



**UNITED KINGDOM
CIVIL AVIATION AUTHORITY**

DECISIONS ON AIR TRANSPORT LICENCES AND ROUTE LICENCES

4/99

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 14 December 1999.

Panel

Chairman: Mr D Andrew
Mr C Senior

Adviser: Mr D Batchelor

Secretary: Mr G J Elsbury

Objections to the Authority's proposal:

Objector: British Airways Plc represented by Mr C Allen, Head of Competition and Industry Affairs, British Airways Plc

Objector: Virgin Atlantic Airways Ltd, represented by Mr C Haddon-Cave QC

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

SUMMARY

1. This hearing was convened to decide which of British Airways or Virgin Atlantic Airways should be allowed to operate a single additional weekly frequency which had become available for UK airlines under the UK/South Africa bilateral air services agreement. This additional frequency had been made available at short notice and with immediate effect. Both British Airways and Virgin Atlantic wished to add frequency to the London/Cape Town route, British Airways to increase from six to seven flights a week and Virgin to increase from one to two flights a week. The Authority has concluded that its decision should be based primarily on which of the two proposed services is likely to produce the greater benefits for users of air services. On the basis of the evidence put to it, the Authority has decided that Virgin Atlantic Airways' proposed service should be given preference over that of British Airways.

THE NOTICE

2. On 1 December 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 in Pretoria on 16 July 1999 between the Republic of South Africa and the United Kingdom, the United Kingdom's share of capacity on air transport services between the United Kingdom and the Republic of South Africa which may be provided by British airlines would, within 6 months of the date of that notice, be insufficient to enable British Airways plc and Virgin Atlantic Airways Ltd to make available all the capacity which they planned to provide.

THE PROPOSAL

3. Following the notice from the Secretary of State, the Authority made its proposal to vary the licences of British Airways (1B/10/369) and Virgin Atlantic Airways (1B/35/147). For reasons of urgency the proposal was not published in the Official Record Series 2. After reciting the notice, this proposal stated that:

"2. The Authority is advised by the Secretary of State that under the UK/South Africa bilateral arrangements UK airlines are currently permitted to operate a total of 27 services a week between the UK and South Africa. BA currently operates 19, and Virgin 8 (including 1 from 3 December), services a week, thereby using all the available capacity. However, with immediate effect, UK airlines will now be permitted to operate a total of 28 services a week between the two countries. Both BA and Virgin wish to take up the single additional frequency which has become available and the Authority is therefore required to allocate it between them.

"3. For these reasons, the Civil Aviation Authority, in exercise of its powers under Section 66 (2) of the Civil Aviation Act 1982, hereby proposes to vary route licence number 1B/10 held by BRITISH AIRWAYS PLC (BA) and route

licence number 1B/35 held by VIRGIN ATLANTIC AIRWAYS LIMITED (Virgin) so as to provide that the total number of flights operated between the UK and South Africa by BA and Virgin in any one week shall not exceed 28 in each direction. The maximum number of flights which may be operated by each airline will be determined by the Authority in the light of its statutory duties and objectives and arguments advanced at the hearing.”

OBJECTIONS AND REPRESENTATIONS

4. British Airways (“BA”) exercised its right to be heard on the Authority’s proposal to vary its licence 1B/10 and made a representation in respect of the proposal to vary Virgin Atlantic Airways’ licence.

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

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

BRITISH AIRWAYS’ CASE

7. This was largely a re-run of the hearing held on 20 September this year (Decision 1/99), but the circumstances of this case were different and should lead the Authority to a different conclusion. As on the two previous occasions that the Authority had been required to allocate a single weekly frequency to South Africa, BA planned to use the opportunity to add a weekly flight from Heathrow to Cape Town. At the first South Africa scarce capacity hearing in 1998 (Decision 3/98), the decisive issue had been capacity. BA had proposed using B747 aircraft as against Virgin’s A340 and the Authority had awarded BA the single additional weekly frequency then available. Earlier this year, both carriers proposed using B747s for the single frequency available, and the Authority found in favour of Virgin on the basis that the benefits of competition were judged to outweigh the benefits of BA being able to offer a daily service. On this occasion, however, capacity was again an issue. BA proposed to use a B747 for the additional service, while Virgin proposed to replace its current single weekly B747 services to Cape Town with two A340 services a week. This meant that BA’s proposal would add to the Cape Town market 401 seats a week in each direction, while Virgin’s proposal would add only 102 seats. There would be considerably greater user benefit resulting from BA’s proposal, therefore, and users would also benefit from BA offering a daily schedule.

8. One change from its evidence to the previous hearing was that BA no longer planned to use B777 aircraft in place of B747s on the Cape Town route in the northern summer trough period given its current schedule. Its B777 resources were now to be deployed elsewhere in BA’s network.

9. A further change was that South African Airways (SAA) was now operating up to 9 services a week between Heathrow and Cape Town, including one via Johannesburg. In September it had been unclear whether SAA would be operating a daily schedule to Cape Town. The fact that its main competitor on the Cape Town route was now operating daily meant that the Authority should now place greater weight on its duty to ensure that British airlines compete as effectively as possible with other airlines than it had in Decision 1/99. Granting this frequency to BA would in no sense be to jeopardise competition, rather it would strengthen it.

10. BA also believed that there was now further evidence that daylight services, which Virgin proposed to operate northbound, were less attractive to users than overnight services. SAA had been able to increase frequency on Cape Town apparently only by utilising an arrival slot at Heathrow originally allocated for a Johannesburg service. Consequently, SAA had substituted a daylight Monday northbound service from Johannesburg and was now offering a special fare at a very low price for this particular flight only. Virgin's single weekly Cape Town flight was also a daylight service northbound. While Virgin's fares to Cape Town ex-UK had matched those of the incumbents, ex-South Africa Virgin had introduced fares at levels below those of the incumbents. This was further evidence that daylight services were unpopular with passengers. The only way in which airlines could attract passengers to daylight services in this market was to offer low fares.

VIRGIN ATLANTIC AIRWAYS' CASE

11. This was the third hearing of what was now becoming a series. The issues in this case were very similar indeed to those facing the Authority in Decision 1/99, the reasons for which applied here with equal if not more force. The reasons for introducing competition remain just as strong and overwhelming as at the previous hearing. The logic of Decisions 3/98 and 1/99 was that one frequency a week was insufficient for a new entrant to provide effective competition. As the Authority stated in paragraph 32 of Decision 1/99, the higher the frequency enjoyed by an incumbent the stronger the reasons must be in favour of the incumbent for the Authority not to grant capacity to a new entrant. If the Authority's policy was to promote active competition, then in a situation where BA currently operated six and Virgin one service a week to Cape Town clearly it should give Virgin a second weekly frequency.

12. Virgin proposed to use the additional frequency to operate two services a week to Cape Town with A340 aircraft in place of its current single weekly B747. This change would help release B747 capacity that would be deployed on two frequencies a week on the London/Johannesburg route in place of two A340 services. The overall increase in capacity Virgin was proposing to put in the UK/South Africa market was therefore equivalent to one B747, the same as that proposed by BA. Although Virgin would be adding less capacity than BA to the Cape Town market, it was increasing capacity to Johannesburg. In any event the Authority's decision should be based on a wider view than just capacity. Capacity, fares and frequency went hand in hand. It did not make sense for new entrants to operate more capacity than they would be able to fill. A new

entrant would be limited in its ability to provide effective competition on fares until its frequency was at or close to that of its competitors.

13. BA's counter-argument - that there are user benefits in allowing it to offer a daily service – remains relatively weak. These benefits are limited to business travellers, and BA already competes in this market more effectively than SAA. Moreover the benefits to users of BA providing a daily service are now smaller than they were at the previous hearing because users now have the option of using SAA's daily service to Cape Town. BA's need to compete with SAA was of no great moment given that BA already outperforms SAA in the UK/South Africa market.

REPRESENTATION BY THE AIR TRANSPORT USERS COUNCIL

14. The AUC made a written representation but did not appear at the hearing. It believed that the additional frequency which had become available should be allocated to Virgin in order to enhance competition on the Cape Town route.

ANALYSIS AND REASONS

Introduction

15. This is the third occasion in a little over a year that the Authority has been required to allocate a single additional weekly frequency between the UK and South Africa, and the second occasion in four months. The Authority welcomes the opportunities for UK airlines to expand their services in this market so that the needs of users can be better satisfied. However it regrets that these capacity increases are being drip-fed one at a time by the South African authorities. The Authority looks forward to a situation where all airlines are able to respond to this market in the manner they see fit without recourse to regulatory proceedings necessitated by artificial government-imposed bilateral restrictions.

16. Both parties agreed that the issues at stake in this hearing were similar to those which had arisen in the two previous cases. Indeed the evidence presented at this hearing was generally limited to amplification of points of difference from the previous hearing. In view of this, the Authority does not propose to revisit in detail in this Decision all of the issues which were addressed in Decisions 3/98 and 1/99. It will focus on the issues which lay at the heart of this case, capacity and competition.

Capacity

17. In Decision 3/98 the Authority faced a choice between BA using the scarce capacity to operate a B747 and Virgin operating an A340. It concluded that the user benefits arising from the substantially greater capacity which BA was proposing to add to the market would not necessarily be outweighed by those arising from Virgin's entry to the Cape Town route, particularly at very low frequency. In Decision 1/99 both carriers were proposing to use B747 aircraft, at least initially, and so in the short term

the Authority saw no reason to favour one carrier over the other on grounds of capacity. At this hearing, however, there was once again a difference between the two carriers in terms of capacity.

18. Virgin argued that it was only by virtue of being awarded the additional frequency that it would be able to operate B747s in place of A340s on two of its services to Johannesburg. But BA established at the hearing that there was nothing to prevent Virgin from operating two B747s and five A340s to Johannesburg today if it were to replace its single B747 to Cape Town with a single A340. The effect of this would be to add capacity to the UK/South Africa market without using a scarce bilateral resource to do so. It was a commercial decision on Virgin's part whether, within the present constraints of the bilateral restriction and its own aircraft resources, it operated its B747 capacity on Johannesburg or Cape Town. This seems right to the Authority. It therefore cannot agree with Virgin that there is no difference between the two proposals in terms of the capacity which would be added to the UK/South Africa market by the use of the additional frequency at issue in this case. The greater capacity that BA proposes to add to the Cape Town route is a benefit to users which counts in BA's favour.

19. Having said that, both carriers expressed the view that it was likely that additional frequencies would become available in the near future. Clearly, the sooner additional capacity becomes available, the less significant for this decision would be the user benefits of greater capacity being added now. But the Authority cannot take into account future changes to the bilateral arrangements which are no more than a possibility.

Competition

20. There was some discussion at the hearing as to how the Authority should balance the short term user benefits which might be derived from greater capacity in the market against the longer term user benefits which might be derived from effective competition. Virgin argued that the Authority should not base its decisions in these cases on short term factors. The Authority agrees that its policy of promoting competition is essentially aimed at securing the long term rather than short term interests of users. However, that is not to say that it will in all cases and all circumstances favour competition irrespective of the short term implications for users.

21. BA argued that awarding this frequency to Virgin would not add significantly to the competitive position. In particular it would add no more to competition on the route than allowing BA to have a seventh weekly frequency. However, Virgin pointed to what it regarded as BA's dominance in the London/Cape Town market. It believed that where extra capacity was added by a carrier with a strong position in the market there was less likely to be consumer benefit because that carrier could use its market power to keep prices up. The answer to that was to inject competition. Virgin also argued that one frequency a week was not sufficient to enable it to offer effective competition to BA. As the carrier with six frequencies a week against Virgin's one, the onus was on BA to demonstrate strong reasons why the Authority should not reach the decision which would help Virgin compete more effectively.

22. This case follows close on the heels of the previous Decision in which the Authority enabled Virgin to enter the Cape Town route for the first time. That Decision was on the basis that there were no strong reasons for favouring the incumbent over the new entrant, as there had been in Decision 3/98. In those circumstances, the Authority found that there were likely to be benefits for passengers from adding Virgin as a competitor to the route. It also noted that where each party was proposing capacity increments which were similar but which were small relative to the total market, there were limits to the price innovation likely to result from the introduction of a new competitor. It concluded that the evidence nevertheless suggested that a new entrant did increase price innovation. The Authority sees no reason now to depart from that reasoning. Moreover, the Authority considers that, in general, a carrier with a strong position in the market may have an incentive to signal and deliver relatively large amounts of incremental capacity in an effort to protect its position. The consequent short term benefit to users may be lower than the long term cost in terms of less competition. Having introduced Virgin as a competitor to this route, it must be the case that its competitive muscle will be enhanced, and the benefits to users consequently increased, if it is enabled to compete more effectively.

23. The Authority does not dismiss BA's claims that competition will be strengthened by allowing it to compete more effectively against the frequency advantage enjoyed by SAA on Cape Town. But equally BA has the option, if it chooses to do so, to switch services from Johannesburg to Cape Town if competitive pressures on Cape Town justify it. While the same argument applies to some extent to Virgin, the fact is that Virgin is currently a significantly smaller player in the UK/South Africa market than either BA or SAA, and if the Authority's aim is to establish active competition, then this points towards it building on Decision 1/99 by awarding this additional frequency to Virgin.

Conclusion

24. The Authority stated in Decision 1/99 that it found that case to be finely balanced. In many ways the Authority finds this case more difficult. The Authority sees short term benefits to users in BA's proposal because of the additional capacity it would provide on the Cape Town route. However, it also sees benefits to users from allowing Virgin to build a stronger competitive presence in the market, and it believes that these benefits will feed into the longer term. It therefore concludes that the interests of users will be best served in this case by awarding the additional frequency to Virgin.

DECISION

25. In accordance with its proposal, the Authority hereby varies the route licence number 1B/10 held by British Airways plc by deleting the following condition:

“British Airways shall not operate more than 19 flights a week in each direction between the UK and South Africa for so long as the total number of flights which may be operated between the UK and South Africa by UK airlines in any one week is limited to 27 in each direction.”

26. In its place, the Authority hereby substitutes the following condition:

“British Airways shall not operate more than 19 flights a week in each direction between the UK and South Africa for so long as the total number of flights which may be operated between the UK and South Africa by UK airlines in any one week is limited to 28 in each direction.”

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

“Virgin Atlantic Airways shall not operate more than 8 flights a week in each direction between the UK and South Africa for so long as the total number of flights which may be operated between the UK and South Africa by UK airlines in any one week is limited to 27 in each direction.”

28. In its place, the Authority hereby substitutes the following condition:

“Virgin Atlantic Airways shall not operate more than 9 flights a week in each direction between the UK and South Africa for so long as the total number of flights which may be operated between the UK and South Africa by UK airlines in any one week is limited to 28 in each direction.”

29. 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 30 December 1999.

G J Elsbury
For the Civil Aviation Authority
23 December 1999