



VBA Constraint

19 August 2003

VBA and FSA

- ◆ VBA categorises airlines that:
 - Focus on point to point short haul operations
 - Start from a very low “greenfields” cost base
 - Have a simple fleet, low distribution costs, flexible employment conditions, low on board product costs, no (or very limited) arrangements with other carriers
 - Have high asset utilisation
- ◆ VBA airlines will always have a unit cost advantage over FSA airlines due to:
 - Simplicity of offering point to point services
 - FSA airlines provide a network offering which generates higher cost

Suitability of Routes

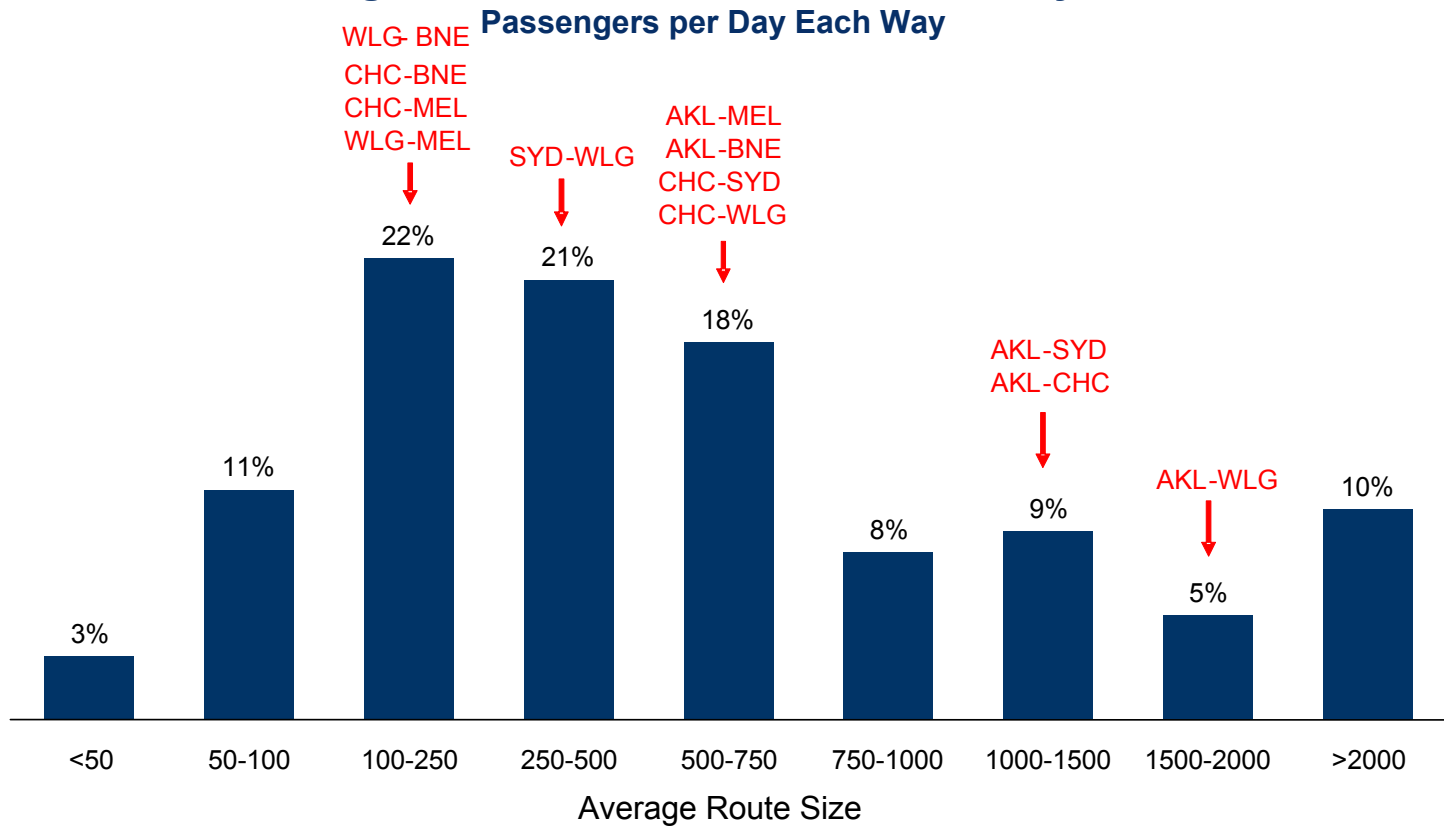
The Tasman and domestic NZ markets are ideal for successful VBA entry:

- ◆ All domestic NZ and Tasman routes (except Perth) are under 5 hours and able to be served by a single narrow body aircraft type
- ◆ Sufficient population base and existing passengers
- ◆ Virgin Blue in Australia is flying 27 out of 30 of Ansett jet routes

Tasman and Domestic New Zealand Routes are prime for VBA entry

Likelihood

Average Size of Routes Entered Into by VBA



Source: OAG, NZ Market Size, all routes VBAs entered January 2002-June 2003, Metro areas combined

Customer Acceptance of the VBA Model

Likelihood

- ◆ Air New Zealand introduced many of the aspects of a VBA model through NZ Express Class in October 2002. The results have been:
 - Passenger growth of over 23%
 - Internet sales exceeding 35%
 - Growth in market share over capacity share
- ◆ The success of Express Class reflects the New Zealand public's embrace of lower cost value propositions:
 - This is consistent with other retail/consumer experience around the world. VBAs are no exception

Stated Intentions of Virgin Blue

- ◆ Virgin Blue's Submission to the Commerce Commission:
 - “Virgin Blue notes that it has taken steps to establish operations on the trans Tasman and domestic New Zealand routes and is now confident that it will be able to commence operations relatively quickly”.
 - “It now appears that by the time the authorisation process is finished there are reasonable prospects that Virgin Blue will have already entered the trans Tasman and domestic markets.”
- ◆ Application to the Australian IASC:
 - “International operations form a very important part of Virgin Blue expansion and as such has the full support of Board and Management to make it a success.”

Claimed Limitations on Entry

- ◆ There are no limitations on VBA entry
- ◆ Virgin Blue claims that it needs protection in respect of:
 - Access to facilities
 - Incumbent response
- ◆ These claims are unfounded

Facilities: Wellington and Christchurch

- ◆ All facilities at Wellington and Christchurch are controlled by the airport companies
- ◆ Wellington Airport: “No Barriers”
- ◆ Christchurch Airport: “We will move heaven and earth to ensure we get a commercial arrangement”

Facilities: Auckland

International

- ◆ Slots are allocated by IATA Slot Planning Committee:
 - Slots include customs and immigration
 - Virgin Blue's slot request has been approved

- ◆ Counters and other facilities are the subject of a Virgin Blue tender: No issues are anticipated

Domestic

- ◆ All facilities (except check-in counters) are controlled by the airport
 - Only issue is check-in counters
 - Air NZ has offered to provide Virgin Blue with 3-4 counters at relevant departure times to accommodate a 5 B737 schedule

Facilities: Auckland

- ◆ Auckland Airport has proven its ability to accommodate growth:
 - “In the past 10 years, international passenger growth had been compounding at between 6.5 per cent and 7.5 per cent a year.” 29 July (NZ Herald)
 - “[Auckland Airport] can service the needs of Auckland for at least the next 50 years.” Don Huse, Auckland Airport CEO, 29 July (NZ Herald)
- ◆ Not only are existing facilities likely to be able to accommodate Virgin Blue, Virgin Blue has said it will build new terminals if needed:
 - “We have started negotiations with Auckland and Christchurch airports, which lease gates to carriers, and they have been very open with us. And we are prepared to build our own terminals although that may take two years.”
(NBR, 20 June 2003)

It is counter-intuitive to suggest an airport would not accommodate a new customer

Incumbent Response

- ◆ VBAs have entered against large FSAs/FSA subsidiaries elsewhere

JetBlue entered against:

- ◆ Continental
- ◆ Delta
- ◆ US Airways
- ◆ MetroJet (US Air VBA)
- ◆ American Airlines
- ◆ United

Southwest entered against:

- ◆ United
- ◆ US Airways
- ◆ Continental
- ◆ Multiple other US carriers

Ryanair entered against:

- ◆ British Airways
- ◆ Aer Lingus
- ◆ Virgin Express
- ◆ Multiple other European carriers

easy jet entered against:

- ◆ British Airways
- ◆ Swissair
- ◆ Iberia
- ◆ Multiple other European carriers

Air Tran entered against:

- ◆ Delta
- ◆ Delta Express
- ◆ US Airways
- ◆ American Airlines
- ◆ Northwest
- ◆ United
- ◆ Continental

Virgin entered against:

- ◆ Qantas
- ◆ Ansett
- ◆ Impulse

Possible Incumbent Response

- ◆ Match the lower fares:
 - This is necessary even though the VBA entrant has a lower cost base and is therefore better positioned to survive a price war
 - Cross-subsidisation by the FSA is difficult because the VBA attacks the FSA's most profitable routes
- ◆ Reduce cost:
 - Develop low cost operations

Air New Zealand Express Class

Likelihood

The success of Air New Zealand Express Class increases the likelihood of success of a VBA entry.

- ◆ It has demonstrated that the market will readily accept a VBA offering
- ◆ There is still a significant cost base differential between Air New Zealand (with network and legacy costs) and Virgin Blue
- ◆ Air New Zealand's domestic network profitability improved post launch of Air NZ Express Class

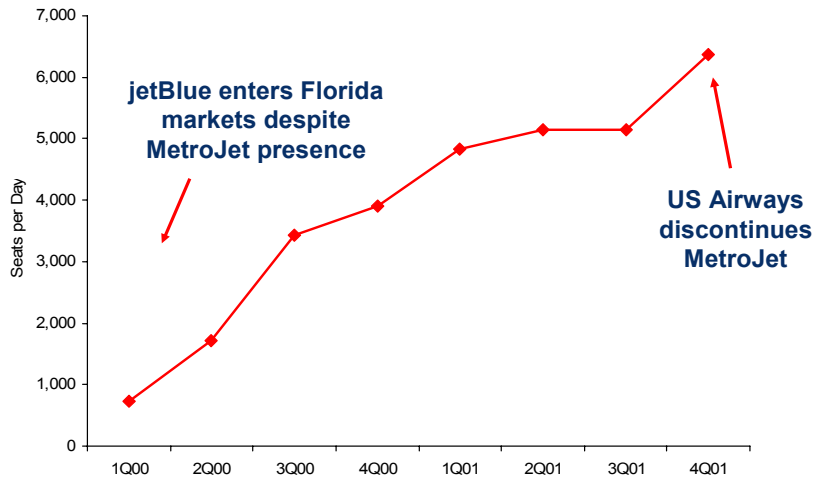
Freedom Air

- ◆ Freedom is constrained by the cannibalisation effect its expansion has on the wider Air NZ network:
 - Revenue cannibalisation – Freedom’s fares are lower and hence overall Air NZ Group revenue falls
 - Network cannibalisation – reduction in Air NZ load factors and hence reduction in the level of connectivity it can provide
 - Some Tasman routes are ‘thin’ in passenger demand and therefore cannot support Air NZ and Freedom

Incumbent Response

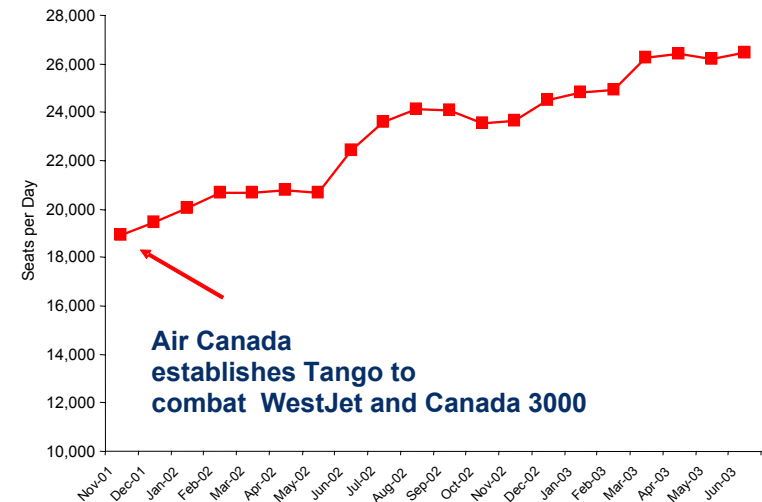
International experience is that incumbent-owned VBAs do not prevent successful entry

jetBlue Total Capacity - Florida
Average Seats per Day



Source: US DOT

WestJet Total Capacity
Average Seats per Day

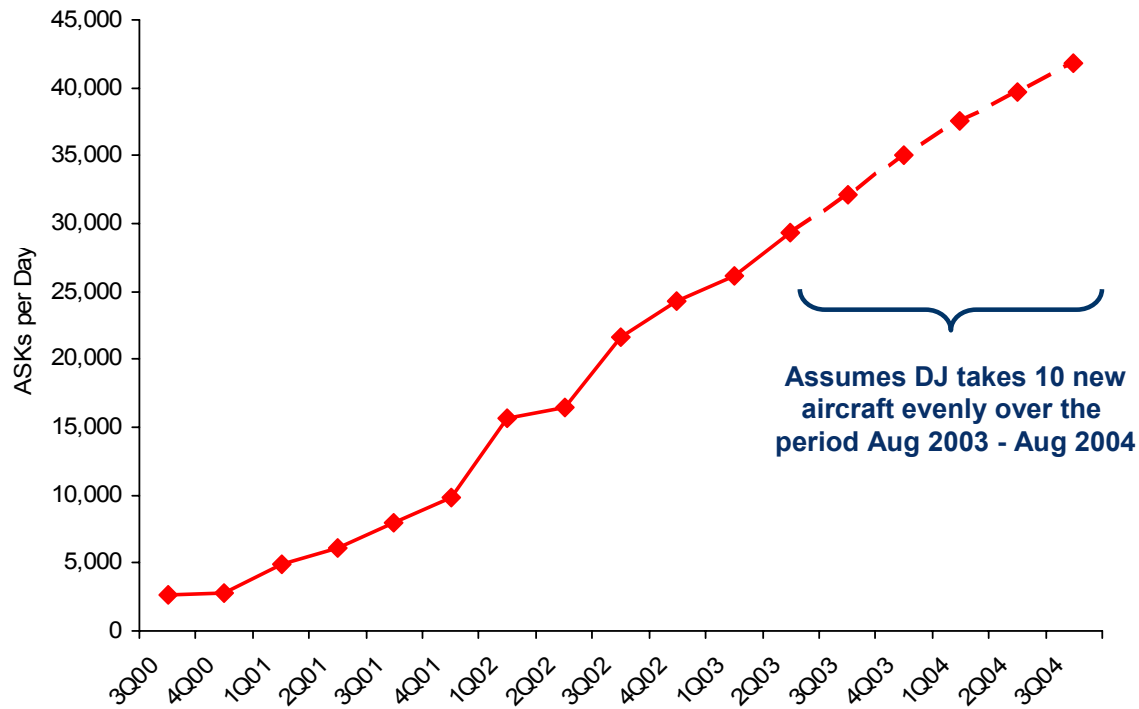


Source: OAG

Extent of Entry

Virgin Blue's capacity has expanded rapidly

Virgin Blue ASKs per Day
August 2000 - August 2004

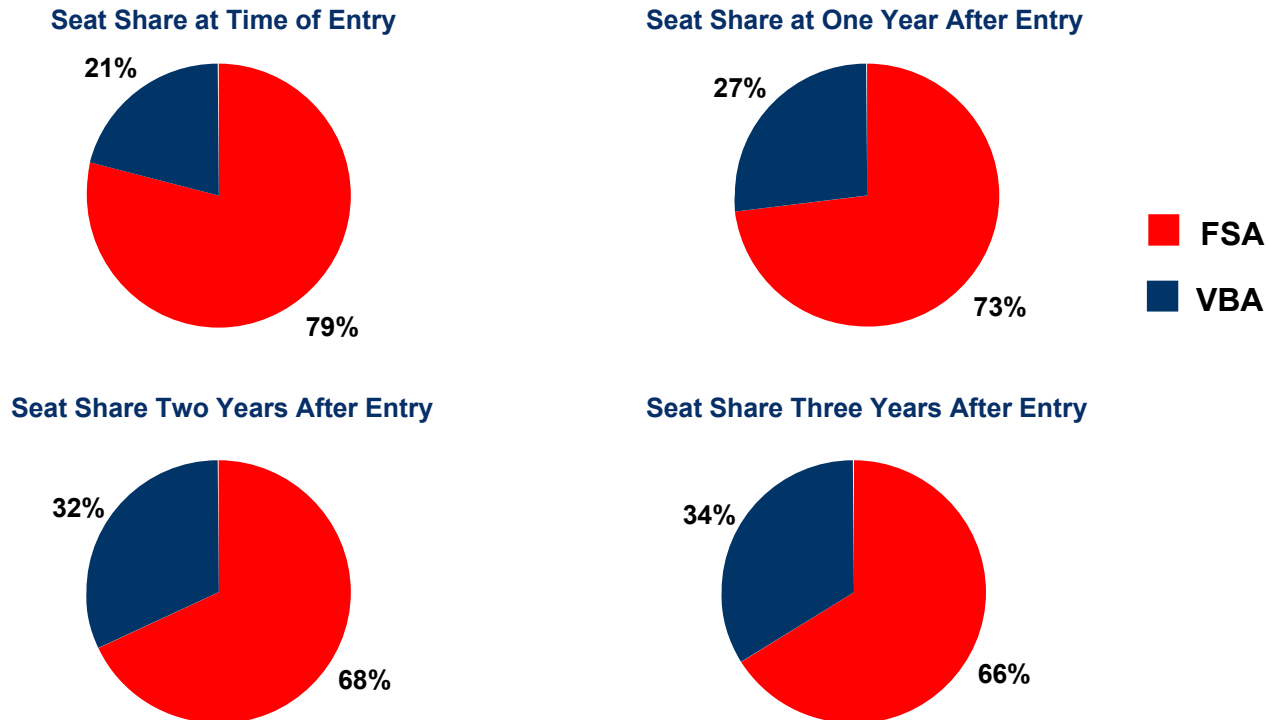


Source: OAG, APG analysis assumes same ASKs per aircraft from Aug 2003 - Aug 2004 as in May 2003

Extent of Entry

VBA's grow rapidly: Australia, Canada and Europe

VBA Seat Share Three Years After Entry-Non U.S. Routes Entered in 3rd & 4th Quarter 2000



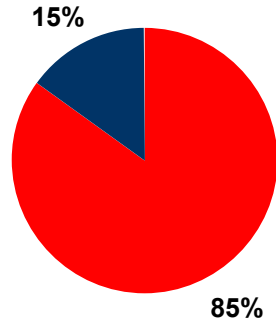
Source: OAG, combined APG Analysis based on all routes entered by U2, G3, DJ, FR in 3rd & 4th Quarter 2000; metro areas

Extent of Entry

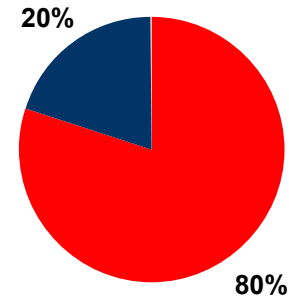
VBA's grow rapidly: Domestic US

VBA Seat Share Three Years After Entry- Domestic U.S. Routes Entered in 3rd & 4th Quarter 2000

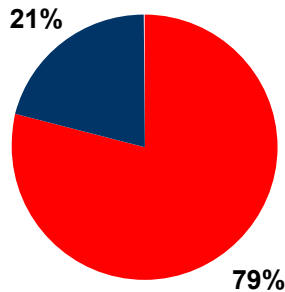
Seat Share at Time of Entry



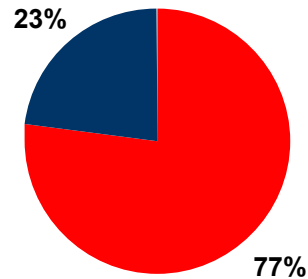
Seat Share at One Year After Entry



Seat Share Two Years After Entry



Seat Share Three Years After Entry

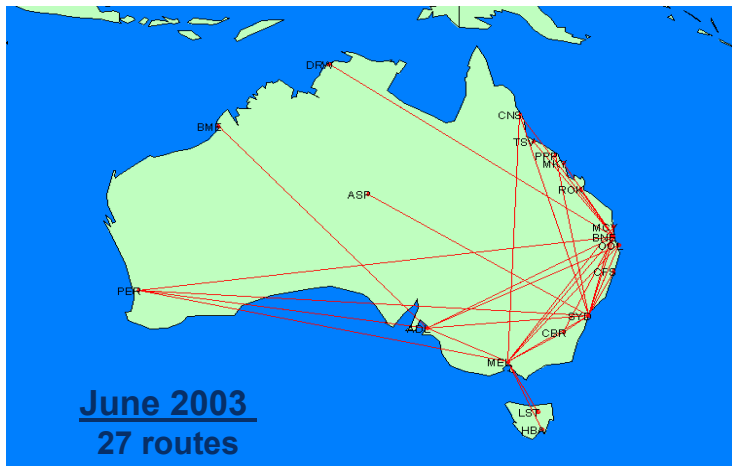
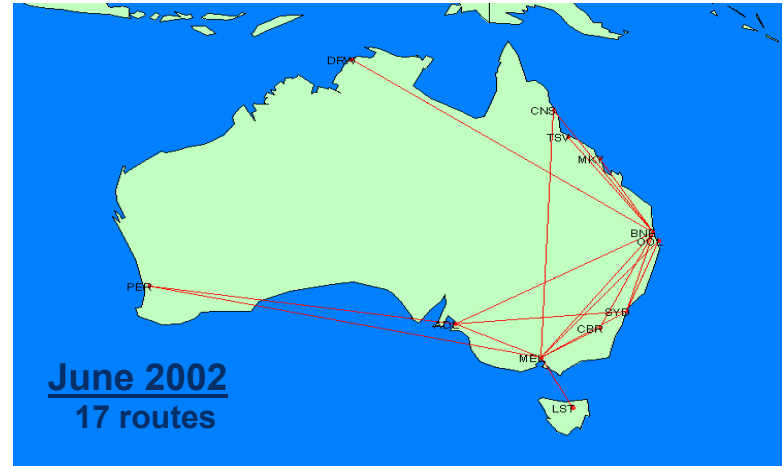
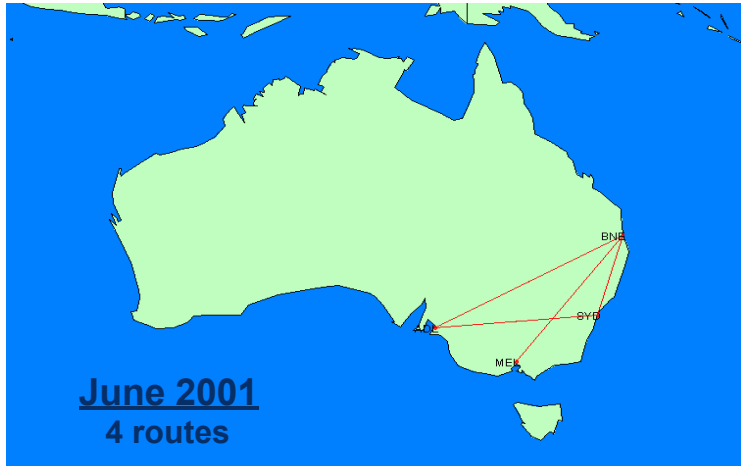


Source: OAG, APG Analysis based on all routes entered by B6, FL, WN in 3rd & 4th Quarter 2000; metro areas combined

Extent of Entry

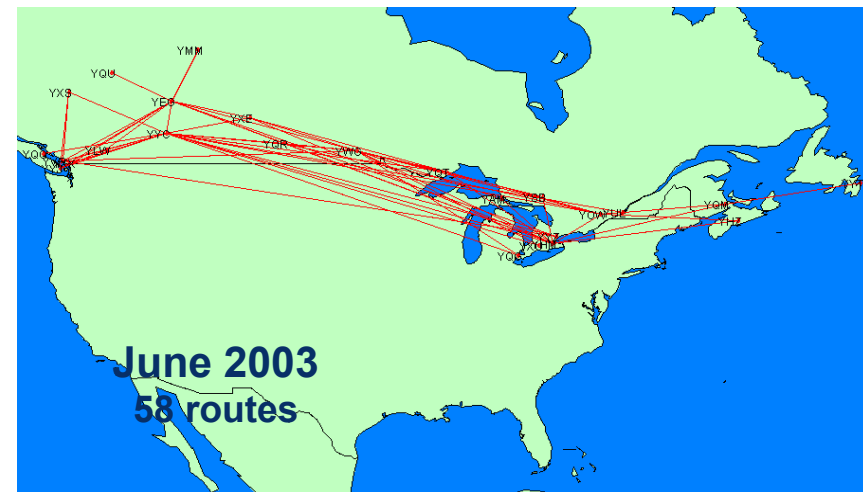
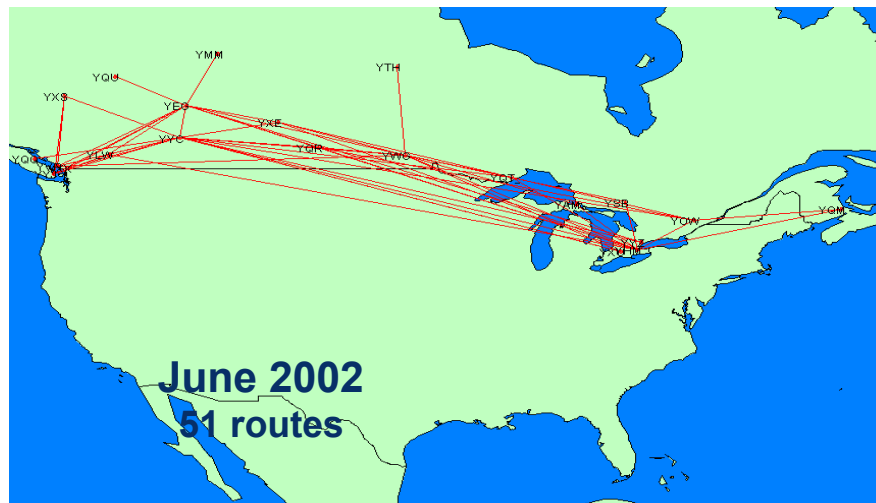
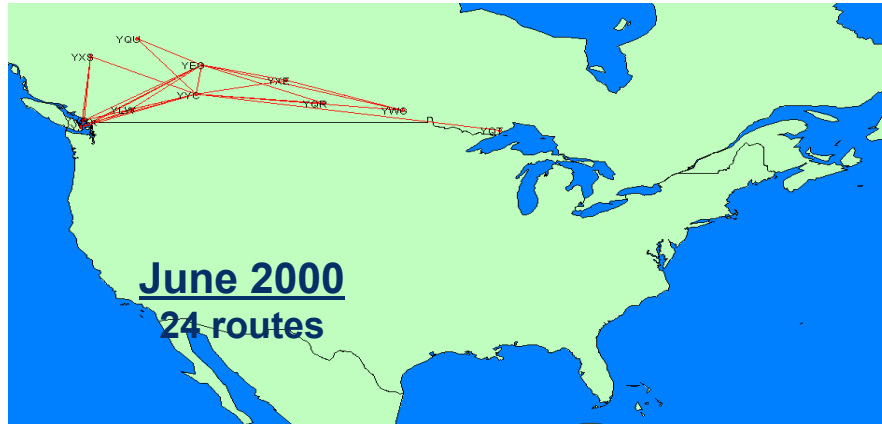
Extent

Virgin Blue's network has expanded rapidly



Extent of Entry

Virgin Blue's growth is consistent with other VBAs, e.g. WestJet



Timeliness of entry

- ◆ Virgin Blue's entry plans are well advanced
- ◆ Virgin Blue's entry is imminent

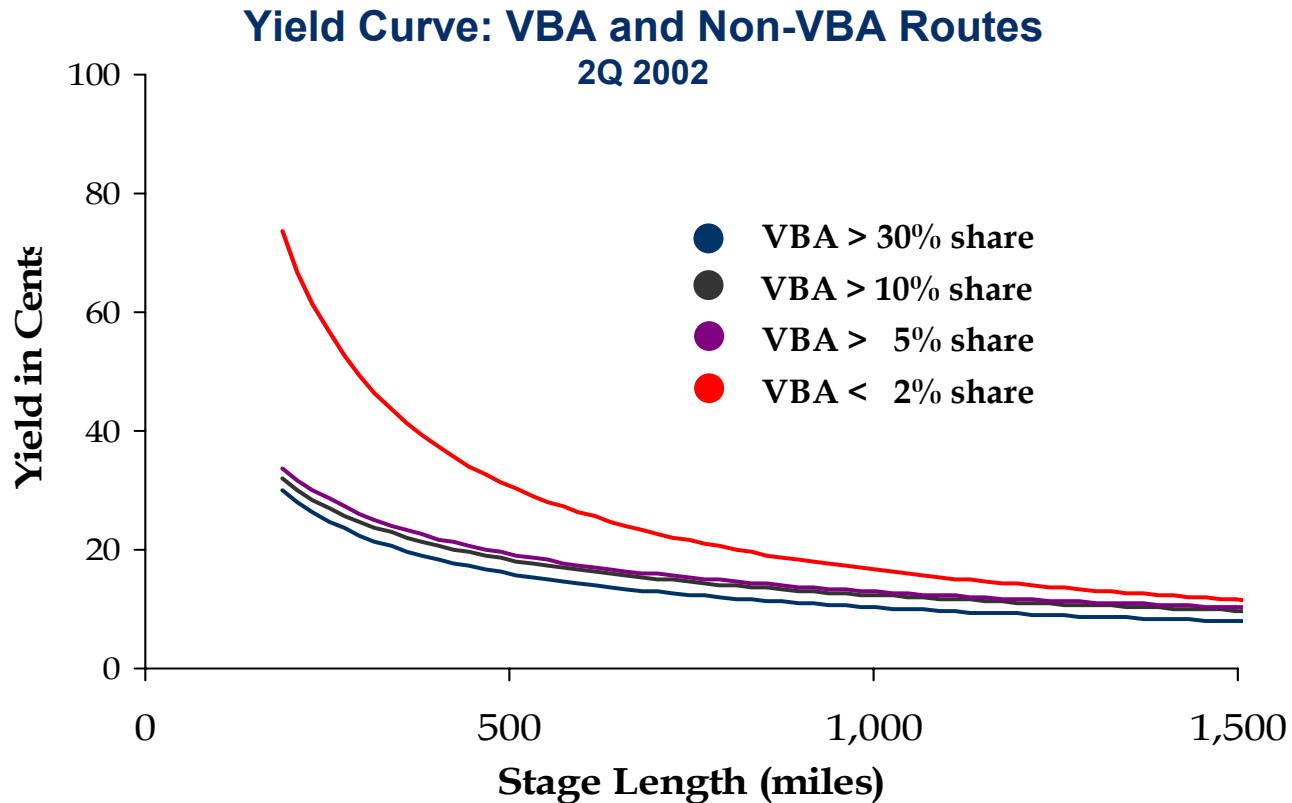
Impact of VBA entry

- ◆ VBA entry will:
 - Reduce fares
 - Stimulate demand
 - Cause an ultimate reduction in FSA capacity
 - Have significant impacts irrespective of the precise VBA model

Impact Occurs at Low Levels of Entry

Impact

Constraint imposed by VBAs is disproportionate to their market share – 5% market share results in significant price reductions



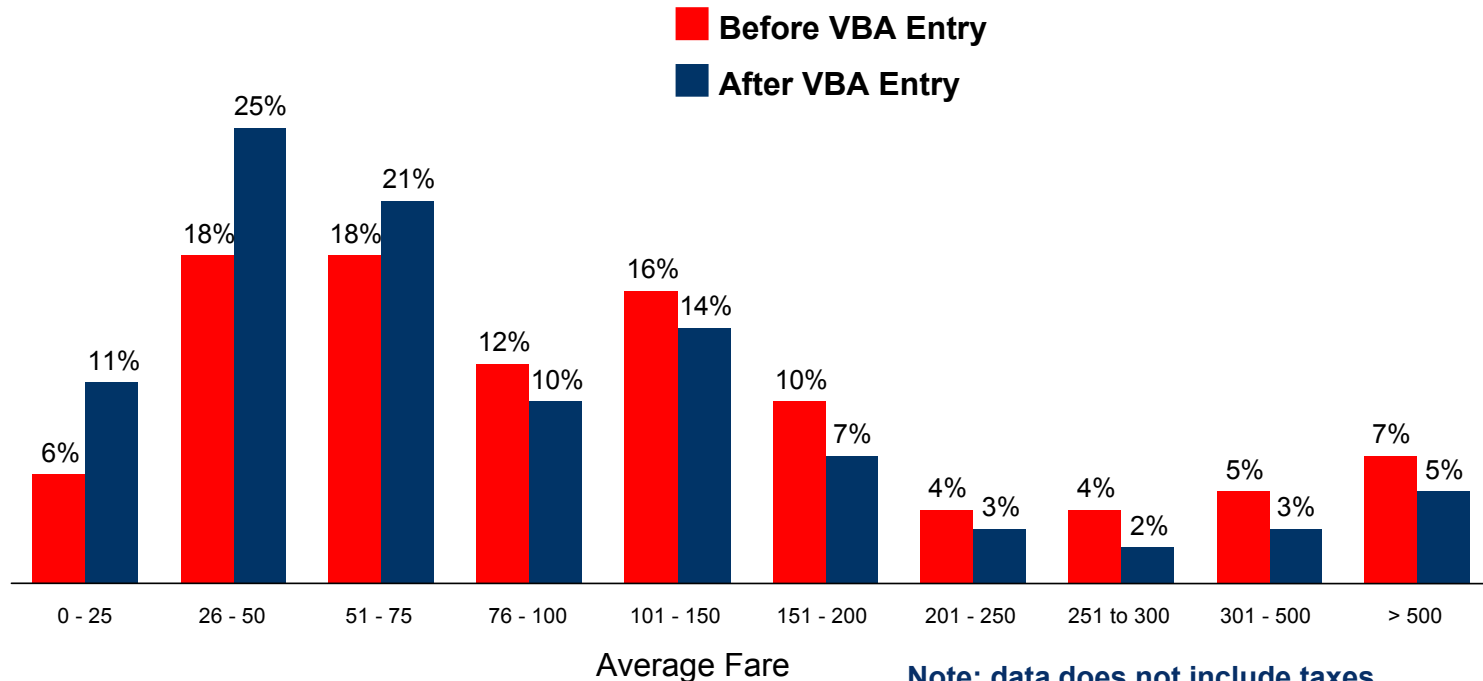
Source: OAG, US DOT, APG Analysis based on sample of 100 US top revenue routes where B6, FL, or WN share >30%, >10%, >5%, and <2%.

Impact of VBA Entry – All Fares

VBA entry impacts all fare classes – FSAs are forced to offer more seats in lower fare classes

Fare Distribution for FSA in Routes Entered by VBA

2nd Quarter 2000 vs 2001; all fares one way



Note: data does not include taxes which would add \$20 to a \$25 ticket

Source: OAG, US DOT, sample of all routes entered into by B6, FL, and WN in 3rd and 4th Quarter 2000

Impact Affects Entered Markets and Other Markets

Impact

- ◆ Impact of a VBA does not only constrain fares in the market entered
 - Qantas simplified its fare structure
 - British Airways reformed its fare structure on all European routes following VBA entry
 - Air Canada reformed its fare structure on all domestic routes in response to WestJet
 - Air New Zealand reformed its fare structure in New Zealand and Tasman in response to worldwide success of VBAs

VBA Entry Impacts Business and Leisure Fares

Impact

- ◆ Business travellers have historically been regarded as “inelastic”
- ◆ VBA entry has shown that they have a much higher degree of elasticity than previously thought:
 - Business travellers are making up an increasing percentage of VBA traffic eg easyJet
 - NZ Express class has demonstrated higher business elasticity than expected
 - Business travellers’ perceptions of a reasonable fare are affected by other available fares

Summary

- ◆ VBA entry is certain in Tasman and domestic New Zealand
- ◆ VBA entry will stimulate demand
- ◆ VBA entry will provide an effective constraint on fares, even at low levels of entry
- ◆ VBA entry will constrain business and leisure fares and will affect markets wider than those entered