UNITED KINGDOM
CIVIL AVIATION AUTHORITY

DECISION ON SCARCE CAPACITY ALLOCATION CERTIFICATES

SCAC 1/10

Applications BA/SCAC/2 by British Airways Plc, BMI/SCAC/2 by British Midland Airways Ltd (trading as bmi) and EJ/SCAC/2 by easyJet Airline Company Limited in respect of the route London–Cairo/Alexandria heard on 8 & 9 September 2010

Panel

Chairman:	Dr H Bush CB Mr R Jackson Mr M Medlicott
Adviser:	Ms H Watson
Secretary:	Mr D Kendrick

Applicants

Applicant:	British Airways Plc, represented by Mr Robert Lawson, Queen's Counsel
Witnesses:	Mr Colm Lacy, General Manager Network Planning Mr Gareth Sinclair, Head of Revenue Management, BA World Cargo
Applicant:	British Midland Airways Ltd (trading as 'bmi'), represented by Mr Bankim Thanki, Queen's Counsel
Witnesses:	Mr Wolfgang Prock-Schauer, Chief Executive
Applicant:	easyJet Airline Company Ltd, represented by Mr Thomas Raphael, Counsel
Witnesses:	Mr Alan McIntyre, Head of Network Planning

BACKGROUND

1. This hearing was convened to decide how to allocate the capacity available on the London–Cairo/Alexandria route between qualifying carriers from 31 October 2010.

2. The number of frequencies (return flights) that can be operated each week in each direction between London and Cairo/Alexandria is regulated by an Air Services Agreement between the governments of the United Kingdom and Egypt. Prior to June 2010, the maximum number of frequencies permitted was 11 each week in each direction by air carriers designated by the United Kingdom and 11 each week in each direction by air carriers designated by Egypt. British Airways Plc was operating seven of the frequencies available to UK designated air carriers and British Midland Airways Ltd was operating four such frequencies. In addition, by agreement with the Egyptian Authorities and Egyptair, British Midland Airways Ltd was operating three of the eleven frequencies available to Egypt-designated air carriers under the UK-Egypt Air Services Agreement.

3. In June 2010, agreement was reached to increase the number of frequencies to 14 each for UK and Egyptian designated air carriers. An additional three frequencies thus became available for UK designated air carriers. Three air carriers, British Airways Plc ('BA'), British Midland Airways Ltd ('bmi'), and easyJet Airline Company Ltd ('easyJet'), each indicated a desire to operate all three additional frequencies. There were thus insufficient frequencies available to enable those air carriers to provide all the services they would wish to provide.

4. In accordance with the Civil Aviation (Allocation of Scarce Capacity) Regulations 2007 ('the Regulations') the Secretary of State for Transport notified the London-Cairo/Alexandria route as having scarce capacity. Under the Regulations, it is the duty of the Civil Aviation Authority ('CAA') to allocate the available capacity between the qualifying air carriers[1] and to grant Scarce Capacity Allocation Certificates[2] reflecting its decision.

5. In accordance with the Regulations, the CAA invited formal applications for a Scarce Capacity Allocation Certificate. The CAA received applications (detailed below) from the three carriers listed above.

6. The CAA received written evidence from these air carriers and conducted a hearing on 8 and 9 September 2010 at which the three air carriers made oral representations. This document sets out the decision of the CAA following that hearing.

STRUCTURE OF THIS DECISION DOCUMENT

7. 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. Part 4 and Annex 9 of the Official Record Series 1 set out the manner in which the CAA will allocate

[1] A qualifying air carrier means a UK air carrier or an European Economic Area air carrier established in the UK

[2] A qualifying air carrier may only operate on a route notified as having scarce capacity if it has a Scarce Capacity Allocation Certificate granted by the CAA authorising the services it operates.

scarce capacity in accordance with regulation 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.

THE NOTIFICATION BY THE SECRETARY OF STATE

8. On 2 August 2010, the Secretary of State, in exercise of his powers and duties under regulation 4 of the Regulations, gave notice to the 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 Cairo/Alexandria (London is defined in this case[3] as Heathrow, Gatwick, Stansted, Luton and London City airports). Accordingly, the Secretary of State asked the CAA to allocate the capacity available on the route between London and Cairo/Alexandria ('the route') between qualifying carriers from 31 October 2010 in accordance with the Regulations.

THE NOTICE

9. 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 13 July 2010, 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 frequencies operated on the route from 31 October 2010 should not exceed 14 frequencies each week in each direction and should not exceed 4,500 seats each week in each direction[4]. The CAA, in accordance with regulation 9 of the Regulations, would determine the maximum number of frequencies that may be operated by each applicant.

APPLICATIONS

10. The CAA received three applications from qualifying carriers for a Scarce Capacity Allocation Certificate for operation on the route. It should be noted that each of the carriers applied to operate to Cairo only (i.e. none of the applicants proposed to operate to Alexandria), with BA and bmi applying to operate from London Heathrow and easyJet from London Gatwick.

11. BA applied for a Scarce Capacity Allocation Certificate to allow it to operate 10 frequencies with a seat capacity of 3,037 each week in each direction on the route from the start of the IATA winter season 2010.

[3] This definition derives from the Memorandum of Understanding between the aeronautical authorities of the UK and Egypt signed on 10 June 2010.

[4] The terms of the Memorandum of Understanding between the aeronautical authorities of the UK and Egypt signed on 10 June 2010 include a cap on seats as well as on frequencies. However, for the reasons set out later in this decision, it has not been necessary for the CAA expressly to allocate the available seat capacity between the successful applicants in this case.

12. bmi applied for a Scarce Capacity Allocation Certificate to allow it to operate seven frequencies with a seat capacity of 1,043 each week in each direction on the route from the start of the IATA winter season 2010.[5]

13. easyJet applied for a Scarce Capacity Allocation Certificate to allow it to operate three frequencies with a seat capacity of 540 each week in each direction on the route from the start of the IATA winter season 2010.[6]

14. In accordance with regulation 10, the CAA published these applications in its Official Record Series 2 on 27 July 2010 and invited objections or representations.

OBJECTIONS, REPRESENTATIONS AND RIGHT TO BE HEARD

15. No objections or representations were received.[7]

16. Each applicant exercised its right to be heard under regulation 13. Pursuant to this regulation the CAA held a hearing on 8 and 9 September 2010.

THE CAA'S STATUTORY DUTIES

17. Section 7(1) of the Civil Aviation Act 1982 ('the Act') allows regulations to be made which require specified decisions to be made only by members of the CAA. In accordance with Section 7(1) of the Act, the Regulations specify that the function of deciding to grant, refuse, revoke or vary a Scarce Capacity Allocation Certificate may only be made by members of the CAA. The quorum for this purpose is normally two members. In this case, a panel of three members was appointed to determine the applications for Scarce Capacity Allocation Certificates.

18. 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 of the Regulations sets out the relevant objectives of the CAA for the purposes of allocating scarce capacity.

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

TERMS OF THE UK–EGYPT AIR SERVICES AGREEMENT

20. The Secretary of State's notification to the CAA in this case followed bilateral negotiations between the UK and Egyptian governments, which resulted in a new Memorandum of Understanding ('MoU') in June 2010. With regard to the London–Cairo/Alexandria route, it was agreed that airlines on each side could operate up to 14 frequencies with a seat capacity of 4,500 seats each week in each direction effective immediately.

21. As described previously, BA and bmi currently operate seven frequencies per week each between London Heathrow and Cairo (bmi operates four of its seven

[5] bmi's original application was for a scarce capacity allocation certificate to allow it to operate 10 services per week in each direction. However, this was subsequently amended on 29 July 2010.

[6] In subsequent evidence easyJet confirmed its intention to start services from January/February 2011.

[7] By default the applications of the parties represented objections to the other parties.

frequencies per week under UK traffic rights and three frequencies per week under ‘borrowed’ Egyptian traffic rights[8]).

22. Airlines of each side are also permitted under the MoU to operate three weekly all-cargo services between Cairo/Alexandria and points in the UK other than London (as defined in the MoU).

23. Regulation 9 (6) of the Regulations sets out that the CAA must have regard to any advice received from the Secretary of State. In relation to this case, advice from the Secretary of State was received on 2 August 2010. This set out that the UK side had made it clear in the talks leading to the conclusion of the June 2010 MoU that it would prefer the removal of all frequency restrictions on scheduled passenger services operated by the designated airlines of both sides. The Egyptian side had explained that it was not able to agree to this proposal at that time. The MoU records that the two delegations agreed to conduct a further round of consultations before the start of the IATA summer 2011 season to review “the operational conditions, traffic statistics and the capacity offered”. The Department for Transport aims to follow up on this commitment. However, it is the Department’s expectation that no further increases in capacity on the London-Cairo/Alexandria route will be achievable before late 2011 at the earliest.

24. The advice from the Secretary of State also made reference to the issue of allocating seat capacity on the route. It was the view of the Secretary of State that both the total number of frequencies applied for by qualifying carriers (20 frequencies each week in each direction) and the total number of seats applied for (4,620 seats each week in each direction) were in excess of the available traffic rights on the route. However, having regard to the applications received, the Secretary of State considered that, whilst there was scarce capacity in terms of the number of frequencies that airlines wished to operate, there was no permutation of allocated rights within the total available that would be likely in practice to result in the weekly seat capacity cap being exceeded. The Secretary of State considered therefore that, in terms of allocating scarce capacity, the constraining factor in practice would be the number of available frequencies rather than the number of available seats. In other words, the Secretary of State did not expect that, based on the applications received, there would be a scarcity of seat capacity on the route within six months. It was the view of the Secretary of State therefore that it would not be necessary for the CAA expressly to allocate the available seat capacity between the successful applicants. This decision therefore allocates frequencies between the qualifying carriers but does not allocate seat capacity.

SUMMARY OF EVIDENCE PRESENTED

25. This section of the decision document provides brief factual summaries of the cases 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, and the elements considered material to the decision, are not covered here but later in this decision.

British Airways’ case

26. In the presentation of its case, BA identified two main issues to which it felt the CAA should have regard in considering its application. First, that its application would

[8] These ‘borrowed’ traffic rights are subject to a commercial agreement between bmi and Egyptair, which will be discussed later in this decision.

best ensure effective competition on the route, and second, that its application offered the best cargo proposition. BA was also of the view that capacity rather than rivalry was the key driver of price on capacity constrained routes (in this case constrained by frequency but not seat capacity).

27. In relation to the first issue, BA referred to the fact that bmi and Egyptair were both part of the Star alliance, operated a codeshare arrangement and had access to the new terminal in Cairo. BA considered that the bmi / Egyptair offering amounted to a “monolith” on the route, i.e. a large single entity, against which other carriers on the route needed to compete. BA considered that granting it 10 frequencies per week would make competition between BA, bmi and Egyptair, and between BA and the codeshare offering of bmi and Egyptair, more intense since it would provide a more even distribution of frequencies between it and the bmi / Egyptair codeshare offering. In contrast, commenting on bmi’s application, BA expressed the view that granting bmi its request would give it a frequency advantage over BA in its own right. In addition, it would increase the frequency advantage that bmi had together with Egyptair through its codeshare arrangement. BA considered that this would not increase effective competition on the route since it would serve to strengthen the position of the bmi / Egyptair codeshare offering, leaving it with only one rival, BA, which would be constrained by the bilateral capacity cap to provide a much smaller offering. BA commented also on easyJet’s application in relation to this first issue. BA considered that easyJet’s application would not ensure effective competition with the bmi / Egyptair codeshare offering since it would divide the available capacity between a greater number of competitors, i.e. BA and easyJet, each of whom would be constrained by the bilateral capacity cap to limit their offerings to seven and three frequencies per week respectively. BA chose not to major on a comparison of the cabin product offerings of the three carriers. However, BA did challenge easyJet’s assertion that the introduction of a no-frills product on the route would impose competitive pressure on BA to improve service quality, particularly on a route of this sector length. BA pointed out that it offered a choice of four cabins, all of which it claimed were superior to easyJet’s single-cabin offering.

28. In relation to BA’s second main issue, that of its cargo offering, BA considered that the circumstances of the case meant that cargo benefits should be treated as a strong factor in the CAA’s decision. Further, it was the view of BA that the CAA should consider the interests of those directly or indirectly involved in related markets, such as cargo shippers, and also of their consumers. In support of its application in relation to this issue, BA considered that it was offering a very substantial cargo proposition as compared with that of the other applicants. BA also considered that its cargo proposition should be considered in light of a level of unsatisfied demand for direct cargo services on the route, which it considered was a result of the capacity cap on the route, as well as from a lack of effective substitutes for its direct services. BA also cited the considerable experience it had in providing cargo services on the route, as well as generally.

29. In respect of how the relationship between capacity and price is affected by rivalry, whilst BA accepted that interplay between competitors is relevant, it considered that capacity is the main driver of price on capacity constrained routes and that price stimulation is a direct function of supply and demand. In support of this view, BA stated that the objective of each of the applicants was to provide an adequate return to their shareholders and therefore that, in a constrained capacity environment, it would not be economic for fares to decrease below what the market would determine for such an increase in capacity. In relation to this point, BA noted that its proposal offered a far larger capacity increase than the competing applications made by bmi or easyJet. BA reasoned that, with capacity increasing in

the region of 16-20% in the market as a whole, and taking into account some demand growth in line with economic recovery and a price elasticity of between 1.2 and 1.5, prices in the market should fall by about 4 to 10%. BA questioned why any carrier would reduce fares beyond what was necessary to fill that capacity.

bmi's case

30. As with the case put forward by BA, bmi's case also stressed the need for the CAA to have regard to which application would best ensure effective competition on the route. bmi's view was that, prior to its entry on to the route in 2007, the London-Cairo market was "stagnating" but that, as a direct result of its entry, the market had been stimulated, with significantly more passengers now able to travel directly and at markedly lower fares. bmi also cited evidence of its high load factor and its high passenger share relative to capacity share, which it considered, in comparison with the equivalent measures of its competitors, in particular BA, demonstrated that it was making the most efficient use of its aircraft. bmi also cited evidence that it carried more Origin and Destination ('O&D') passengers than BA and that the CAA should have particular regard to this evidence in relation to its objectives under the Regulations. As to why the additional competition provided by bmi had proven, in the view of bmi, to be so effective on the route, bmi cited a number of factors: first, that it offered a daily service; second, that it competed across the full range of products offered by BA and Egyptair; third, that it operated from Heathrow, which involved 'head-to-head' competition with BA and Egyptair; and, fourth, that it had dedicated premium slots at Heathrow to the Cairo service. For these reasons, it was the view of bmi that it had been able, to date, to engender real and effective competition to both BA and Egyptair on the route.

31. bmi considered that the CAA should grant bmi seven frequencies per week in order to "entrench and ensure" the successful rivalry that bmi had brought to the market to date. bmi argued that allocating the additional capacity to BA risked returning to the market "stagnation" prior to 2007, particularly if bmi lost its three borrowed frequencies. Allocating the additional capacity to easyJet was also unlikely, given its inferior frequency and timings compared with bmi, to offer the most effective and reliable competition on a route with scarce capacity. The only selling point of the easyJet proposal was based on price competition in a liberalised market. bmi submitted that, in this case, it was appropriate to award the frequencies to carriers which served as many market segments as possible.

32. It was the view of bmi that the rivalry it had brought to the market depended heavily on an arrangement with Egyptair and the Egyptian authorities whereby it could borrow three frequencies from the Egyptian allocation. bmi expressed the view that, while this agreement was an innovation that had benefited consumers, the CAA should treat bmi's hold over the borrowed frequencies as "tenuous" and being "for the short term only". bmi considered that there was nothing in the agreement between it and Egyptair which would stop Egyptair terminating the arrangement without notice, and that Egyptair had a significant commercial interest in operating all of the Egyptian frequency allocation itself. Notwithstanding this point, it was the view of bmi that, going forward, it would continue to operate three frequencies from the Egyptian allocation for as long as it could access these frequencies and that their operation was commercially viable. bmi gave evidence that the Middle East market, where it serves 11 destinations, was one of bmi's key markets, generating close to 40% of its revenues. Cairo had a crucial role within this, as a regional hub upon which bmi wished to build.

easyJet's case

33. easyJet, which was applying for three frequencies on the route, considered that its application would produce the greatest benefit for consumers. easyJet characterised the London-Cairo market as, in effect, a duopoly between bmi / Egyptair and BA. easyJet considered that only by granting it the three frequencies it was seeking could the CAA introduce a new competitor into the market. In its view, the entry of easyJet would encourage vigorous price competition and produce far greater market differentiation and product choice than maintaining the 'duopoly' between the existing carriers operating from Heathrow.

34. In support of its case, easyJet put forward evidence which, in its view, showed that pricing on the route between BA and bmi was similar. easyJet stated that it would price its London-Cairo service at a level significantly lower than the current BA, bmi and Egyptair pricing. easyJet stated that the starting fare on its routes was based on marginal avoidable cost and that, on the London-Cairo route, it would introduce return prices that would be around 55% lower than those currently offered by BA and bmi. More generally, easyJet drew attention to the history of market entry by no-frills carriers, which easyJet considered showed that no-frills carriers could consistently price far lower than full-service-carriers, and remain profitable. In support of this last point, easyJet cited its ability to offer the lowest fares in the market, which it considered was driven by its being the lowest cost operator on the route (easyJet's view was that its Cost per Available Seat Kilometre was significantly less than that of BA's short haul equivalent).

35. easyJet also emphasised the consumer benefits that the introduction of a different business model could produce. The introduction of the no-frills business model into the market would, in the view of easyJet, increase product choice and favour innovation. In support of this, easyJet cited a number of examples of fare restrictions that are applied in the London-Cairo market currently, for instance restrictions that apply to the duration of stay and consequently which may dictate the day(s) of travel. In contrast, easyJet stated that it does not price discriminate since there is only one fare on offer at any one time for a flight and that one-way pricing means necessarily that there are no minimum stay restrictions. easyJet considered that, to purchase a ticket without such restrictions[9] on any of the competing carriers from Heathrow, passengers would be required to pay a significant premium to both the 'lead-in' fares offered currently by the incumbent carriers on the route and compared with easyJet's fare proposals.

36. easyJet drew attention to its yield management system, which increases prices as available seats are taken up according to defined algorithms aiming to achieve 100% load factor on the day of departure (easyJet cited evidence that its network average load factor for 2008/09 was 85.5%). Not only did easyJet propose that it would have the highest load factors of the applicants, but it also considered that it would carry the most additional UK O&D passengers as compared with the proposals of both BA and bmi.

37. easyJet argued that, given Gatwick and Heathrow were both in the same market, a high pricing carrier could not profitably increase its prices at Heathrow by a significant amount in the face of competition with an airline operating out of Gatwick. In addition, easyJet submitted that its experience was that demand for its flights was affected by the pricing of routes from other London airports to the same destination

[9] One which, in the view of easyJet, would be comparable to the type of unrestricted fares that it was proposing to make available

airports. It also gave the example of easyJet's entry on the route Luton-Tel Aviv, which it argued had lowered BA's pricing on Heathrow-Tel Aviv.

38. Longer term, easyJet considered that allowing it to operate on the route would provide a platform from which it could operate services from UK regional airports. easyJet cited its 'join the dots' strategy, which was to develop network points that were then served from an increasing number of easyJet bases, which allows easyJet to develop its brand at the destination city. However, easyJet expressed the view that it was usually only practical to commence the process of establishing the network point with a service from a London airport, rather than from a UK regional city, due to the number of potential passengers in London and its attractiveness as a destination from abroad. easyJet considered that a service between Gatwick and Cairo would be the commercially sensible way to establish Cairo as a network point. easyJet also drew attention to the fact that it operated to a number of other tourist destinations in Egypt and that an easyJet Cairo service offering one-way pricing would benefit passengers travelling on multi-centre breaks in Egypt.

ANALYSIS

Summary

39. The CAA must allocate scarce capacity in a manner which it considers is best calculated to achieve the objectives set out in regulation 9 of the Regulations. It has considered the arguments presented by the applicants in their written evidence and at the hearing. The CAA notes that none of the applicants proposed that frequencies currently operated by BA and bmi be reallocated. Neither did they suggest that the three additional frequencies might be divided amongst the applicants. In practice therefore, it can be seen that the three applicants are competing for the three additional frequencies agreed at the June 2010 negotiations. However, it is the responsibility of the CAA to allocate all of the frequencies available on the route in the manner which it considers is best calculated to achieve the objectives of regulation 9. Accordingly, the CAA's assessment of each applicant's proposal for the three additional frequencies against the Regulation 9 objectives must take into account the offerings already available in the market. To this end, the CAA has assessed how the allocation of the additional three frequencies negotiated at the June 2010 bilateral talks would best facilitate achievement of the regulation 9 objectives on an incremental basis. The CAA has also assessed and satisfied itself that the overall allocation of available frequencies which results is such that it best facilitates achievement of the regulation 9 objectives.

40. None of the parties 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 consumers in order to quantify such elements, but has undertaken a comprehensive assessment of the arguments and evidence brought forward by the applicants, based on a largely qualitative evaluation of the likely alternative outcomes.

41. It is the view of the CAA that, on balance, the grant of the three additional frequency rights to easyJet, with BA granted the seven frequency rights that it operates currently under UK traffic rights and bmi granted the four frequencies that it operates currently under UK traffic rights, would best facilitate achievement overall, and on an incremental basis in relation to the additional three frequencies, of the objectives set out in regulation 9 of the Regulations. The reasons for this decision are set out below.

42. The route in question is subject to capacity constraints in the form of a limit on the frequencies that can be operated by airlines on both sides. The market declined at the beginning of the decade to around 300,000 passengers per year, but has grown considerably in the last three years, with almost 500,000 passengers carried during 2009. In terms of carriers currently operating the route, in the year to June 2010, the share of passengers breaks down as follows (with share of flights in brackets): BA 32% (31%); bmi 25% (32%); Egyptair 44% (37%). Passenger load factors on the route appear relatively high, as does BA's northbound cargo load factor.

43. The choice before the CAA was either to strengthen one of the UK incumbents on the route or to allow a new entrant to join the market. In summary, having weighed up the propositions, the CAA was not persuaded that allocating the frequencies so as to strengthen one of the existing incumbents at Heathrow relative to the others would deliver as significant a benefit to consumers as would the introduction of easyJet as a new entrant, offering a differentiated product from a different London airport, with greater choice and potential competitive stimulus in terms of fares and innovation.

44. In relation to bmi's case, the CAA acknowledges that the entry of bmi onto the route in 2007 led to both an increase in capacity and an increase in rivalry between competing airlines operating from Heathrow. The CAA notes bmi's argument that it should be granted the additional three frequencies in order to ensure that the consumer benefits associated with its entry are not lost (as a result of the possible withdrawal of the arrangement whereby it 'borrows' frequencies from the Egyptian allocation). However, based on the evidence presented to it, the CAA does not consider that the outcome that bmi will no longer be able to continue to borrow frequencies from the Egyptian allocation to be sufficiently likely in the near term to justify it granting the three additional frequencies to bmi. This reasoning requires the CAA to consider the benefits of granting bmi's application with it continuing to operate the frequencies it borrows from the Egyptian allocation (as opposed to operating at a lower frequency level without the borrowed frequencies). That bmi has been an effective competitor on the route since its entry in 2007 has already been acknowledged above. Given this, and given that bmi, through its codeshare arrangement with Egyptair, has, to a degree, a competitive advantage over BA in terms of the frequency it can offer[10], the CAA does not consider that adding to bmi's frequency advantage by granting it the additional three frequencies would enhance the rivalry between the three competing airlines operating from Heathrow.

45. In respect of BA's case, and considering the evidence presented to it (set out in detail elsewhere in this document), it is the view of the CAA that current rivalry on the route is characterised primarily by three-way competition between BA, bmi and Egyptair (indeed, BA itself acknowledges that bmi and Egyptair compete on price). Notwithstanding this, the CAA acknowledges BA's argument that it is at a frequency disadvantage in comparison with the codeshare offering of bmi and Egyptair and that, other things being equal, there could have been consumer benefits associated with enabling BA to compete on a more comparable basis in frequency terms. However, having compared all the propositions before it, the CAA considers that, in this case, consumer benefit will better be enhanced through the introduction of a new entrant in the form of the alternative proposition offered by easyJet, offering a differentiated product and operating from Gatwick, than through altering the balance between the existing UK competitors in terms of frequencies.

[10] Although not over Egyptair, as things stand currently.

46. The CAA notes the case put forward by BA in relation to the cargo benefits of its proposal and acknowledges that BA has proposed to carry significantly more cargo than the other two applicants. However, based on the evidence presented to it, the CAA is not convinced that the cargo market in this case can be defined so narrowly that viable supply and demand side substitutes will not be available for most cargo services offered by BA. The CAA acknowledges that there may be some categories of cargo for which a direct routing is desirable. However, the CAA is not convinced that this segment of the market is substantial compared to the cargo market overall and hence that the BA case is as strong in this regard as BA would suggest (see the Cargo section of the Consumer Benefits analysis for further detail). For these reasons, the CAA does not consider that the additional cargo benefits likely to flow from BA's proposals, taken in addition to any passenger benefits arising from its proposals, are sufficient to justify granting the three additional frequencies to BA.

47. 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. Given this, the number of O&D passengers to be carried by each party is relevant to the CAA's considerations. As explored further in paragraph 85 below, it was not possible to agree on suitable assumptions for this figure for each party; in any case such projections are inherently uncertain. Given this, the CAA does not consider it possible to conclude definitively on the number of O&D passengers each airline should be assumed to carry under its proposals. However, the CAA does not consider this to be material to its decision in this case, as even the 'lower bound' figure for transfer passengers produced by BA at the hearing[11] results in BA being projected to carry only slightly more O&D passengers than easyJet (with use of higher figures showing an easyJet advantage), with both airlines projected to carry significantly more O&D passengers than bmi.

48. It is the view of the CAA that, on balance, granting the three additional frequencies to easyJet would be likely to deliver the greatest benefit to consumers. Having considered all the propositions before it, it is the view of the CAA that additional rivalry from a new entrant in the form of easyJet, which proposes to introduce a no-frills service operating from Gatwick, is likely to lead to the greatest consumer benefit. The CAA acknowledges that easyJet is proposing to operate on the route with three flights per week and is unlikely to be able to increase its frequency in the foreseeable future given the capacity constraint on the route. The CAA is not relying, therefore, on an expectation that the introduction of easyJet will impact competition on the route to the extent that no-frills carriers have been able to historically in other markets, i.e. where their entry into unconstrained markets has led typically to a wider choice of fares. However, the CAA is persuaded by easyJet's business plan for operating the route, and is of the view that the introduction of easyJet will enhance the degree of rivalry on the route, in particular through its offering of lower, one-way fares, and will therefore increase competitive pressure on Heathrow services to the benefit of passengers at that airport.

49. The CAA considers that the existing three-way rivalry on the route extends to product rivalry. Each of the three existing carriers offer a similar full-service product and operating from Heathrow, meaning that those consumers that wish to take advantage of such a service already have available a number of competing propositions. In contrast, the product offered by easyJet provides something quite

[11] This lower bound figure applies only to the additional frequencies BA was seeking.

distinct, which should increase the choice available to consumers in the market and thus yield greater product benefits than allocating the additional capacity to either of the existing UK carriers on the route.

50. Given the scope and nature of the offerings already in the market the CAA therefore considers that, on balance, the award of seven frequencies to BA, four frequencies to bmi, and three frequencies to easyJet would best facilitate achievement of the regulation 9 objectives overall and that the award of the three additional frequencies to easyJet also best facilitates achievement of the regulation 9 objectives on an incremental basis.

Market definition and rivalry

51. 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.”

52. Consideration of market definition is usually the first step in identifying the competitive constraints faced by a supplier and assessing market power. In the context of scarce capacity allocation it is important in 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.

53. In line with OFT guidelines[12], and in line with the views of the parties expressed in evidence and at the hearing, the CAA has in this case decided that it is not necessary to define the market uniquely. Instead, it has concluded that it is sufficient to focus on the features of the market most relevant to the case (such as the competitive constraint exercised by the services under consideration), and exclude those that are not.

54. Data available to the CAA and the parties for the purposes of considering the relevant market(s) included the origin/destination and journey purpose of passengers travelling on the route; the proportion of traffic travelling indirectly; and the cargo traffic on the route.

55. There was agreement between the parties that passengers and cargo constituted separate markets. These are therefore covered in turn below.

[12] Market Definition: Understanding Competition Law, OFT 403, 2004.

Passenger market(s)

56. There was general agreement between the parties, and the CAA concurs, that the most relevant features of the passenger market in this case were that:

- London-Cairo was the most appropriate geographic dimension (see from paragraph 74 below for a discussion of rivalry between services operated, and those proposed, from Heathrow and Gatwick airports).
- The London-Cairo market is predominantly for direct travel between the city-pair. CAA survey data suggests that in 2009 about 10% of passengers travelling between London[13] and Cairo did so indirectly. BA suggested that, should prices rise for direct flights, indirect travel might become more attractive as a substitute, and therefore the possibility of indirect travel would provide some competitive pricing constraint. However, no evidence was presented that indirect flights were a close substitute despite the capacity constraint on the route.
- It was not useful in this case to distinguish between time-sensitive and non-time sensitive passengers, or between passengers travelling for business versus leisure purposes.

57. In addition, the CAA concludes from the evidence presented that:

- Passengers connecting in London from international services can choose from a number of alternative hubs through which to connect to/from Cairo. The competitive offering presented to such passengers would therefore be unlikely to be affected significantly by the addition of three frequencies from London.
- Passengers connecting in London from domestic services can choose from a number of alternative hubs through which to connect to/from Cairo and, therefore, are also unlikely to be affected significantly.
- Passengers travelling on from Cairo to beyond points can choose from a number of alternative hubs through which to connect and, therefore, are also unlikely to be affected significantly.

58. Given that the parties agreed that Heathrow and Gatwick airports are in the same market for the purposes of this case, the CAA did not see it as necessary to consider the implications of any alternative market definitions and has accordingly made its decision on that basis.

Cargo market(s)

59. BA stated in its written evidence that, in the previous six months, its share of the northbound Cairo–London air cargo market (northbound being the main cargo flow on the route) was approximately 6%, including cargo connecting to other flights. Of that share, 70% was high-density perishables for the UK market, with the remainder largely garments and textiles destined for North America. BA stated that its current bellyhold capacity was not meeting the rising demand for freighting cargo out of Cairo and that, at times, it was weight constrained and/or volume constrained on flights.

60. BA was of the view that its cargo customers choose to use its service primarily for time-sensitive products; if these customers' products were not time-sensitive they would use shipping instead. Although BA did not suggest that indirect routes could

[13] London City airport was not surveyed in the 2009 CAA Passenger Survey.

not provide some substitution for direct routes, it did argue that, in this case, indirect routes were inferior substitutes as they added time, costs (e.g. fuel), logistical complexity and customs issues. BA also acknowledged the possibility that the geographic market for cargo could be wider than the London-Cairo city pair, for instance that it could include other UK airports as well as other Egyptian airports, but considered that the additional costs and complexity of operating a flight / road haulage combination meant that it was an inferior substitute to a direct air cargo product. In addition, BA acknowledged the possibility of supply-side substitution, but expressed the view that, given that the end customer might have a preference for the origin of the goods (BA considered that there was demand for Egyptian perishable products specifically, as well as garments and cotton products from Egypt), supply-side substitution might be limited (and, indeed, might lead to additional costs being incurred if the products had to be sourced from further away).

61. bmi cited the European Commission's decision concerning the BA-Iberia merger case[14] and its findings in relation to cargo. Although this decision was in relation to a different market, bmi argued that it presented useful precedents. The decision held that there was no need to segment the market into different types of airline provider (e.g. all-cargo vs. bellyhold). However, BA did not consider that cargo carriers specialising mainly in courier and parcel business such as FedEx, UPS, and DHL could provide an effective substitute for direct bellyhold services since these carriers did not offer the full range of services required by cargo customers, and some actually sub-contract to BA. BA acknowledged that other operators, such as Cargolux, Martinair, Air France, and KLM, offer a wider range of products, but that these carriers, in addition to flying indirect, focus more on general freight, rather than the specialist services that BA provides. The Commission's decision also set out that it was likely that any indirect/one stop route was a substitute for any direct/non-stop route. easyJet and bmi argued that indirect routes, for instance via hubs in Continental Europe, could be considered as effective substitutes for the direct route. easyJet also suggested that cargo could be carried from Egypt to airports outside London as a suitable substitute as it would need trucking from Heathrow anyway. BA argued that indirect routes were inferior substitutes particularly in relation to time-sensitive cargo (e.g. perishables, pharmaceuticals); however, bmi pointed to the view in the Commission decision that no segmentation according to the type of cargo should be made.

62. The CAA accepts that BA's direct northbound cargo service may, at times, be operating at or around capacity; however the CAA does not consider, based on the evidence presented to it, that the constraint on BA's operations resulting from the capacity cap is leading to a significant constraint in the air cargo market overall. The CAA concludes that, although it is not necessary to define the air cargo market uniquely, a degree of substitution for direct London-Cairo bellyhold operations is available from a number of sources, such that, when considered in total, these substitutes could apply a sufficient competitive constraint on direct operations. In the view of the CAA, a sufficient degree of both supply and demand substitution, although imperfect, could come from indirect services, all-cargo operations, and services between other Egyptian and UK airports. For example, Egyptair currently operates one service each week between Luxor and Heathrow on which bellyhold cargo is carried. As set out earlier (see 'Terms of the ASA' section) the bilateral agreement between the UK and Egypt provides for the possibility of all-cargo services (albeit not daily) between Cairo and any non-London airport in the UK (indeed, prior to its recent expansion of direct services between Cairo and London, Egyptair operated an all-cargo service between Cairo and Manston airport). BA

[14] COMP/M.5747 – Iberia/British Airways

argued that there was demand for specific Egyptian products. The CAA acknowledges that there may be some products for which there is a preference for Egyptian-sourced products, but no evidence was produced to demonstrate that there were not suitable substitutes, or that this was a large proportion of the market.

Rivalry

63. All parties focused in their evidence on the nature of competition between carriers currently operating on the route, and what their respective proposals would bring to this.

New entry vs. additional capacity

64. As described previously, it was BA's view that capacity is the main driver of price on capacity constrained routes, and that BA's proposal offered by far the largest capacity increase of the three applicants. BA also argued that, with an additional three frequencies, it could offer a service at the beginning as well as the end of a day on three days per week, which would also bring additional connecting opportunities with the UK regions. BA's case was that consumers would benefit from its adding more capacity, especially given its range of passenger products and its cargo offering. BA also argued that it could compete with the combined offering of Egyptair and bmi on a more equal footing, to the ultimate benefit of end consumers, if it could operate at a frequency more comparable to the codeshare partners.

65. bmi argued that it had provided effective competition to BA and Egyptair since entering the route in 2007, pointing to falls in fares in both business and economy class of 30%, and increases in passenger numbers. bmi put this down in part to the offering it had been able to bring forward, in terms of frequency, through its commercial arrangement with Egyptair, to the benefit of consumers, and to its ability to provide 'head-to-head' competition with the other Heathrow carriers. bmi's proposals would also increase connectivity to UK consumers.

66. easyJet promoted the rivalry effects of a new entrant approaching the market differently and offering a differentiated product, highlighting the impact on product and price from introducing a competing, low cost, no-frills business model. easyJet expected both to stimulate new passengers and also to take some from the existing carriers operating from Heathrow, and argued that this possibility would act as a competitive constraint on the three incumbents operating from Heathrow. easyJet argued that as the route is 80% leisure traffic, price is a key factor for passengers and therefore its low-fares offering would provide genuine rivalry to the offerings of the other carriers.

67. easyJet argued that there was a difference between constrained and contestable routes. On the latter, the potential for new entry would constrain pricing within the market to some degree. However, with the former, where there was no potential for entry, competitive discipline could be imposed only by actual competition. easyJet argued that this strengthened the case for introducing additional competitors into a constrained market.

Impact of the bmi / Egyptair commercial arrangements

68. bmi and Egyptair, both members of Star Alliance, operate under a codeshare arrangement whereby each places its code on the other's flights and sells those flights alongside its own. This particular arrangement was described by bmi as 'plain vanilla', comprising a conventional free-flow codeshare whereby the operating carrier

determines the inventory (i.e. its revenue management system determines how many seats are made available in any particular booking class and therefore for any given fare type, and for how long) and the marketing carrier has access to this and sets its own fares independently of the operating carrier. The codeshare is underpinned by a Special Prorate Agreement (SPA), the terms of which determine the 'wholesale' price each carrier will charge the other, the price varying according to booking class. bmi gave evidence that the SPA is revisited roughly every six months/ once a year.

69. Neither BA nor easyJet disputed that, under the codeshare, bmi and Egyptair price independently. bmi stressed that the extent of the bmi / Egyptair cooperation should not be overstated, claiming that rivalry between them was “intense”. bmi cited a trade press[15] survey of alliances which described the level of cooperation as ‘low intensity’. In bmi’s view, the two carriers operate as completely separate entities, for example using different terminals at Heathrow. Any discussions between bmi and Egyptair on the issue of scheduling were associated with the provision of airport slots. bmi maintained that some customers preferred to travel with a specific carrier; hence not all codeshare flights could be viewed as equivalent from the passenger’s perspective. From bmi’s perspective, it only had complete control (e.g. in generating and retaining cost efficiencies) over ‘own metal’ flights, and so these were more valuable.

70. BA’s case was based on the argument that it operated in direct competition with a combined bmi and Egyptair operation, which, as previously mentioned, it saw as a “monolith”, evident in the codeshare arrangements and use of the Cairo terminal. BA argued that it needed the additional frequencies to enable it to compete effectively with this combined operation, which together offered 17 of the currently available 28 frequencies per week from Heathrow.

71. The CAA does not consider that bmi and Egyptair should be viewed as a single entity when considering rivalry in the market. Each makes price and capacity decisions independently and has its own distinct product features. The two compete with each other on fares (a point which BA acknowledges) and the codeshare arrangement is such that the operating carrier is at all times in control of its own inventory. Neither does the CAA agree with easyJet’s suggestion that, because one carrier may offer similar prices on ’own metal’ and codeshare flights that this demonstrates a lack of price competition. However, the CAA does accept that bmi is able to offer a frequency advantage over BA through its codeshare with Egyptair. It also accepts that there is likely to be a sharper rivalry between BA vs. bmi and Egyptair than between the two alliance partners themselves.

Competitive constraint from easyJet

72. easyJet confirmed that it would not utilise any award of fewer than three frequencies per week, seeing this as the minimum to run a competitive commercial service. No party argued that three services per week from Gatwick would not be sustainable. However, BA and bmi argued that easyJet’s proposed offering of three services per week would not present a competitive constraint to the current Heathrow service.

73. BA pointed to easyJet’s argument that BA would not substantially affect competition in the cargo market by increasing its share of the market to 8.75%, and likened this to easyJet’s entry into the passenger market, which would give it a

[15] Airline Business, September 2010.

similar 8.8% market share. easyJet's counter to this was that the easyJet figure would be new market share, compared with BA's cargo increment of 3% over its current offering; and that the introduction of a new entrant would have a different effect (creating more 'dynamic' benefits – see from paragraph 89 below) from an increase in capacity by an incumbent. In addition, easyJet argued that the cargo market is wider, and more competitive, meaning that a 3% increment would have a lesser effect. BA argued that any difficulty it would have competing with the combined bmi / Egyptair offering would pale against the difficulties faced by a new entrant offering only three services per week and a total seat capacity of 540 in each direction. Awarding the frequencies to easyJet would, in BA's view, fragment competition and thus make it less effective.

74. All parties agreed that both Heathrow and Gatwick airports were in the same market for the purposes of this case (see Market Definition section above). However, bmi drew a distinction between operations from Heathrow airport as compared to Gatwick airport in terms of the degree of rivalry that such operations can provide. bmi argued that the introduction of three services per week from Gatwick would not stimulate price competition with carriers at Heathrow to any significant degree.

75. easyJet argued that it was illogical to imply, as it felt bmi was seeking to do, that competition from Gatwick should be discounted or given less weight. easyJet considered that were only two possibilities: either flights from Gatwick were in the same market as those from Heathrow, in which case they would impose a real competitive constraint; or that they were not, in which case this separate Gatwick market was not served at all currently and so easyJet entry would transform provision in that market. easyJet stated that its view was that the former definition applied and that, in its view, it had been accepted by all the parties that flights from Gatwick were in same market as those from Heathrow Therefore , by definition, it must be accepted that strong and effective price competition exists between the two. easyJet stated that its experience was that demand for its flights was affected by pricing of routes from other London airports to the same destinations. It also gave the example of its entry on the route Luton-Tel Aviv, which it argued had led to a lowering of BA's pricing on Heathrow-Tel Aviv. In addition, easyJet cited the example of London-Toulouse, where, in its view, there had been no impact on easyJet's revenue per seat (RPS) on the Gatwick-Toulouse route when BA moved its Toulouse services from Gatwick to Heathrow. In summary, it was easyJet's view that services from Gatwick offered a very real and significant constraint in relation to Heathrow services.

76. easyJet argued that three services per week from Gatwick was a sustainable offering even if there was no further expansion, even over the medium term, as a result of an inability to liberalise further the traffic rights between the UK and Egypt. It expressed a desire to grow the route, should it prove successful, but that the success of its proposition was not reliant on this.

CAA conclusions on rivalry

77. Based on the evidence presented to it, the CAA's view is that the current rivalry on the route is characterised primarily by three-way competition between BA, bmi and Egyptair. The CAA's view is that, given the number of airlines already competing on the route, and given the relative similarities in their service offering (especially in relation to product and frequency), allocating the frequencies so as to strengthen one of the existing incumbents at Heathrow relative to the others would not enhance rivalry in the market to as significant a degree as would the introduction of easyJet as a new entrant with its proposition, which, due to the nature of its business, could be expected to bring an additional element to competition in the market.

78. The CAA does not agree with bmi that easyJet's proposal will not stimulate competition with the existing Heathrow services because it is proposing to operate from Gatwick. Rather, the CAA agrees with the general consensus that, for the purposes of this case, Gatwick and Heathrow can be considered to be in the same market, and therefore that there will be competition between services from the two airports. As to the degree of this competition, the CAA considers that a number of factors are relevant, in particular the price, product, and frequency of the Gatwick service relative to those from Heathrow. Noting the nature of easyJet's proposed offering, the CAA considers that easyJet's services from Gatwick are likely to be sufficiently attractive to a large enough proportion of passengers to be considered an effective substitute to the existing services from Heathrow. Similarly, and in response to the point made by BA, it is the view of the CAA that the nature of easyJet's proposition is likely to mitigate significantly the difficulties that might otherwise be faced by an airline choosing to operate a thrice-weekly service in competition with incumbents operating a daily service.

79. The cargo propositions of the parties are discussed below, but these did not feature any issues around rivalry between the parties themselves in the carriage of cargo.

Consumer benefits

Capacity proposals

80. BA proposed to operate seven of its ten services per week using a Boeing 747-400 and the remaining three services per week using a Boeing 777, both in a four-class configuration. This would be equivalent to a total seat capacity of 3,037 seats per week in each direction, which was, as BA pointed out, the biggest capacity increase of the proposals. In response to challenges from the other parties that its load factors were lower than other competitors on the route, BA pointed to economy cabin load factors averaging around 90% (albeit lower in the current calendar year because of exceptional circumstances). BA expected to see load factors increasing under its proposals as it attracted more passengers and took advantage of its network connections. In response to easyJet's challenge that BA might choose to maximise fares at the expense of load factors, BA explained that its revenue management systems were designed to maximise revenue through volume. With the incremental three frequencies, BA's case was that it would increase capacity on the route, which would automatically bring down fares over time, and that it would continue to offer passengers a better proposition overall than bmi or easyJet as well as enhancing competition. bmi challenged BA's position, saying that it would be counter-intuitive to grant additional frequencies to the carrier with the largest unused spare capacity currently.

81. bmi proposed to operate its seven services per week using an Airbus A321 configured with 31 business and 118 economy class seats; a total seat capacity of 1,043 seats per week in each direction (just counting the UK designated air services utilised and not the Egyptian ones which it is currently able to use). Prior to the Summer 2010 season, bmi had used the larger A330 on the route. bmi said that it would have the option of putting a larger aircraft on the route again in future, as an A330 would become available in March 2011. bmi argued that it made most effective use of current capacity, pointing to its high passenger share relative to capacity share compared with that of BA. bmi was keen to "entrench and ensure" its success on the route by gaining seven frequencies per week in its own right, whilst also seeking to continue to utilise the Egyptair frequencies. The incremental benefit it would deliver

from the additional three frequencies would be to offer better connectivity to UK customers, to generate cost savings, with benefits to consumers, and to guarantee the ongoing competition with existing carriers by operating frequencies in its own right.

82. easyJet proposed to utilise an Airbus A320 with 180 all-economy seats, equating to a total seat capacity of 540 seats per week in each direction. easyJet argued that its proposal would deliver fare benefits (see below) to a greater number of O&D passengers and that the no-frills product would increase choice for consumers. Although primarily a leisure route, 'full service' premium passengers were already catered for, and the easyJet product would also appeal to business passengers seeking lower fares, as the CAA's own analysis recognised.[16]

Beneficiaries

83. As noted in paragraph 47 above, 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 consumers from each proposal. None of the parties 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.

84. No party attempted to apportion benefits in terms of business versus leisure passengers, connecting traffic etc. Given the position on market definition, this was probably not necessary, However, there was significant debate about the number of O&D passengers generated by each proposal, as estimated by easyJet in its submissions, given the nature of the demand to be satisfied and interests to be met, as set out in the paragraph above.

85. BA and easyJet disagreed over calculations of which would carry the most additional O&D passengers with their competing proposals. Central to this disagreement was the proportion of international connecting traffic carried on this route by BA, which easyJet had used as an indication of the proportion of connecting traffic which would be carried on the three additional frequencies, if awarded to BA, in the future. BA argued at the hearing that the figure produced by the CAA's 2009 survey for the proportion of BA London–Cairo passengers connecting to or from an international flight at London (45%, with a 95% confidence interval of this being between 40-50% and a 99% confidence of between 39-51%) was too high. BA's own figures produced in oral evidence were that in calendar year 2009, only 32% of its passengers on the route were foreign connecting passengers (reducing to 24% in the current calendar year to date). BA went on to reveal its own forward projections of how many additional O&D passengers it would carry on the route were it to be awarded the additional frequencies, and in respect of these frequencies suggested that the proportion would fall to only 10%. BA therefore argued that using its own figures in the O&D calculations generated by easyJet would give both easyJet and BA roughly the same number of additional O&D passengers. bmi countered that the CAA survey showed bmi to be carrying more O&D passengers than BA on services currently operated.

[16] *No-Frills Carriers: Revolution or Evolution? A study by the CAA.* CAP 770, November 2006

86. Given the category of consumers that the CAA is required to focus on (as described above in paragraph 83), these figures for historic and projected O&D passengers are relevant to the CAA's consideration. However, forward projections inevitably carry some uncertainty. BA raised questions over how representative the CAA survey could be of the passengers BA carries, given the sample size. In contrast, bmi and easyJet stated that they would prefer the CAA to rely on its survey results rather than on BA's figures, which were produced as oral evidence at the hearing with no supporting documentation as to how the figures had been derived, and which therefore none of the parties had the full opportunity to test. As a result, parties at the hearing were unable to agree on suitable assumptions to be made. Given this, and given the inherent uncertainties in making such projections, the CAA does not consider that it is possible for it to conclude definitively on the number of O&D passengers each airline should be assumed to carry. However, the CAA does not consider this to be material to its decision in this case, as even the 'lower bound' figure for transfer passengers produced by BA at the hearing results in BA being projected to carry only slightly more O&D passengers than easyJet, with both airlines projected to carry significantly more O&D passengers than bmi[17].

87. The following sections weigh up in more detail how each applicant proposed to use the additional capacity in terms of fares, schedules, product and carriage of cargo.

Fares

88. With an existing fare structure in place, bmi and BA did not produce any specific proposals for the fares they would offer should they be awarded the additional frequencies. As described above, BA argued that the addition of capacity would lead to prices in the market falling over time as the supply/demand balance reached a new equilibrium ('static' fare benefits). Since its proposal offered the greatest proposed additional capacity, BA considered that its proposition would bring the greatest 'static' fare benefit. While BA recognised that the interplay between competitors was relevant in this regard, it saw the capacity increase as being a more important component, because some price stimulation would be needed to fill that capacity. BA reasoned that, with capacity increasing in the region of 16-20% in the market as a whole, and taking into account some demand growth in line with economic recovery and a price-elasticity of between 1.2 and 1.5, prices in the market should fall by about 4 to 10%. BA questioned why any carrier would reduce fares beyond that necessary to fill the capacity.

89. BA explained that its pricing strategy was to set a (transparent) fare ladder, and then let the market decide: if seats sell then the price goes up, if not then the price stays the same or reduces. It would sell fewer seats at each point on the ladder as the price increased, selling most at the fare in the lowest booking class (with around 50% of passengers on this route currently buying "the lead-in fare or lower").

90. bmi agreed that the addition of capacity would put downward pressure on fares, but also saw a role for greater rivalry from "high quality" "head-to-head" competition from rivals operating at Heathrow ('dynamic' fare benefits), citing as an example bmi's entry onto the Cairo route in 2007 when passenger numbers grew and fares

[17] Based on BA's figures and using easyJet's methodology, which is based on the additional three frequencies. However, based on easyJet's original figures, bmi is projected to carry substantially more O&D passengers than BA. bmi did not present its own figures or projections on the number of O&D passengers it expected to carry.

fell. bmi's price levels would be driven by what it thought the market levels were to fill the aircraft. On this route, it would generally price below BA and above Egyptair.

91. easyJet also recognised the role that rivalry plays in price competition, and argued that the addition of the incremental capacity by a new competitor would reduce prices still further, citing the track record of no-frills, low-fare airlines over the past 15 years. easyJet set out its proposed fare ladder, which included a low lead-in return fare of £148.20 (including taxes, charges for one bag checked into the hold and payment by credit card) and which compared with the lowest currently available return fare of £322.20 from Egyptair. easyJet's proposed maximum fare was some way below the highest economy fares of BA and bmi. easyJet also set out its own estimates comparing average fares for each airline on this route and on London–Tel Aviv as a further comparator.

92. BA contended that easyJet's average fare would need to be substantially higher than easyJet's lowest proposed fare, given BA's assessment of easyJet's costs on the route. BA and easyJet disagreed over the costs that easyJet would face. easyJet acknowledged that its average fare would be higher than the lowest fare, which met only marginal avoidable costs ('marginal cost of carriage'), at which relatively few seats would be sold. BA argued that, taking the costs it had calculated for easyJet using published sources, and considering easyJet's forecast profit figures over the three years at a constant load factor, easyJet would have to raise fares by year three. easyJet did not accept BA's assessment of its costs, saying that BA had used unrepresentative data, in particular on fuel costs, and that true figures should be roughly 50% lower than those stated by BA. BA estimated that easyJet was predicting that its one-way fare would rise by year three (to £155). easyJet agreed that its financial forecast assumed that it would be looking to grow its revenue per passenger over the period[18]. However, easyJet pointed out that this was an 'artefact' of the methodology it used to generate such forecasts (the methodology assumes a constant load factor but allows prices to vary), and that it was possible that such an increase could in fact be achieved through an increase in load factors rather than a rise in prices. easyJet was of the view that the market would determine the appropriate fare levels.

93. BA also challenged the comparability of easyJet's fares with its own, given what was and wasn't included in the fares of each airline. easyJet noted that fares quoted in its evidence included charges for one hold bag and payment by credit card, and that the difference between the two airlines was that easyJet's customers had the choice of what additional ancillary services they could buy, unlike with BA. easyJet argued that even if its average fare increased, and taking into account such ancillaries, its fares would still be substantially lower than those offered by BA and bmi. easyJet explained that the proposed fare ladder replicated that already on offer on its Hurghada route, which, although not capacity constrained and so not directly comparable, had proven both popular and profitable with this fare offering. easyJet also argued that keeping fares down was key to its brand offering, and to attracting customers to its website, hence it would not be able significantly to raise prices. In addition, as a new entrant easyJet argued that it would need to price competitively in order to attract passengers and fill seats. Its revenue management model sought to deliver 100% load factor on the day of departure, so it would need to price competitively to achieve this.

[18] easyJet's forecast assumed that its seasonally adjusted average one-way fare by year three would rise to £161 one way from £131 in year one.

94. easyJet pointed to the fare restrictions BA and bmi currently applied to cheaper tickets. For example, BA required a Saturday-night minimum stay and bmi a three-night minimum stay. easyJet argued that its own one-way pricing structure attached no such restrictions to its fares, hence increasing choice for consumers not wishing to pay for BA and bmi's more flexible fares. It also allowed consumers to combine two one-way journeys, thus permitting travel back from a different city or on a different airline. This innovative (for the London-Cairo route) fare structure would put pressure on the other carriers to remove their current restrictions. easyJet gave the example of the intra-European aviation market as one largely free of such fare restrictions, and produced evidence that BA itself attributed this to the entry of no-frills carriers offering no such restrictions, forcing incumbents to change in order to compete. BA countered that easyJet's fares themselves came with a different form of restrictions, such as charging full fares for children and not providing refunds. BA doubted that the fare restrictions in the market would be affected by the outcome of the hearing. bmi thought that its three-day minimum stay was not a particularly onerous requirement for the majority of its passengers.

95. The CAA considers that, in general, competition is the best available mechanism to ensure that fares are set at reasonable levels in relation to cost. On capacity constrained routes, where there is a risk that the degree of rivalry might be less than would be the case if the route was unconstrained, it is the view of the CAA that particular attention must be paid to the degree of (existing and prospective) rivalry on the route to ensure that the fare benefits associated with allocating additional capacity will be realised in practice. The CAA considers that this view is broadly consistent with that put forward by the parties, although the CAA acknowledges that each party may have differing views as to the balance between capacity and competition in terms of which is more important for generating fare benefits, or the most appropriate form of competition to best ensure those benefits are realised (e.g. 'head-to-head' versus, for instance, competition from other airports), in any particular case.

96. In this case, in relation to the additional capacity that each airline is proposing to provide, the CAA has already noted in paragraph 86 above that, subject to the inherent uncertainties in making such projections, even taking the 'lower bound' figure for transfer passengers produced by BA at the hearing, BA is projected to carry only slightly more O&D passengers than easyJet, with both airlines projected to carry significantly more O&D passengers than bmi[19]. In terms of 'static' fare benefits, therefore, the CAA does not consider that significant weight should be placed on any differences in such benefits derived from differences in the number of additional O&D passengers that each airline is projected to carry, in particular in relation to the applications of BA and easyJet.

97. Given this, the CAA considers that the key issue in relation to fare benefits in this case is the impact that existing and future rivalry will have on 'dynamic' fare benefits. As set out in paragraph 45 above, the CAA recognises that allowing BA to compete with the bmi / Egyptair codeshare on a more equal basis (in terms of capacity and frequency) would be likely to enhance rivalry on the route and yield benefits for consumers. However, based on the evidence presented to it, the CAA's view is that the current rivalry on the route is characterised primarily by three-way competition between BA, bmi and Egyptair, and that bmi and Egyptair compete on price (a point which BA itself acknowledges). The CAA does not consider, therefore, that enhancing the competitive position of BA relative to its existing rivals is likely to

[19] Based on BA's figures and using easyJet's methodology. See footnote 17.

yield as great an increase in ‘dynamic’ fare benefits as would the proposition offered by easyJet, which is to introduce a new entrant operating from Gatwick with a different business model (i.e. low cost, ‘no-frills’) to that offered by the existing airlines operating from Heathrow.

98. The CAA accepts easyJet’s argument that its proposal is more likely to deliver greater ‘dynamic’ fare benefits for consumers than the proposals of BA and bmi, even though this will remain a capacity-constrained route. In reaching this view, the CAA has not relied unduly on a comparison of the various fare ladders submitted by each of the applicants – given that no information was provided by the applicants on the number of seats that would be made available at given price points, it would not be appropriate for the CAA to attach undue weight to this information. Indeed, the CAA accepts that easyJet’s average fares may rise over time, as it establishes itself on the route, and this is a possibility that easyJet itself recognises. Neither is the CAA relying on an expectation that the introduction of easyJet will impact competition on the route to the extent that no-frills carriers have been able to historically. However, the CAA considers that easyJet’s business model, focussed on offering low, one-way fares will be likely to exert downwards pressure on fares, as well as offering greater choice around price and quality to consumers.

Frequency, schedules and connections

99. Central to BA’s case is that the additional frequencies are necessary for it to be able to offer a more competitive service in terms of frequencies, schedules and connections to that offered by the bmi / Egyptair codeshare partners. BA stated that it would like ideally to offer a double-daily service.

100. bmi pointed out that through the codeshare with Egyptair it already offers a choice of two or three daily departures to Cairo at different times of the day. The additional three frequencies would allow it to expand this offering to a very attractive thrice-daily service (except on one day).

101. easyJet noted that, unlike for the incumbent carriers, denying it these frequencies was equivalent to preventing it entering the market for the foreseeable future. easyJet argued that three frequencies per week would be sufficient to give it a platform from which it could mount a greater frequency should more capacity become available. It had chosen the schedule for its services to fit with its view of the Egyptian market (business days, days of the week to fit with cruise departures and to serve midweek and weekend breaks) and saw the Cairo operation as part of a wider strategy to ‘join the dots’, for example between its bases at UK regional airports and points served from London as it had done in the case of Manchester–Sharm el-Sheik. The Cairo route would also fit well with the 21 services per week easyJet operated to other Egyptian destinations (Gatwick - Sharm el-Sheikh, Gatwick - Hurghada and Luton - Sharm el-Sheikh). bmi criticised easyJet’s offering of three services per week as not being able to meet all categories of demand. As well as offering only a single-class product, bmi considered that easyJet would offer inferior flexibility in term of timing for both leisure and business passengers, and also that the timings of its services differed with the day of the week.

102. It is the view of the CAA that the allocation of additional capacity can, in this case, be expected to yield benefits for consumers beyond the static / dynamic fare benefits discussed above, in terms of a wider choice of flight times and days of operation allowing greater flexibility to change travel plans at short notice, as well as additional connection opportunities. However, the CAA considers that these incremental flexibility benefits must be considered alongside the (higher) level of

rivalry that could be delivered by introducing a new entrant to the route as opposed to allocating additional capacity to an incumbent.

103. In this case, the CAA accepts that bmi's codeshare with Egyptair gives it a clear frequency advantage over BA. Allocating the additional three frequencies to bmi would of course enhance the flexibility of its offering further in terms of frequency, schedules and connections[20]. However, the CAA considers that this should not be achieved at the expense of rivalry which, in the view of the CAA, could be adversely affected by strengthening the frequency advantage of the codeshare partners. Rather, the CAA acknowledges BA's argument that it should be allowed to increase the frequency of its service so that it can compete with the bmi / Egyptair codeshare offering on a more equal basis. The CAA agrees that BA's proposal would allow it to offer a more flexible, and therefore attractive proposition with which to compete with the bmi / Egyptair codeshare offering, and that this outcome would yield benefits both for BA and for consumers in terms of frequency, schedule and connections. However, ultimately, this advantage did not outweigh the likely benefits overall of the easyJet proposal, as outlined elsewhere in this decision.

Product

104. BA pointed to the fact that it offers a choice of four different classes on all services to Cairo catering for a wide range of customer requirements, and argued that, even leaving aside its premium products, the package that economy class customers receive for their money (baggage allowance, catering, seat allocation etc) compared favourably with a low cost carrier offering. In contrast, BA argued that the degree of product choice offered by easyJet was limited in that it offered only one product class in comparison to BA's four. BA did not see the product differences between BA and bmi as determinative in this case.

105. bmi considered that Heathrow was a premium product compared with Gatwick. It also argued that its product offered quality, particularly for business passengers, and that its offering to customers was enhanced through its alliance membership, for instance through frequent flier co-operation and access to the new terminal at Cairo airport. bmi argued also that easyJet's product would only appeal to a narrow section of the market, therefore not satisfying all categories of public demand.

106. easyJet argued that introducing a new product offering (including services from Gatwick), would increase consumer choice, and that other products were already available in the market. easyJet acknowledged that its product had, in some respects, less luxurious features. However, easyJet considered that the no-frills model allowed the consumer a choice of a combined price and product proposition. easyJet argued that, for those consumers that wanted a product closer to the full-service product, various items available free of charge on board full-service carriers were available to purchase on easyJet flights. For those consumers that prioritised a cheaper product, without the free on-board extras offered on full-service carriers, this was available also. easyJet argued that, even for those consumers that wanted to 'build' a product closer to the full-service product, this could be achieved for a lower overall cost on an easyJet flight than on a full-service carrier.

107. In relation to whether its product satisfied all categories of public demand, easyJet took the view that categories of public demand should be defined by

[20] The CAA's view is that, whilst improved domestic connections might help support traffic on the route and bring some consumer benefits, given the alternatives already available to connecting passengers these benefits are unlikely to be significant in this case.

reference to markets rather than, for instance, cabin class. Further, easyJet contended that, even if the CAA was to accept that premium product demand was in some way a separate category of demand, it was not the case that the CAA had to ensure that the additional capacity satisfied all categories of public demand (as defined) on an incremental basis, but rather that all categories of public demand should be satisfied overall. In relation to this point, easyJet considered that the public demand for a premium product was already satisfied by the existing premium capacity in the market.

108. In relation to commencing operations to Cairo from Gatwick, easyJet considered that, given the number of world renowned tourist sights within Egypt, visitors often travel on multi-centre breaks and that, with easyJet's range of Egyptian destinations, travellers who wish to fly into Cairo, travel independently, and fly directly back home from either Luxor, Hurghada, or Sharm el Sheikh (or the reverse), would be in a position to do so. In the view of easyJet, a new Gatwick-Cairo service would complement easyJet's existing services and allow independent travellers to travel more freely on affordable one-way fares. Further, easyJet considered that its entry into the market would increase the choice of London airport available to customers travelling to Cairo, giving them the choice of Gatwick. In the view of easyJet, passengers value using their local airport and conversely disvalue increased travel time, and therefore passengers with a preference for travelling from Gatwick would benefit additionally from its entry. In addition, easyJet stated that it would have the option in future of making this route part of its 'join the dots' strategy in terms of developing network points that were then served from an increasing number of easyJet bases (see paragraph 38).

109. As stated previously, it is the view of the CAA that the current rivalry on the route is characterised primarily by three-way competition between BA, bmi and Egyptair. The CAA considers that this three-way rivalry extends in particular to product rivalry, with each of the three existing carriers offering a similar full-service product and operating from Heathrow. The CAA agrees with easyJet therefore that, for those consumers that wish to take advantage of such a service, there are already a number of competing propositions. In contrast, the product offered by easyJet, which proposes to introduce a low cost, no-frills, operation from Gatwick, offers something quite distinct from that already available in the market, which should increase the choice available to consumers in the market and thus yield greater product benefits than allocating the additional capacity to either of the existing UK carriers on the route.

Cargo

110. In 2009, 82% of UK-Egypt cargo by weight was carried as bellyhold on the London-Cairo route. 13% by weight was carried on dedicated cargo flights from Cairo to Manston (Kent International). The 2010 UK-Egypt MoU allows three services per week for all-cargo operations between Cairo/Alexandria and points in the UK other than London. In 2009, BA carried 55% of the cargo tonnage on the direct route, Egyptair 37% and bmi 8%. London-Cairo volume during 2009 was stronger northbound than southbound. Load factors were high: 90% northbound, 80% southbound (which compares to low 70s on other routes).

111. BA proposed to increase its current bellyhold cargo capacity on the route by an extra 60 tonnes per week. BA argued that its current bellyhold capacity was not sufficient to meet the rising demand for freighting cargo out of Cairo on direct services. Further, it argued that much of the cargo carried was driven by UK demand (e.g. 70% of freight total volume being highly perishable products grown in the Nile

delta). BA hoped it would pick up some of the cargo currently travelling by indirect routes.

112. BA said that around 10% of its turnover for its network as a whole was accounted for by cargo, and that this route would be “in the order of magnitude of double” that.

113. bmi’s proposal would also have increased cargo tonnage carried (although much lower than BA’s operation because bmi used narrow-body aircraft on the route), but bmi saw this as of limited significance to its overall proposal. bmi stated that 30% of BA’s cargo is destined for third countries, not the UK, thus reducing the benefit to the UK consumer. bmi pointed to the recent slowdown in cargo tonnage carried as evidence that the market was not constrained; however, this could also be attributable to the general slowdown in air cargo demand due to the economic downturn.

114. easyJet did not propose to carry any cargo on the route. It pointed to BA’s assessment that BA currently has 5.75% of the cargo market by weight, and would only be able to add an incremental 3% market share with the additional frequencies, as evidence that BA’s proposal would not significantly affect the competition in, and hence deliver material consumer benefits to, the cargo market, even if narrowly defined. BA gave evidence that cargo capacity was more than just tonnage (on which easyJet’s market share analysis was based), being also a volume/value issue, but did not put forward an assessment of BA’s share of the cargo market using these other measures.

115. BA’s case is clearly the strongest in this regard. The issue for this decision is how material the potential benefits from the cargo aspect of the applications is as compared to the projected passenger benefits. The high load factors (90% northbound; 80% southbound) do suggest that there is a capacity constraint on direct London-Cairo bellyhold carriage. It is accepted, as argued by BA at the hearing, that some customers may prefer direct services for some products, for example perishables, but not that these constitute a separate market. Given the likely, wide, market for cargo as a whole (see Market Definition section) direct bellyhold cargo (as with this proposition) does appear just a small element overall, and with many suitable substitutes on offer. The CAA’s objective to ensure all categories of demand are satisfied appears to be met already by the alternatives on offer in the market. BA did not produce evidence of the magnitude of benefits to UK cargo consumers (as opposed to the potential benefit to BA itself in terms of increased turnover) from their proposals. Given the scale of the cargo proposition, the CAA’s view is that this would probably lead to a smaller reduction in price or smaller gain in consumer benefits (particularly given the wide nature of the market and the other options available) relative to the passenger benefits which are the focus of other sections of this decision.

Sustainability

116. The sustainability of the proposals of each party are 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".[21]

117. There was no suggestion by parties that the BA proposal would not be sustainable.

118. bmi argued that a central reason for awarding it the additional frequencies was to ensure certainty of its operations on the route. bmi currently operates four services per week under UK traffic rights, and three services per week under Egyptian traffic rights. The Egyptian Government agreed to the 'loan' of these frequencies in 2007, subject to bmi and Egyptair reaching a commercial agreement related to the loan. bmi gave evidence that this commercial arrangement consists of bmi being loaned three frequencies a week from the Egyptian allocation in return for a financial consideration and slot loan agreement at Heathrow with Egyptair.

119. bmi suggested that the frequency loan arrangement with the Egyptian side should only be seen as a short-term agreement, and that it could be ended at any time. bmi saw that this could happen through either the introduction of another Egyptian carrier on the route or through Egyptair wishing to increase its 'own-metal' offering to double daily. Alternatively, bmi suggested that the price of the borrowed frequencies could become disproportionately high. bmi's preference would therefore be to run a daily service under UK frequencies, and then to continue to borrow the three additional frequencies for as long as it was able to, in order to increase its offering to 10 services per week.

120. bmi did not provide evidence that the frequency loan agreement was in any imminent danger of being terminated. Although bmi claimed to have no guarantee that the arrangement would continue (bmi currently has certainty only for the Winter 2010 season), the CAA considers that it is unlikely to be in Egyptair's interests to end the agreement, as it is one based on reciprocal advantage. In return for allowing bmi to operate a small number of (otherwise unused) frequencies from the Egyptian allocation, Egyptair is able to utilise one of bmi's Heathrow slots (for which it pays a nominal sum to bmi, despite the fact that Heathrow slots are highly valuable) and is in the process of negotiating for another. Clearly, if Egyptair was to seek to operate all fourteen of the Egyptian frequencies itself then, assuming bmi withdrew its current slot loan arrangements with Egyptair, it would need to acquire four (or possibly five, depending on any new commercial arrangements with bmi) additional slots at Heathrow. Although Egyptair could seek to acquire slots on the secondary market, these would be at a higher cost than the nominal amount paid to bmi.

121. Egyptair currently operated 10 services per week on the route, which gave it the scope to operate one additional service under Egyptian traffic rights. Should Egyptair wish further to increase its frequencies, an alternative to clawing back the frequencies loaned to bmi would be for the Egyptian Government to seek to negotiate an increase to the frequency cap under the MoU with the UK Government – a request the CAA considers (on the basis of the Secretary of State's advice) that the UK Government would treat favourably. BA considered that awarding the three unused UK frequencies to bmi would make this course of action less likely. There was no evidence produced that a second Egyptian carrier has plans to operate the route, although of course one might do so in the future.

[21] 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.

122. bmi gave evidence that it had decided, on entering the route, that a daily service was the minimum necessary to be competitive on the route. It suggested that if the loaned Egyptian frequencies were withdrawn, four services per week would lead to deterioration of the route for bmi. The CAA accepts that this would result in a reduced offering from bmi. However, even if this course of events were to occur, the CAA is not persuaded, given bmi's codeshare agreement with Egyptair (covered in more detail in paragraph 68) that bmi would be left with an unsustainable offering.

123. easyJet had factored marketing spend into its forecasts to seek to mitigate the risk attached to a lower frequency service, and had been conservative in its load factor assumptions. It cited evidence also of its experience of entering routes with a part-week service in competition with well-established legacy carriers, giving the examples of Geneva-Stockholm, Manchester-Munich and Gatwick-Helsinki. On this basis, and considering easyJet's commercial proposition overall as discussed elsewhere in this decision, the CAA sees no reason to question the sustainability of easyJet's application.

Slots

124. All carriers confirmed in their applications that they expected to have access to sufficient airport slots at both ends of the route to operate their proposed services. No carrier questioned these assertions.

Financial forecasts

125. The CAA's published policy on information is set out in paragraph 9 of Annex 9 to the 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." Given this policy, and the concerns of the parties about commercial confidentiality, all parties agreed to produce three-year forecasts of revenue passengers, seats, sectors, load factors, cargo, average aircraft size and profit. No parties produced more detailed cost and revenue forecasts as set out in the pro forma table provided at Annex 9 of the CAA's Official Record Series 1, and there was limited discussion of the figures provided at the hearing, again due to the limited scope of the data provided and parties' concerns about commercial confidentiality.

126. BA challenged easyJet's profit figures on the basis that its fares would have to rise over time to meet the forecasts. See paragraph 92 of the 'Fares' section above for a discussion of this.

127. bmi did not put forward revised figures when confirming its intention to operate 10 services per week in total (i.e. continuing to use the borrowed Egyptian frequencies). BA challenged bmi's profit figures, which were higher than BA's, but on the basis of bmi operating fewer frequencies than BA. bmi said this was due to its assumptions about the (positive) future of the route, the load factor it could sustain, the efficiency of the aircraft it was using, and attracting more business passengers over time.

128. BA's forecasts showed that it would anticipate carrying more cargo than bmi and an increase from its current carriage. See from paragraph 110 for more discussion of cargo issues.

129. Cost efficiency is relevant to the extent that it affects the sustainability of a carrier on the route, which is covered above. In terms of cost efficiency, easyJet would incur start-up costs, while the other carriers would not. easyJet argued that part of its business case for this route was the links with other Egyptian destinations currently served, as well as the possibility of serving Cairo from other points in the future. bmi claimed that continuing to depend on the Egyptian side for the loan of frequencies would have implications for its cost efficiency. There was disagreement between easyJet and BA on the nature of each other's costs. The CAA is of the view that there were no arguments made in relation to cost efficiency that were material to the decision in this case.

Development of the route

130. BA indicated the desirability of being able to offer a double-daily service on the route, and its intention to grow its cargo offering. easyJet stated its intention to grow the route further, ideally to seven services per week were it awarded its application of three services per week and further frequencies became available. bmi confirmed its intention to continue to operate the three frequencies per week loaned from the Egyptian side and to develop the Star Alliance/Egyptair codeshare offering. All carriers appear to have a good level of commitment to developing the route.

Likelihood of introducing/maintaining services

131. BA and bmi stated in their applications their intention to start operating from the start of the Winter 2010 season. easyJet confirmed in evidence its intention to begin operations from January or February 2011, as it usually required a three-month selling window for new services.

132. easyJet noted in its written evidence that bmi had a track record of asking for extra scarce capacity and then not using it in the short to medium term, as had happened with India and Kiev. bmi, in response, pointed out that the reasons for pulling off the Mumbai route had been explored in detail during the Kiev hearing. In the case of Kiev itself, the route had been loss-making, and the Ukraine had been suffering from political and economic problems. Hence the decision had been taken, as part of bmi's restructuring programme to eliminate the worst-performing routes and improve the airline's profitability, to pull off the Kiev route.

133. The proposals of the carriers appear similar in this regard.

134. In assessing the consumer benefits pertaining to, and the sustainability of, the proposals, as set out from paragraph 39 onwards, the CAA has considered the outcome best calculated to meet the requirements of regulation 9 (3)(a), (b) and (c) of the Regulations.[22]

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

Other considerations

Competition with other airlines

135. 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 EEA carriers established in the UK[23], which essentially means that it is non-EEA carriers that are the ‘other carriers’ referred to: in the case of this market, Egyptair.

136. Egyptair currently out-carries both BA and bmi in terms of the total number of passengers and the number of O&D passengers. It has been adding capacity and new aircraft on the route, and appears to provide a credible, comparable alternative to the full-service offering of BA and bmi.

137. BA pointed to the combined bmi / Egyptair offering through Star Alliance and suggested that this objective would be met best if BA, rather than Egyptair’s alliance partner bmi, were awarded the additional frequencies to compete with Egyptair.

138. bmi argued that granting the easyJet application would fragment competition among qualifying carriers such that competition with Egyptair would be less effective.

139. The CAA considers that there is merit, in this case, in the introduction into the market of a carrier operating from Gatwick. The level of competition between the carriers already operating the route suggests that qualifying carriers were already competing effectively with other carriers (the CAA’s role being to ensure that the totality of the distribution of rights meets the requirements of the Regulations), and that this is therefore not a significant factor in this case.

Effective use of airports

140. Regulation 9(3)(e) provides that the CAA must allocate scarce capacity in a manner which it considers is best calculated to ensure the most effective use of airports within the UK.

141. BA argued in its evidence that its application ensured the most effective use of airports in the UK by providing mixed passenger and cargo services, hence reducing the need from freighter-only cargo services.

142. easyJet argued that its entry from Gatwick would allow Heathrow slots – under greater capacity pressure – to be used for other purposes, increasing the effective use of London airports.

143. The CAA does not consider that arguments presented by the applicants under this part of the Regulation were a significant factor in this case.

Effect on existing services

144. 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)

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

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.

145. Views of parties have been recorded elsewhere in this document as to the benefits or otherwise of introducing a new entrant onto the route as opposed to strengthening an existing service. On balance, in this case, the CAA considers that there will be more consumer benefit to be derived from the introduction of a new entrant offering a differentiated product to the market.

Environment

146. 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.

147. easyJet and BA both made a case that their applications delivered more environmental benefits; and then disagreed with each other's evidence. At the hearing, BA concluded that in its view there was no great distinction to be made between the applicants in this regard, and that it would not be a determinative factor; no other party made a counter-case. The CAA therefore does not consider the environment a sufficiently material issue in this particular case, given the overall assessment of other benefits, to require a conclusion on the relative merits of parties' proposals under this part of the Regulations.

Advice from the Secretary of State

148. The CAA has had regard to the advice received from the Secretary of State (as provided for in regulation 9 (6)) on 2 August 2010. 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

149. Pursuant to the reasoning set out in this document, the CAA therefore decides to grant Scarce Capacity Allocation Certificates as follows:

- to British Airways plc for the operation of seven services per week in each direction on the route London-Cairo/Alexandria
- to British Midland Airways Ltd (trading as bmi) for the operation of four services per week in each direction on the route London-Cairo/Alexandria
- to easyJet Airline Company Ltd for the operation of three services per week in each direction on the route London-Cairo/Alexandria

David Kendrick
For the Civil Aviation Authority
30 September 2010