



**UNITED KINGDOM
CIVIL AVIATION AUTHORITY**

DECISIONS ON AIR TRANSPORT LICENCES AND ROUTE LICENCES

3/99

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 25 October 1999.

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 & Industry Affairs, British Airways Plc

Witness: Mr J Wood, Director Commercial Policy and Planning, British Airways Plc

Objector: Virgin Atlantic Airways Ltd, represented by Mr C Haddon-Cave QC, Instructing Solicitor, Miss J Durham, Virgin Atlantic Airways Ltd

Witnesses: Mr R Branson, Chairman, Virgin Atlantic Airways Ltd
Mr M Siladi, Head of Asia Pacific, Virgin Atlantic Airways Ltd

SUMMARY

1. This hearing was convened to decide how to allocate the third and fourth weekly frequencies available for UK airlines to serve Shanghai under the UK/China bilateral air services agreement. Virgin Atlantic Airways already operated two services a week between London Heathrow and Shanghai, and both it and British Airways wished to take up the two additional frequencies which became available to the UK from the start of the Summer 2000 season. The Authority has concluded that its statutory duties would be best served by awarding both frequencies to Virgin, thereby allowing it move to four services a week to Shanghai. It believes that this will best promote competition between British airlines and with foreign airlines to the benefit of users of air services.

THE NOTICE

2. On 27 September 1999 the Secretary of State, in exercise of his powers under Regulation 3(5) of the Civil Aviation Authority Regulations 1991, gave notice to the Authority that in his opinion, by virtue of provision made by or under the terms of the Memorandum of Understanding concluded on 7 October 1998 between the People's Republic of China and the United Kingdom, the United Kingdom's share of capacity on air transport services between the United Kingdom and the People's Republic of China which may be provided by British airlines would, within 6 months of the date of that notice, be insufficient to enable Virgin Atlantic Airways Limited and British Airways plc to make available all the capacity which they planned to provide. This notice was published in the Authority's Official Record Series 2 on 5 October 1999.

THE PROPOSAL

3. Following the notice from the Secretary of State, the Authority published its proposal to vary the licences of British Airways (1B/10/368) and Virgin Atlantic Airways (1B/35/146) in its Official Record Series 2 on 5 October 1999. After reciting the notice, this proposal stated that:

"2. The Authority is advised by the Secretary of State that under the bilateral arrangements between the UK and the People's Republic of China UK airlines may currently operate up to two services a week on routes between the UK and Shanghai, increasing to up to four services a week from Summer 2000. Virgin Atlantic Airways currently operates two services a week between London and Shanghai. From the start of the Summer 2000 season, Virgin Atlantic Airways wishes to operate two additional services a week between London and Shanghai and British Airways wishes to enter the route with two services a week. The Authority is therefore required to allocate the two additional services a week which become available from the start of the Summer 2000 season.

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 Shanghai by BA and Virgin in any one week shall not exceed 4 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 the 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.

BRITISH AIRWAYS’ CASE

7. This case was very similar to that heard in December 1998 when the Authority had to decide how to allocate the first two weekly frequencies available for UK airlines to serve Shanghai. In many respects nothing had changed, but there was now one major difference. The BA proposal would give users a choice on this route they would otherwise not have. Granting BA the frequencies now available was the only way in which, in the near and medium term future, the Authority could generate direct competition on the London/Shanghai route which would otherwise be absent. Virgin was currently the only carrier operating on the route and there was no immediate prospect of any Chinese airline providing non-stop services. The Authority had clearly established over a number of scarce capacity cases that unless there were strong reasons to do otherwise, it would favour the option which provided additional competition.

8. A secondary consideration to be taken into account was that when the capacity available to UK carriers was agreed at bilateral talks with China in January 1998, it was clearly the intention of HMG and the carriers to achieve a minimum of 2 frequencies for both Virgin and BA. Capacity formed one part of a wider bilateral agreement with China which addressed a number of issues of both a political and commercial nature. BA contributed to the success of the negotiations by making concessions in certain areas at some cost to itself. If BA had known that it would not in fact gain the ability to operate to Shanghai as a result of the agreement, it would have had no incentive to make any such concessions or to provide any other support. In these circumstances, the Authority would need a very strong reason for overturning the intent behind this agreement.

9. BA proposed to operate from Heathrow on Tuesdays and Thursdays, returning from Shanghai on Wednesdays and Fridays, using B777 aircraft with 259 seats. For the purposes of its traffic forecast, it was assumed that China Eastern would commence twice-weekly services during the summer of 2001, although BA believed a 2002 start was more likely. BA forecast passenger carryings of 35,642 in 2000/2001, growing to 41,495 in the third year of operation. The service was expected to move into profit in the second year.

10. In the past the Authority had on occasions been faced with the difficulty of seeking to introduce effective competition in markets where the incumbent airline or airlines would enjoy a significant frequency advantage over any new entrant. Here was a situation where the Authority could avoid any such problem on this route in the future by now awarding the additional frequencies to BA. Virgin was not currently competing against another carrier on this route, and Virgin could not therefore argue that it needed the additional frequencies in order to compete effectively on this route.

VIRGIN ATLANTIC AIRWAYS' CASE

12. As a result of the Authority's Decision 5/98 to award Virgin the first two frequencies to Shanghai, this was the first time that Virgin had appeared at a hearing before the Authority as the incumbent carrier on a route with BA seeking to enter. There were now very strong reasons for Virgin to be awarded the next two frequencies on the route. Allowing it to increase from two to four services a week was crucial to Virgin's development of the route and to the profitability of the route. Indeed it would be damaging to competition in the wider UK/China market if Virgin were not allowed a proper opportunity to develop this route and establish a firm presence. The Authority had itself noted in earlier decisions, notably Decision 3/98 in respect of Cape Town, the importance of increasing frequency in order to serve the business market effectively.

13. Virgin now proposed to add Wednesday and Thursday departures from London to its current Monday and Saturday services, producing a schedule of four services a week using A340 aircraft with 255 seats. At last year's hearing it had forecast that its services would become profitable by the third year of operation, assuming that it were to operate four services a week from the second year, i.e. from Summer 2000. Actual results from the first four months of Virgin's service indicated that the overall market was growing at a slower rate than originally envisaged. There were a number of reasons for this, including the deterioration in the Chinese economy and slow recovery in Asian markets generally. It now forecast that it would incur a loss of over £5m in the first full year of operating four services a week, reducing to losses of £2.2m and £0.3m in the subsequent two years.

14. If, on the other hand, the next two frequencies were awarded instead to BA, Virgin's losses in the second and third years would be higher than this, at £3.5m and £2.3m respectively. Whereas it would expect to be almost breaking even by year three if it were awarded the third and fourth frequencies, there would be no guarantee that it would ever reach profitability if confined to two frequencies. The effect would be to

considerably increase the start-up losses for Virgin and make it much more difficult for either carrier to make a profit in the medium term.

15. It would also significantly increase BA's grip on the UK/China market as a whole to the detriment of competition and industry structure. BA remained the only designated British airline on the route between London and Beijing and, in the absence of any change to the bilateral arrangements, would continue to be so for the foreseeable future. Fairness alone suggested that Virgin should be permitted to increase frequency on Shanghai given BA's protected position on Beijing. But allowing Virgin to increase to four frequencies on Shanghai was also likely to have the beneficial effect for users of encouraging BA to take up more of its entitlement on Beijing in Summer 2000. Conversely, splitting the available UK frequencies on Shanghai between Virgin and BA would have the effect of weakening the ability of Virgin to compete with European carriers flying direct to Shanghai. BA also continued to have an increasingly dominant presence in the Hong Kong market.

16. Virgin argued that the twin grounds of the Authority's Decision 5/98, namely enhancing competition and industry structure, applied with even more force in this case. It submitted the results of market research supporting the contention that the UK/China air travel market should be regarded as one market. It found that only one third of business travellers interviewed made journeys between the UK and one of the three China gateways without visiting any other point in China. Taking China as a whole BA enjoyed a considerable frequency advantage over Virgin, and therefore competition would be strengthened most by awarding the additional Shanghai frequencies to Virgin. As regards industry structure, the continuing need for a relatively small airline such as Virgin to expand its present frequencies in a market as important as the UK/China market remained all the more urgent today as, for instance, the ties of BA and Cathay Pacific in One World continued to strengthen.

17. In terms of user benefit, it was Virgin's contention that it provided users with a product distinctly superior to that offered by BA. It cited the latest IATA survey for Europe-Asia routes and its own survey of business travellers to China as evidence that users valued Virgin's product more highly than that of BA. It also argued that Virgin's entry to the Shanghai route had led to highly dynamic pricing in the UK/China market, leading to reductions in BA's fares to China and an increase in the variety of fares available to the benefit of users. Granting the additional frequencies to Virgin would ensure that these benefits continued.

REPRESENTATION BY THE AIR TRANSPORT USERS COUNCIL

18. The AUC made a written representation but did not appear at the hearing. The view it presented was based solely on its judgement of the balance of consumer interest. In the short term it believed it would make little difference to passengers on this route whether these two frequencies were granted to BA or Virgin. It saw a marginal short term benefit from deciding in favour of Virgin in that passengers holding non-interlineable tickets would have a wider choice of return flights and the attractiveness of Virgin's network would be enhanced. However, it believed this decision turned on the

potential longer term benefit to passengers from introducing competition on the route. If the Authority were satisfied that the route would support both airlines operating twice weekly, the additional frequencies should be awarded to BA in order to provide direct competition. The benefits of such competition would, in the AUC's view, outweigh the marginal short term and wider benefits of permitting Virgin to double its frequency. Although such a decision would carry a risk that Virgin's service would never become profitable and might thus ultimately be withdrawn, it would be reasonable to assume that BA would then pick up the two additional frequencies. The AUC believed that a desire to foster strategic competition between UK airlines should override the establishment of direct competition only if there were very little chance of maintaining that competition. The AUC was therefore in favour of granting the two additional frequencies to BA on competition grounds.

ANALYSIS AND REASONS

Introduction

19. This case naturally bears close similarities to last year's hearing at which the Authority had to decide how to allocate the first two weekly frequencies which became available for UK airlines to serve Shanghai. On that occasion the Authority found in favour of Virgin (Decision 5/98). The bilateral agreement then in place between the UK and China provided for two further frequencies to become available from the start of the summer 2000 season. However, Decision 5/98 was confined to consideration only of how the first two frequencies should be allocated and was without prejudice to any hearings which might be held subsequently in respect of services to Shanghai. Indeed the Authority expressed the hope in Decision 5/98 that future scarce capacity proceedings would be unnecessary. It is regrettable that once again regulatory intervention is required in matters which should most appropriately be left to the commercial judgement of airlines. It is the Authority's firm view that the interests of air travellers and shippers are best met by free competition between airlines subject only to the application of normal competition policy.

20. The policies the Authority pursues in exercising its route licensing functions, including the allocation of scarce capacity, are set out in its Statement of Policies (CAP620). Its primary concern in carrying out its statutory duties 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 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. Thus it will seek to encourage the development and maintenance of an environment in which efficient British airlines can operate profitably and in which competition between British carriers and with foreign airlines can flourish and user choice is enhanced.

21. This does not mean that the Authority will at every available opportunity and in all circumstances favour a new entrant over an incumbent on a particular route when deciding how to allocate scarce capacity. In paragraph 7 of the Statement of Policies, the Authority states that it will license liberally competing services wherever doing so is likely to benefit users. In judging where the balance of user benefit lies, it must take into account both the short and long term interests of users. The long term interests of users will be best served by an environment in which efficient British airlines can operate profitably and in which competition can flourish. These wider considerations were central to Decision 5/98 and remain pertinent in this case.

22. In some ways the evidence before the Authority in this case was more narrowly focused than in the previous Shanghai case heard last year. In that case, issues such as network competition between British and foreign airlines and the potential impact of Shanghai services on the viability of services to Hong Kong were much to the fore. Much less was said about those issues at this hearing. The focus in this case was much more on whether the interests of users would be best served by allowing BA to compete directly with Virgin on this route with each at low levels of frequency or by allowing Virgin to increase frequency to a level which, in Virgin's submission, would be more sustainable in the longer term. Alternatively, the choice might be regarded as being between injecting competition into the London/Shanghai route versus strengthening competition in the wider mainland China market. The choice would then depend on the extent to which the relevant market is regarded as UK/China rather than UK/Shanghai.

User benefits

23. In terms of the specific service proposals put before the Authority there was nothing to choose between the two carriers. Both were planning to use similar sized aircraft operating on days of the week not currently served by direct flights. Virgin argued, as it has done at previous scarce capacity hearings, that the quality of its product was superior to that of BA, citing the results of its own survey in support of this contention. BA commented that the two carriers could trade claims on the subject of product quality, but the fact was that only BA's entry to the route would introduce a choice of direct services for users. The Authority addressed these sorts of issues in its recent Decision 1/99 concerning the allocation of a single additional frequency between the UK and South Africa. In that case Virgin put the same arguments about the quality of its product, but it was also able to argue as the prospective new entrant to the Cape Town market that only it would widen user choice. The Authority reached no conclusion on the respective merits of the two airlines' products but the fact that Virgin's entry would widen choice was a factor in its decision.

24. The Authority stated in Decision 1/99 that it would need compelling evidence for the relative quality of service to be a significant factor in a scarce capacity decision. While the Authority recognises that survey results may provide some indication of the way in which users perceive or value competing products, they are also critically dependent upon the specific questions asked and the methodology employed. The Authority's policy is to promote competition as the best available means of ensuring that the desired quality of service is delivered. Only a competitive market affords users the

opportunity to vote with their feet. For this reason, the Authority's predisposition is to widen the choices available to users where possible rather than to second guess the choices users will make.

25. On fares, both airlines pointed to their track records of pricing innovation and leadership. The Authority has little doubt that Virgin's entry to the Shanghai route will have contributed to more competitive pricing activity in the UK/China market. However it is also confident that, whichever of the two airlines is awarded the additional frequencies to Shanghai, prices will be set according to the competitive conditions and capacity available in the market. It does not see that there is anything to choose between the two airlines on the specific issue of fares *per se*.

Viability

26. Virgin argued that BA's entry to the route with two services a week would make it extremely difficult, if not impossible, for it to bring the route into profit. The likely effect of this would be that Virgin would withdraw from the route in the face of sustained losses, so leaving BA in a monopoly position. BA did not see why, if it operated on two different days of the week from Virgin, there would be any material adverse effect on Virgin's services on other days of the week. Virgin also believed that BA had understated certain of its costs and that its bottom line forecasts were therefore overstated, although it was not seeking to argue that BA's services would not be viable.

27. It seems to the Authority that the impact on the viability of Virgin's existing two services of BA operating two services a week depends on the extent to which London/Shanghai can be regarded as a discrete market. If it is wholly separate from other routes, then BA may have a point. There is no obvious reason why BA operating the third and fourth frequencies should have any greater negative impact on Virgin's existing services than if Virgin were to operate them itself, other than as a result of competitive pressures which would translate into consumer benefits. But the greater the interrelation between the Shanghai route and other routes to China, where BA has a significantly stronger presence than Virgin, the less this would hold true.

Relevant markets and competition

28. There was much discussion at the hearing, as at the previous one, as to whether the relevant market should be regarded as the London/Shanghai route or the wider UK/China market. In Decision 5/98 the Authority said that, while it remained difficult to quantify, it seemed reasonable to conclude that there were respects in which China could be regarded as one market. To the extent that this was true, competition between British airlines was likely to be strengthened more by allowing Virgin rather than BA to serve Shanghai. Both airlines submitted evidence to the hearing on this point. BA relied on marketing data from computer reservation systems to demonstrate that the majority of passengers travelling between London and Shanghai were doing so either directly or making a direct connection. A smaller proportion were making stopovers on their way between London and Shanghai. Virgin's survey suggested that only 33% of business travellers to China were visiting a single destination in China.

29. The London/Shanghai route has only been served since May this year. There is therefore little data yet available on which to base informed judgements about the extent to which Shanghai represents an economically distinct market from London/Beijing. The airlines each submitted evidence pointing in opposite directions. The truth is that there will be some passengers for whom Shanghai is their only destination in China and some for whom it forms one part of a more complex itinerary. Given the low frequency of direct services to Shanghai, indirect services over Beijing or Hong Kong will undoubtedly continue to present significant competition to direct services, even in respect of passengers only wishing to travel between London and Shanghai. It is also likely to remain the case for some time that passengers visiting points in China other than Shanghai will comprise a substantial proportion of the total travelling on direct London/Shanghai services. As the China market grows in the future, the extent to which the London/Shanghai route will be seen as one part of a wider UK/China market is likely to diminish.

30. But, unlike Hong Kong, for the time being the routes to Beijing and Shanghai remain relatively thin. There is undoubtedly a degree to which the two markets are interrelated, although the extent to which this is the case remains uncertain. What is certain is that, at least for the time being, BA is the sole UK airline operating on the London/Beijing route. To award BA the additional two frequencies now available on Shanghai would be to create a situation in which BA was able to operate up to eight services a week in total to Beijing and Shanghai while Virgin was able to operate only two services a week to Shanghai. Such an outcome does not sit well against an objective of fostering effective and sustainable competition between UK airlines. This would be so even if there were no question mark over Virgin's viability on the Shanghai route in such circumstances. But the Authority can readily see that creating such an outcome would carry a risk that Virgin would find it hard to compete effectively on the Shanghai route. How serious that risk would be is unclear, and was a matter of dispute between the two airlines. But the Authority accepts that there is a degree of risk that Virgin might find it impossible to maintain its viability on the route in those circumstances. This serves only to strengthen its view that competition between British airlines would be best served by awarding the two additional frequencies to Virgin.

Conclusions

31. This case is highly unusual in that the incumbent carrier on the Shanghai route is Virgin, and it is BA that is seeking the right to enter the route in order to provide competition. On the face of it, the Authority's predisposition in favour of competition would point towards BA in this case. However, this would be to ignore the wider considerations which the Authority took into account in finding in favour of Virgin at the first Shanghai hearing last year. It then concluded that competition in the UK industry and in the UK/China market was likely to be strengthened to a greater degree by awarding Shanghai to Virgin rather than to BA. The central question facing the Authority in this case is whether now awarding the next two Shanghai frequencies to BA would have the effect of weakening or strengthening competition in the UK industry and in the UK/China market. Given the particular circumstances of this case, with nothing to choose between the two airlines in respect of narrow user benefits and with BA enjoying

a protected position on the Beijing route, the Authority believes its duties would be best served by awarding the additional two frequencies to Virgin.

DECISION

32. In accordance with its proposal, the Authority hereby confirms the following condition which was added to the route licence number 1B/10 held by British Airways plc by Decision 5/98:

“British Airways shall not operate services between the UK and Shanghai.”

33. 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 4 flights a week in each direction between the UK and Shanghai.”

34. 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 3 December 1999.

G J Elsbury
For the Civil Aviation Authority
30 November 1999