additional capacity on the London–Kiev route would in itself result in downward pressure on prices whoever received the additional frequencies.

17. BA noted that the additional services it planned to offer would improve connecting possibilities with its domestic services (currently flights from Heathrow to Kiev in BA's winter schedule are too early to allow connections from domestic flights). BA stated its intention to increase the amount of cargo carried on this route should it receive the additional frequencies. It currently has excess demand for cargo capacity, which is being accommodated by transporting the additional cargo overland to Leipzig in Germany and then onwards by air. BA said that it would also be able to carry mail² should it receive the additional frequencies, which was not possible with its current services. BA stated that its proposed schedule with the new services would be aimed at prime times for business and leisure passengers. For the winter season BA proposed a phased introduction of the five additional frequencies beginning with three in winter 2009/10 and adding the fourth and fifth frequencies in subsequent winter seasons. BA saw this as a sensible response to the seasonality of demand in the market.

18. BA's view was that the business traveller was not primarily motivated by price. The benefits accruing to these travellers from BA's proposals would therefore come from the increased frequency and BA's service. For the leisure traveller, it was of the view that these passengers would benefit from lower fares as capacity was increased and prices reduced to fill this. BA planned to draw on its network connections to help fill the additional capacity in the short term while the point-to-point market was growing.

19. BA's view on market definition is set out in more detail in the section on market definition below. BA claimed that there would be no benefit from introducing an additional competitor on the route, as it already faced competition from Ukraine International Airlines (UIA) and Wizz Air. BA argued that a greater benefit to the user would arise from increasing the choice of services available from the same carrier. BA pointed to a promotional fare that it had introduced on the day of the hearing (18 December 2008), of £198 return, which it said was a direct response to the start of Wizz's operations from Luton.

20. BA considered that it faced competition from other carriers offering services indirectly from London via other European hubs. It thought that the Kiev route displayed the characteristics of a route where indirect services would be seen as an

² References to 'cargo' should be taken to include mail unless otherwise stated.

acceptable substitute for all passengers. BA also argued that its product was superior to bmi's, and cited evidence in support of this from the SKYTRAX World Airline Star Rating programme. BA contended that bmi's fare proposals were little different from its own and that bmi's proposed lower introductory fares would not endure. BA stated that it would be able to make more seats available in lower fare brackets as well as utilising tactical promotions to price competitively to fill the increased capacity should it be awarded the additional frequencies. BA stated that, unlike bmi, it was already established on this route and would not incur any significant start-up costs in providing the additional services, but rather would be able to use its local assets in Kiev more efficiently.

21. BA argued that bmi's projections for its services on the London–Kiev route were questionable, as was its track record in sustaining new services. Further, it argued that changes in bmi's ownership led to uncertainty as to whether the additional services would be brought into operation and maintained (either because they would not fit the strategy of Lufthansa as its new parent company or because Lufthansa would see these services as competing with its own, indirect, offering).

bmi's case

22. bmi presented its proposals for entry onto the Kiev route as part of its 'mid-haul' strategy. bmi's main argument was that the greatest benefit to consumers would flow from introducing additional competition on the Heathrow–Kiev route. bmi pointed to recent examples of its entry onto other routes in competition with BA, where the market had grown and fare levels had been reduced. It suggested that giving the user a choice between two Heathrow carriers would bring end-user benefits, as carriers would need to compete to attract business. bmi thought that the user would benefit from an immediate increased choice of price, product and schedule, and that a new entrant would be more likely to encourage innovation and the offering of a competitive fare structure in the future, amongst all carriers.

23. bmi's application was amended from seven services per week to five services per week, as it said that it recognised that, were bmi's original application to be granted, this would involve the withdrawal from BA of two of its seven current weekly services, and that it did not wish, at this stage, to make a case for this substitution. bmi did, however, make clear that seven services per week was its ideal, and that if it were successful in its application for five frequencies, it would seek to increase frequency to daily should additional frequencies become available under the ASA. bmi did not think that entry onto the route with a frequency of less than five services per week would be economically viable, and that it would not therefore take up any award of fewer than five frequencies. bmi proposed to run a year-round operation including all five frequencies in the winter season. It pointed to UIA's relatively high load factor in the winter months as evidence that the winter market could be tapped into.

24. bmi stated that its Star Alliance membership made it better placed to offer an attractive combination of price and alternative schedules to passengers who would be able to travel via an intermediate hub (such as Frankfurt, Munich or Vienna) on one leg of their journey. bmi claimed that its product was at least equivalent to BA's; it was unfamiliar with the SKYTRAX World Airline Star Rating programme produced as evidence by BA at the hearing but suggested it might not be representative of its 'mid-haul' product, which offered 2+2 seating and greater seat pitch in business class. bmi set out its proposals for connections to the UK regions, which would be possible in both directions with its proposed schedule. bmi forecast growth on the route and that it would both capture passengers currently travelling indirectly and stimulate new passengers to the market.

25. bmi proposed fares in both business and economy cabins that were significantly below BA's. Although it labelled its lower business fare as "promotional", at the hearing it said that when these fares expired it was bmi's normal policy to replace them with fares which remained competitive (citing the example of Moscow where current business fares were very similar to those at launch). In bmi's view genuine competition produced fare reductions and stimulated the market. bmi also proposed to offer competitive fares from the UK regions, in competition with those offered via continental hubs as well as via London.

26. bmi observed that prior to the hearing BA had not made any concrete proposals to change existing fares, other than a broad observation that where supply was constrained the addition of capacity would lead to lower fares. In addition, there was no evidence prior to the hearing that BA had responded to Wizz's entry to the market. bmi questioned BA's commitment to the London–Kiev route. BA had not taken up in full previous opportunities to increase capacity on the route, such as the three-frequency headroom available under the ASA or operating bigger aircraft.

27. bmi's view was that bringing a new carrier onto the route would sharpen the responses of UK carriers, enabling them to compete more effectively with other airlines. It also argued that this increase in capacity was an opportunity to introduce a competitor on a route where available capacity is likely to be restricted for the foreseeable future, arguing that should the frequencies be allocated to BA then a future new entrant seeking to use newly available frequencies would face the challenge of competing against a BA service of up to 12 per week.

STRUCTURE OF THIS DECISION DOCUMENT

28. 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 relevant 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. Guidance on how the CAA interprets regulation 9 can be found in Official Record Series 1 Part 4 and Official Record Series 1 Annex 9, and this is referred to where appropriate. 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.

ANALYSIS

Summary

29. bmi had applied to operate five services per week on the route, and confirmed that it would not take up an award of any fewer than this. BA had applied to operate 12 services per week (an increase from seven services per week operated at the time of the application).

30. The CAA has considered the arguments presented by both parties in their written evidence and those presented at the hearing. It is the view of the CAA that, on balance, the grant of the five available frequency rights to bmi (with BA granted the remaining seven frequency rights that they currently operate) would best facilitate achievement of the objectives set out in regulation 9 of the Regulations, which governs the CAA's allocation of scarce capacity. The reasons for this decision are set out below.

31. In summary, the CAA is of the view that the introduction of an additional competitor onto the route will be likely to deliver more benefits to end users than the granting of the capacity to the incumbent. bmi considered that the introduction of competition from its services was more likely to achieve benefits to users over time. BA's main argument in support of its application was that additional consumer benefit would come not from introducing another competitor to the route, but from allowing BA to introduce a double-daily service on five days per week; additional capacity on the route in itself would be the key, over time, to maintaining downwards pressure on fares.

32. The CAA considers that, in general, competition is the best available mechanism to ensure that the user has a choice of product and services, that quality of service is maintained and that fares are set at reasonable levels in relation to cost. In a situation where bilateral constraints prevent carriers offering all the services that they wish to provide, the CAA has to make a choice between carriers. The balance of benefits between, on the one hand, introducing (or fostering) competition, and on the other hand, allowing a single carrier (which may, according to how the market is defined, be in competition with additional carriers) to build capacity will vary depending on the case in point. The CAA is of the view from the evidence presented either supporting or refuting this in this case that adding a direct competitor on this route would yield consumer benefits over and above those that would be generated by the addition of the capacity rights alone, as it would add to competition and increase the likelihood that these capacity rights are used in an efficient manner.

33. BA argued that it already faced competition from other carriers; however there is only very limited evidence of this acting to affect its behaviour to date. BA argued that, in addition, benefits would flow from the increased flexibility it would be able to provide through increased frequency of service. However, BA did not make the case that the increase in flexibility offered would be substantial, since under the schedule it proposed (albeit that it would like to change this at some point in the future) the flight timings of its current and proposed future services were similar. The CAA is therefore of the view that BA's proposals are not sufficiently different in terms of schedule benefits to make this a conclusive argument in this case.

34. bmi argued that it would have more commitment to developing the route than BA, and saw this route as important in the context of its 'mid-haul' strategy. BA does have a track record of developing the route over time; however, while it has had opportunities to continue to develop capacity on the route further, it had not taken full advantage of these opportunities, although it had offered explanations as to why this was the case. Whilst some doubt was raised by BA as to the sustainability of bmi's operation of the proposed services, the CAA has no firm evidence before it that bmi will not operate them. bmi gave an assurance at the hearing of its commitment to the route, as part of bmi's overall strategy, and that its plans have been endorsed by its prospective new parent. bmi's proposals do appear to be part of a coherent route structure, covering 'mid-haul' routes. The CAA is therefore of the view that there appears to be no material distinction between the carriers in terms of the likelihood of their actually bringing the new frequencies into operation in line with their proposals, should they be awarded them.

35. The CAA has therefore concluded that, on balance, the introduction of a further carrier on the London–Kiev route would be more likely to offer choice and lower fares and lead to the development of the route to the benefit of consumers.

Market definition

36. Paragraph 9 of Official Record Series 1 Part 4 states: “The manner in which the CAA will set about allocating scarce capacity in accordance with regulation 9 is to assess how best to maximise economic efficiency. 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 this analysis, the CAA will take into account the effect on competition of the proposed services. This will include considering to what extent an award of scarce capacity would affect rivalry in all the relevant markets, using standard competition analysis and having regard to the Office of Fair Trading’s relevant published guidance and guidelines. Any detrimental impact on competition will then be weighed against the benefits which would arise from awarding the scarce capacity to the relevant carrier.”

37. In the context of scarce capacity allocation, consideration of market definition (usually the first step in identifying the competitive constraints faced by a supplier and assessing market power) is important to assessing the market position that each party is likely to hold in the case of the different proposals under consideration, and the consequent effects of this on, for example, the extent to which benefits will flow to the consumer. Neither party offered a quantification of the benefits its proposal was intended to achieve. In this case the CAA has not sought to prepare a monetised analysis of the costs and benefits that would accrue to airlines and users in terms of quantifying such elements, but has undertaken a comprehensive assessment of the arguments and evidence brought forward by the two applicants, based on a largely qualitative evaluation of the likely alternative outcomes.

38. In line with OFT guidelines³, the CAA has in this case decided that it is not necessary to define the market uniquely; but, instead, that it is sufficient to focus on the issues most relevant to the case (such as the competitive constraint exercised by the services under consideration), and exclude those that are not.

39. Data available to the CAA for the purposes of considering the relevant market(s) showed the proportions of traffic travelling (a) in business class or economy class; (b) for business or leisure purposes; and (c) via direct or indirect services. Some of the data were based on a sample of passengers or sales via travel agents only.

40. BA’s view was that the relevant market was all passengers travelling on services from all London airports (which in this context included Heathrow, Gatwick, Stansted, Luton and London City) to Kiev, travelling both directly and indirectly. BA stated that its network strategy was based on ‘London’ airports overall and that it believed consumers shared this view and would be more influenced by where they lived, or the total end-to-end journey time, than the specific airport offering. It argued that its current Heathrow–Kiev service already faced competition from Ukraine International Airlines (operating from Gatwick), which, it pointed out, carried a similar number of London–Kiev passengers to BA, and from Wizz (which had just begun services from Luton). There was therefore no need for the introduction of another carrier onto the route to provide a competitive constraint. BA argued that it also faced competition from indirect services from London via other European hubs.

41. bmi’s view was that although there was some competition from services from other London airports (which bmi accepted could be seen as in the same market),

³ Market Definition: Understanding Competition Law, OFT 403, 2004.

there would still be benefit in introducing 'head-to-head' competition on the Heathrow–Kiev route. It also thought that there was still some relevant differentiation between passengers travelling for business and leisure purposes, and between passengers travelling directly and indirectly.

42. Both parties agreed at the hearing (and the CAA concurs) that a distinction between those travelling in business and leisure cabins was not an appropriate means of defining relevant markets in this case. Both parties agreed that a distinction could be drawn between time-sensitive passengers and other passengers in that the former are more likely to view a narrower range of services as reasonable substitutes. BA argued that time-sensitive passengers were not necessarily those travelling for business purposes or in the business class cabin. BA saw passengers more as a continuum, with different drivers for different passengers, but with enough common ground at any point on the continuum to make it inappropriate to group them into separate markets. There was, therefore, not necessarily a business/leisure class or purpose-of-travel distinction.

43. The CAA accepts that passenger types will range along a spectrum and that hard and fast divisions are not always possible or helpful. The important question is the extent to which the likelihood of passengers trading up or down the fare ladder, or trading off other factors such as journey time, the convenience of travelling direct etc, provides a competitive constraint on airlines.

44. BA drew attention to the proportion of London–Kiev passengers travelling indirectly (around 12%), and that a significant proportion of these were travelling in business class. It suggested that passengers' acceptance of indirect options increased with a journey time of more than 3½ hours, low frequency of direct services and/or alternatives with short connecting times (which, it argued, was the case here). It concluded that this signified that indirect services were seen as a substitute for direct services and therefore acted as a competitive constraint on its activities.

45. The CAA considers it likely that passengers travelling between London and Kiev for leisure purposes will, in general, not be as time sensitive as those travelling for business purposes, but will be more price sensitive. Price sensitive passengers such as these are therefore more likely to consider services from other London airports, and indirect services involving a change of aircraft en route, as satisfactory substitutes. However, there was not sufficient evidence that, even taking into account product differences, the strength of passenger substitution between these alternatives is sufficient to result in BA facing competitive constraints such that the addition of a competitor would not deliver benefits.

46. The CAA notes the number of passengers, particularly those travelling in business class, travelling indirectly. However, the CAA is not convinced that this can be considered as evidence that indirect services are necessarily suitable substitutes for direct services for a substantial proportion of passengers. It considers that other factors, for instance the high load factors on the direct services (which BA acknowledged was creating 'spillage' to indirect services) could be causing more passengers to travel indirectly than would otherwise be the case. Further, it may be that passengers travelling indirectly value the alternative schedules that indirect services can provide compared with BA's once-daily service. The published fare levels of indirect carriers are noticeably lower than those of BA's direct service, and bmi pointed out that this might also be an influencing factor. BA agreed that it was able to charge a premium for direct, as opposed to indirect, services; it considered this was due to direct routes commanding a premium over indirect routes, and that it

could also be a reflection of BA's service offering. The CAA questions whether time-sensitive passengers, for example those travelling for business, would be inclined to regard a significantly longer journey time as a satisfactory substitute were there a suitable direct service. It appears that a distinction can be made for those passengers who are time-sensitive, who are less likely to consider indirect services as a satisfactory substitute for direct services.

47. BA claimed that all London airports were in the same market and that it faced sufficient competition already from Ukraine International Airlines operating from Gatwick and Wizz from Luton. However, BA produced no compelling evidence of this. UIA's fare levels are substantially lower than BA's, particularly in business class, with an even greater distinction for Wizz's. The only evidence BA presented of it reacting to competition from these carriers was the short-term promotional leisure fare introduced (on the day of the hearing) in response to Wizz's entry. It appears that a significant proportion of passengers view BA's offering at Heathrow as being sufficiently different from that offered by UIA at Gatwick to support a significant, and non-transitory, differential in fares, particularly for business class services. This suggests that there are significant factors, relating to either passenger preferences for Heathrow or the product offered by BA, that are likely to affect the degree of competition faced by BA at Heathrow. This implies that the addition of a broadly comparable service offering at Heathrow will have a greater competitive impact than the addition of a similar service at a different airport, or of a different service offering at Heathrow.

48. No evidence was presented to suggest that either the carriage of cargo on London–Kiev passenger services represented a significant separate product dimension of the market; or that the geographic dimension of the market should be widened to include services offered from points in the UK other than London. Neither of these considerations appeared sufficiently material to the overall analysis of the market definition and subsequent consideration of economic benefits generated from the two parties' proposals, to require further examination.

49. In conclusion, although the CAA does not see it as necessary to define 'the market' uniquely in this case, it is of the view that:

- in respect of passengers sensitive to price more than time (probably predominantly those travelling for leisure purposes), it is more likely that there is a significant competitive constraint exercised on BA's current Heathrow–Kiev services both by direct services operated from other London airports (Wizz from Luton and Ukraine International Airlines from Gatwick) and by carriers offering an indirect routing from London to Kiev. However, whilst this constraint may be significant, a combination of service offering and airport-related factors mean that these services may not be very close substitutes for all of these passengers;
- in respect of time-sensitive passengers, these other services may offer some alternative, although probably to a lesser degree, but there is no compelling evidence that BA's behaviour at Heathrow is significantly constrained by these services. Where passengers use those other services in lieu of a BA flight, this appears more likely to be because of a more convenient schedule, more convenient airport, or simply BA flights being full at peak times – a result of artificial constraints in the market – rather than passengers actively choosing to switch because of competitive prices and/or product offerings.

50. Overall, therefore, the nature of the market appears to be such that there are unlikely to be sufficient constraints on BA's behaviour such that the CAA can discount the potential for an additional competitor significantly to increase competition for either group of passengers. This is particularly the case for time-sensitive passengers, who face fewer reasonable substitutes than non-time sensitive passengers.

Consumer benefits

Capacity proposals

51. As noted in paragraph 36, the CAA's 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 users from each proposal. Neither party offered a quantification of the benefits its proposal was intended to achieve. Given that the Regulations only have effect in the UK, the public demand to be satisfied and the reasonable interests to be furthered are those of consumers originating in the UK. As well as UK-originating passengers, these consumers may also include those who, directly or indirectly, are involved in related markets, for instance cargo shippers.

52. Both applicants have proposed services from Heathrow with similar aircraft types and timing, aimed at catering for those travelling for business and leisure purposes and for cargo shipments. The CAA is of the view that there does not appear to be a significant difference between these proposals in terms of the capacity offered, on the evidence available, except in terms of winter frequency during the first two years, where bmi would utilise all available frequencies immediately whereas BA would phase them in.

53. Neither carrier was able to give a breakdown of its future passenger forecasts in terms of the split between different types of passenger, although bmi did break down where it expected growth to come from (ie overall market growth, substituting for other carriers, stimulating the market). bmi said that it would seek, over time, to change the mix of those travelling to carry more business passengers. BA said that where necessary it would seek to utilise any spare additional capacity, at least in the short term, by using its network to bring international connectors to the route.

Fares

54. BA did not set out any concrete proposals to change its existing fares should it receive the additional rights. BA said that it has a fares ladder with different offerings catering for different types of travellers, and that this could be adapted if necessary, promotional fares introduced, or inventory control altered, to respond to circumstances.

55. BA argued that the volume of passengers travelling for business was generally determined more by factors such as the general performance of the economy as opposed to airline ticket price, and that this market segment would not therefore be stimulated to a significant extent by price decreases. However, it is important to note that it is the sensitivity to the relative prices between different suppliers that affects the strength of competition, by influencing the propensity for passengers to switch between competing offers, rather than whether a reduction in average fares prompts more passengers to travel overall. Whilst the CAA agrees with BA that business passengers are less likely to be prompted to travel by price, this is not sufficient to

conclude that a significant number will not respond to price competition between BA and bmi.

56. Indeed, the available evidence suggests that market entry has prompted some response by BA. For the leisure market, BA had, on the day of the hearing, introduced a promotional leisure fare of £198 return (£129 single), in response to Wizz's entry into the market from Luton. However, apart from this, BA did not provide evidence that it sought to compete on fares with other carriers currently operating to Kiev. Furthermore, there was a significant differential in price between the fares offered by BA at Heathrow and both the fares offered by Ukraine International Airlines at Gatwick and by indirect carriers. BA said that its higher price reflected its product and service offering. In addition, BA did not deny that its current fares appeared to be among the highest in comparison with its published fares on other routes of similar lengths. The size and persistence of the fare differential on London–Kiev services suggests to the CAA that these alternatives are not sufficiently close substitutes for BA's offering at Heathrow and therefore that the addition of a direct head-to-head competitor on the route would increase the competitive constraint on BA on the route.

57. bmi proposed a fares ladder that would mirror (with a small differential) BA's in most of the standard fare types, but also featured introductory promotional fares in both cabins some way below those currently offered. bmi confirmed at the hearing that its introductory fares would be time limited, to be replaced by 'competitive' fares, but that the introductory business class fare offered (nearly 20% below the lowest business class fare offered by BA) would be likely to be replaced by a fare at a similar level (as had happened on the Moscow route), and that bmi fully expected BA to respond to this.

58. bmi also set out proposals for fares from the UK regions to Kiev, which would be aimed at competing with the lower fares currently offered by indirect carriers via continental hubs. bmi stated that its intention was to attract passengers currently travelling indirectly via continental hubs both from the UK regions and from London airports. bmi's proposed ex-Kiev fares appeared to be set at a level to compete with Ukraine International Airlines (BA's were somewhat higher than UIA's).

59. BA's central argument in support of its application was that additional capacity on this route – to whomever it was awarded – would itself have the effect of reducing prices overall over time. In addition, it argued that it already faced competition from other carriers operating London–Kiev. However, bmi argued that greater benefits to the end user were likely to occur where that additional capacity was given to a new carrier, thus creating competition that would be expected to deliver benefits as carriers compete to attract passengers, whether by lower fares or other means. bmi cited several examples of routes where it had entered the market, passenger numbers had grown and overall published fare levels reduced.

60. The CAA notes that it is not the fare ladder itself that is the main driver of the average fare paid, but rather the availability of seats at individual price points on the ladder. Therefore, the similarity or not of the fare ladders is not conclusive as to the fares benefits that will accrue to consumers. The CAA also recognises that both cases for delivering benefits presented by the parties have some merit, and that the balance between them will vary on a case-by-case basis depending, amongst other things, on the pre-existing level of competition in the marketplace. In considering which proposal is likely to deliver 'lowest charges consistent with economic return' (as set out in regulation 9 of the Regulations), the CAA recognises that there are no guarantees as to the level, and volume of fares at each level, that will be offered in

the short term and over time. However, on balance, the CAA considers that in the case of London–Kiev the addition of a competing service, at Heathrow and comparable to BA's in terms of quality and onward network, and with the introduction of different fare types and levels (both initially and as the carriers respond to each other's offerings over time), is more likely to result in overall fare benefits to consumers than giving extra capacity to the incumbent.

Schedules

61. bmi gave evidence that it had analysed traffic on different days of the week and selected a schedule that would offer services on days of high demand for both business and leisure travellers. BA argued that the benefits of its application would arise from offering a twice-daily service on five days of the week (which were different days than those chosen by bmi), and that additional choice of service by the same carrier would be a benefit. However, the CAA observes that BA's proposed schedule for the additional frequencies is timed relatively close to its existing services. It does not therefore appear to offer substantial additional choice, and does not allow a day return journey on BA flights alone. BA indicated that it would like to improve its schedule, and would continue to seek to do so, but that this had not proved possible to date due to difficulties in securing appropriate slots at Kiev.

62. bmi's proposal is scheduled close to BA's existing and proposed services, and therefore offers little additional choice of schedule either. However, bmi argued that its Star Alliance membership meant that it was better placed to offer an attractive combination of price and alternative flight times on indirect routings for one leg of the journey (via Austrian or Lufthansa hubs).

63. Neither of the proposals in isolation is likely to offer a complete substitute for indirect services; for example, for the time-sensitive business traveller seeking to complete business in a single day or wishing to travel back to the UK after a full day's business without an overnight stay. These possibilities are available via indirect on-line or interline connections; bmi's proposals allow a combination of direct and indirect routings that would introduce some degree of additional choice and flexibility, potentially at a lower price, beyond what is already available. The CAA concludes that there is no material difference in the parties' proposals for timings in respect of their direct services, and that this is therefore not a deciding factor in this case.

Connections

64. Both parties outlined the connections to domestic services they would offer using the additional frequencies. BA's current winter schedule did not allow regional connections on the outward leg; its proposals would rectify this for the five new frequencies. Both applications are judged as substantially equivalent in this respect.

65. BA confirmed that it would seek to use international connectors to fill up spare capacity, at least while the market develops. bmi set out in its evidence its forecasts for connecting passengers. To the extent that the CAA's considerations focus on benefits to UK consumers, international connecting traffic is likely to be of most importance where it improves route viability. This argument was not presented in the context of the decision in question. Given this, and in the absence of evidence to the contrary, the CAA therefore considers that neither party presented evidence to make its proposals in this area material to this case.

Product

66. BA argued that its overall 'brand' and service offering was superior to that offered by bmi, quoting the SKYTRAX ranking system which puts BA ahead of bmi. bmi pointed out that many carriers, including BA, were happy to put their code on bmi flights under codeshare agreements, implying that they were happy with the product, and that the product the SKYTRAX system had assessed appeared to be an 'average' of all short-haul products including domestic, so the result was not a true reflection of the proposed offering on the Kiev route. bmi cited its 2+2 fixed business class configuration with superior seat pitch as favourable when compared with BA's 3+3 with unused middle seat and flexible moveable curtain.⁴ The CAA concludes that both offerings in terms of the overall product have merit, and that the bmi product would introduce a further element of choice; however, the relative difference or otherwise between the two products is not a deciding factor in this case. The CAA notes, however, that there may be potential for competition on product in the future, particularly in attracting the business passenger.

Cargo

67. Both parties included revenue from cargo operations in their forecasts for use of the additional capacity, including assumptions about both mail and freight. BA argued that it was currently having to divert some available freight carriage, and that the additional frequencies would enable it to carry mail whereas its existing services had not. It forecast higher cargo tonnage per flight than bmi. BA was unable to quantify the proportion of extremely time-sensitive cargo such that the additional services would deliver benefits to UK end-users over and above the existing provision. bmi's understanding was that it would be able to carry mail with an offering of five services per week. The CAA considers that there is insufficient evidence of benefits to UK end users offered by one party over another to make this a determining factor in this decision.

Sustainability

68. The sustainability of the proposals of both parties is considered important by the CAA in ensuring that additional capacity granted would be utilised (constituting 'effective provision') and therefore that benefits claimed by the applicants would be realised in practice. 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".⁵

Slots

69. Both carriers confirmed that they had applied for and secured the necessary slots at Kiev. BA, when questioned about the closeness of the timing of its proposed new schedule to its existing services, indicated that it would in future seek to change the slots to introduce more of a gap in scheduling. It noted, however, that there were constraints at the Kiev end on the ability of UK carriers to overnight aircraft at Borjispol, hence restricting the lateness of outgoing services ex-Heathrow or

⁴ BA's evidence referred to a change to its Club Europe configuration. BA announced this in November 2008 for effect 23 February 2009. BA currently offers a 2+3 configuration and will move to a 3+3 configuration but with the middle seat on each side of the aisle left unfilled.

⁵ 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.

earliness of incoming services to Heathrow. Scheduling times also needed to be compatible with connections at London.

Financial forecasts

70. The applicants were invited to submit forecast cost and revenue information using a pro-forma. bmi provided the pro-forma in full to the CAA and to BA. BA declined to provide a detailed breakdown to bmi, citing reasons of commercial confidentiality, requesting the CAA to consider it on a confidential basis. BA provided bmi with outputs and total profit each year but no cost/revenue breakdown. The CAA's published policy on information is set out in paragraph 9 of Annex 9 to Official Record Series 1, which states that "It should be noted that the CAA will consider all information presented to it that is made available to all other parties to the hearing. This means that the CAA will exclude from consideration any information presented by any party on a confidential basis. The CAA has adopted this policy in order to maximise the fair and transparent nature of the hearing process". It remains the view of the CAA that there is no compelling reason on this occasion to depart from its published policy – a policy that was known to all parties prior to the commencement of this scarce capacity hearing. Therefore, consistent with this clear and established policy, the CAA has excluded from consideration BA's detailed Annex 9 pro-forma, considering only the information provided by BA to bmi.

71. BA, already established on the route, forecast a profit for its proposed operations for each of the first three years. bmi planned to spend £500,000 over three years on start-up costs in the form of marketing and advertising. bmi forecast a loss in the first year of operation, progressing to a total profit for the route (based on five services per week) broadly equivalent to BA's total profit projection by year 3 (based on 12 services per week). BA pointed out that bmi's yields per passenger were forecast to go up; bmi commented that this was due to a forecast change of passenger mix, as it sought to attract increasing numbers of business passengers over time. The CAA regards it as a reasonable assumption that bmi's penetration of higher-yielding market segments such as business passengers would increase over time, for example as it establishes relationships with corporate clients. It is not obvious how bmi would generate this parity in profits, which may indicate either a level of optimism in bmi's forecasts or an understated forecast by BA. However, it is not possible to compare further the yield information and underlying assumptions made by both carriers, due to the confidentiality issues mentioned above. BA declined to disclose the profitability of this route relative to others, and did not present evidence, from its analysis of the information provided by bmi, which fundamentally challenged bmi's forecasts. On this basis, the CAA accepts the figures as best estimates and sees no material difference between the two applications.

Development of the route

72. BA has had some opportunities available to it in the past to develop capacity on the route further but had not done so. There has been headroom of three additional frequencies under the ASA since summer 2006. bmi said it had not sought to operate these as it felt this limited frequency would not be competitive against the existing offerings. BA had introduced a service from Gatwick with these additional frequencies when they became available, but had withdrawn it after one season, as a low frequency service from Gatwick, alongside services from Heathrow, had proved to be unviable. BA claimed that it had not previously been possible to introduce these additional three frequencies from Heathrow because in its view the Kiev slots it had been able to secure would have been 'inoperable' at Heathrow. BA argued, in support of its application, that there was significant 'spillage' on the route –

passengers who would otherwise have travelled with BA having to take alternative routings due to lack of capacity. However, bmi pointed out that BA had not sought to capture this 'spillage', for example by increasing the size of aircraft operating the route.

73. BA's application set out its intention to phase in new winter frequencies, adding three in 2009/10, and one in each of the following two winter seasons, which it saw as a sensible response to a market with considerable seasonality. bmi planned to operate five services per week year-round. It saw this as necessary to present a credible operation at this level of frequency, particularly with BA operating a daily service year-round. bmi also pointed to the relatively high load factors achieved by Ukraine International Airlines as evidence that there was a winter market it could seek to tap into. bmi set out its ambition to operate a daily service on the route, should additional bilateral rights become available to enable this, as foreshadowed by the Memorandum of Understanding agreed at the most recent UK/Ukraine air service talks that gave rise to this scarce capacity situation.

74. bmi saw the introduction of five services per week as a minimum in order to provide effective competition. The CAA accepts the validity of bmi's position in this case. Therefore, bmi noted that should BA be awarded the additional frequencies currently under consideration then bmi would be unlikely to apply should a further few frequencies subsequently become available on the route.

Likelihood of introducing/maintaining services

75. BA argued that bmi had a poor track record in sustaining new services. It offered as evidence the Mumbai route where bmi had previously been granted capacity and then withdrawn services. BA argued that it could therefore not be guaranteed that bmi would continue to operate this route over time if its application were to be granted. bmi queried BA's evidence in this regard and countered with recent examples of mid-haul routes where its entry, in competition with BA, had led to increases in passenger numbers and decreases in fares. bmi saw the withdrawal of services that were no longer profitable as a sensible commercial response, and one which other carriers (including BA) were also likely to make or have made.

76. BA argued that future market developments (Lufthansa becoming majority owner of bmi and a possible future chain of events whereby Lufthansa takes over Austrian Airlines, which already owns 22.5% of Ukraine International Airlines) could ultimately mean that granting the frequencies to bmi would lead to *less* competition in the market. The suggestion was that Lufthansa would not want bmi to compete with its indirect services, and also that the Austrian stake in Ukraine International Airlines would lead to bmi being less inclined to compete with an airline in which a partner had a financial interest. bmi's response was that the Lufthansa strategy was to encourage competition, even within the same commercial family.

77. In relation to BA's argument that the possible future Lufthansa – Austrian Airlines – Ukraine International Airlines ownership structure could lead to less competition, the CAA considers that, even if the speculative chain of events that BA sets out comes to pass, it is unlikely that Lufthansa would have the ability or incentive to implement the strategy that BA contends. First, Lufthansa's (possible future indirect) minority stake in Ukraine International Airlines is unlikely to allow it to exercise control over that airline such that it could implement the strategy proposed by BA. Second, given the CAA's view on market definition in this case, that the services offered by other airlines are not close substitutes for all of BA's current passengers, and given the size of Lufthansa's (possible future indirect) minority shareholding in

UUA, it is unlikely that a Lufthansa-instigated strategy to restrict bmi competing on the route would be profitable as compared with allowing bmi to pursue its stated strategy. In relation to BA's argument that Lufthansa would not want bmi to compete with its indirect services, since fares evidence generally suggests that indirect passengers need to be compensated by lower fares for the inconvenience involved in an indirect routing, the CAA does not consider it likely that Lufthansa would face a significant incentive to sacrifice a higher-yielding direct service in order to divert passengers to a lower-yielding indirect service, particularly as to do so would then provide BA with an opportunity to utilise the available capacity.

78. BA argued that bmi's forthcoming change in ownership would lead to the route being withdrawn. bmi confirmed at the hearing that the London-Kiev route was part of a strategy which had been approved by the bmi Board (which included Directors representing Lufthansa, a long-standing minority shareholder that would now become bmi's parent company), that the approach of the new owners was to encourage bmi as a commercial entity to continue to offer competition, and that this route had specifically been discussed with the new parent's representatives. bmi's Chief Executive stated at the hearing: "I think it [the Panel] can have every confidence that we are going to do it on the basis of what we have done on Moscow; on the basis of what is in the bmi strategy document; on the basis that we have got an extremely strong and supportive shareholder who has ticked the strategy. But ultimately there are no guarantees...".

79. The CAA acknowledges that, in general terms, there may be more risk associated with new entry compared with an incumbent increasing frequency on an existing route. Nevertheless, the CAA regards bmi's plans as a credible part of its mid-haul strategy and notes its intention, clearly articulated by bmi's Chief Executive on the day of the hearing, to operate as it has proposed. While bmi has withdrawn from services granted at the India hearing, it has offered a plausible explanation for doing so, and that single precedent is insufficient reason to lead to a different conclusion in this case. The CAA therefore concludes that it has no evidence in this case to doubt bmi's intentions.

80. bmi countered that there was no guarantee that BA would operate the additional services if granted, as it had not taken up previous opportunities to expand capacity on the route, and its current winter schedule restricted domestic connections. BA replied that it was committed to developing this route, and that it had 10 years' experience of operating it.

81. The CAA concludes that there is no substantive evidence before it that one carrier over the other is more likely to utilise fully and sustain the new frequencies under consideration. It appears to the CAA that the addition of a carrier at Heathrow offering a similar service to BA is likely to provide a stronger incentive on both BA and bmi to make the best use of all of the available capacity rights.

82. In assessing the consumer benefits pertaining to, and the sustainability of, the proposals, as set out from paragraph 52 onwards, the CAA has considered the outcome best calculated to meet the requirements of regulation 9 (3)(a), (b) and (c) of the Regulations.⁶

⁶ Regulation 9 (3) 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

Other considerations

Competition with other airlines

83. 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 are EU carriers established in the UK⁷, which essentially means that it is non-EU carriers that are the 'other carriers' referred to. BA states that a successful application would enable it to compete on a stronger footing (in terms of frequency of service) with Ukraine International Airlines. However, the extent to which there is active competition here currently is not obvious. bmi intends to seek to compete with UIA – for example it is seeking to operate in the winter with reference to the load factors UIA currently secures for that season, and it is targeting its ex-Kiev fares at UIA's traffic. On balance, there does not appear to be a significant difference between the proposals in terms of achieving this objective, and the introduction of competition between qualifying carriers appears to the CAA to be the best way to ensure that they are actively competing between themselves and with others.

Effective use of airports

84. Both carriers agreed that their proposals were equal in terms of meeting regulation 9 (3)(e) - to ensure the most effective use of airports within the United Kingdom.

Effect on existing services

85. 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.

86. The impact on BA of allocating it the additional frequencies would be to strengthen its competitive position and potentially lower its average costs. Were this a thin or newly established route, the arguments for building BA's existing capacity as the incumbent might have been stronger.

87. bmi's original application was for seven services per week, which would have required the substitution of bmi for BA on two of BA's existing services per week. bmi subsequently amended its application so that it was solely for five services per week, i.e. the currently unused three and the two new additional services. As a result, the effect on BA is somewhat different. BA has not argued that the introduction of bmi on the route at five services per week would make its service untenable (as it was arguing when the bmi proposal was to substitute for two of its services). The impact on BA of granting bmi the additional capacity would therefore appear to be one of

interests of users of air transport services; (c) to secure the effective provision of civil air transport to and from the United Kingdom.

⁷ See The Civil Aviation (Allocation of Scarce Capacity) Regulations 2007 for a full definition.

introducing competition, which is likely to provide a challenge to the incumbent, but which will in the view of the CAA be likely to have a positive effect from the point of view of end users.

88. In terms of other qualifying carriers currently operating – Wizz from Luton and carriers offering indirect connections from the UK generally – the effect will again be to introduce further competition and more capacity to the market, whichever of the proposals by BA or bmi is selected.

89. In terms of having regard to ‘any benefits which may arise from enabling two or more airlines to provide the service in question’, BA argued that there was already sufficient competition, and that additional capacity of itself would deliver benefits. As set out in more detail in the Consumer Benefits section above, the CAA takes the view that, on balance, in this case, granting the additional frequencies to bmi and therefore introducing an additional competitor, introducing the number of carriers competing ‘head-to-head’ on the route from one to two, will enhance competitive pressures to a greater degree and will be more likely to deliver benefits to consumers than granting the additional frequencies to BA as the incumbent.

Environment

90. 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. Both carriers agreed their proposals were equivalent in this respect.

Advice from the Secretary of State

91. The CAA has had regard to the advice received from the Secretary of State (as provided for in regulation 9 (6)) on 20 November 2008. 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 to affect the CAA’s decision.

THE DECISION

92. Pursuant to the reasoning set out in this document, the CAA therefore decides to grant scarce capacity allocation certificates as follows:

- to British Midland Airways Ltd (trading as ‘bmi’) for the operation of five services per week in each direction on the route London-Kiev
- to British Airways Plc for the operation of seven services per week in each direction on the route London-Kiev

G J Elsbury
For the Civil Aviation Authority
January 2009