



VIRGIN BLUE

**APPLICATIONS FOR AUTHORISATION OF QANTAS/AIR AIR NEW ZEALAND/AIR PACIFIC
PROPOSED ALLIANCE**

CROSS SUBMISSION

21 JULY 2003

The Commerce Commission has provided an opportunity for cross-submissions in response to the Applicants' submission of 20 June 2003.

Virgin Blue appreciates this opportunity and recognises that it may be useful for the Commission if Virgin Blue uses this cross-submission to clarify its position on certain matters. Virgin Blue does not believe, however, that it is useful for it to respond in any detail to the latest submissions of the Applicants. Virgin Blue is, of course, happy to answer any specific questions that the Commission has in relation to the Applicants' submission or other relevant issues.

Virgin Blue's Position

Virgin Blue has stated its position in its first two submissions and this fundamental position remains the same:

- the proposed Alliance raises substantial competition issues, particularly with respect to the extent and sustainability of a new entrant facing a combined Air New Zealand and Qantas; and
- these competitive issues could only be addressed by ensuring that the appropriate conditions exist to enable new entrants such as Virgin Blue to be a competitive, sustainable and significant competitor to the Alliance.

Virgin Blue has clearly submitted that with the right conditions in place it would be able to provide a competitive constraint to the Alliance parties and, further, that the level of competition that it would provide as a low fare carrier is potentially greater than that which may prevail under a duopoly FSA model.

In this regard, Virgin Blue agrees generally with the Applicants' claims in Chapter 3 of its submission regarding the potential of Virgin Blue to be an effective competitive constraint on the Alliance. The Applicants' claims in relation to the competitive impact of a low fare carrier such as Virgin Blue are consistent with Virgin Blue's experience as set out in its submission to the Commission dated 20 June 2003.

Virgin Blue strongly believes that, given the right conditions or undertakings in place, it could be an effective competitor which would be able to provide a competitive constraint on the Alliance parties and thereby address the potential detriments flowing from the Alliance (particularly price increases).

However, the Applicants appear to be arguing that there are no barriers to Virgin Blue's expansion and Virgin Blue's success is a "sure thing", even if the Alliance proceeds. This greatly overstates the certainty of Virgin Blue's successful entry on a scale sufficient to effectively constrain the Alliance and is partially contradicted by the Applicants' acknowledgement of the need for conditions.

In the absence of suitable conditions or undertakings being in place, the Commission can have no certainty that Virgin Blue will be able to act as an effective competitive constraint on the Alliance in the short to medium term.

The principal constraints (but not the only constraints) for a new entrant low fare carrier (as previously submitted) are:

- access to facilities;
- the predatory/strategic response of the Alliance parties to a new entrant low fare carrier.

Access to facilities

Given the Alliance's effective control of facilities at key airports, Virgin Blue may not be able to acquire sufficient access to facilities (particularly terminals and associated facilities such as gates and desks) to enable it to do more than enter as a marginal competitor.

Virgin Blue believes that in order for it to be a successful constraint on the Alliance it must be given a proportion of first rights of use to facilities at key airports (including peak hour use of terminals and desks). It is not sufficient that the Alliance juggle its schedules to a minor extent to allow Virgin Blue to use their facilities.

Virgin Blue considers that these conditions (in particular finalised access arrangements) should be in place prior to any authorisation approval for the proposed Alliance taking effect. Such a pre-condition would be an incentive for the Alliance to agree on access arrangements. If the approval precedes Virgin Blue obtaining acceptable access arrangements, there is little incentive on the Alliance to agree to access and it is likely that Virgin Blue's expansion would be delayed as a result.

The predatory/strategic response of the Alliance

The Alliance has the ability and incentive to respond aggressively to Virgin Blue's entry in a way that constrains Virgin Blue's presence and expansion on the trans-Tasman and domestic routes. This has occurred on some routes in Australia as detailed in Virgin Blue's initial submission.

Virgin Blue has previously set out its concerns with the capacity response of incumbent airlines to new low fare entry. This problem is well understood and has been the subject of regulatory intervention in other jurisdictions, for example, in Australia, the United States and Canada.

Virgin Blue has identified two principal measures to address the capacity response of the Alliance parties, namely, a capacity ceiling on relevant routes and the divestiture of Freedom Air (removing the bullet in the gun). The divestiture of Freedom Air was also seen as a means of enhancing the time to market for a new entrant (discussed below).

The principal and direct way to ensure there is no strategic capacity response from the Alliance parties is through a capacity ceiling. Virgin Blue's concerns with the Alliance parties current capacity ceiling proposals are set out in its 20 June 2003 submission.

As to the question of the divestiture of Freedom, Virgin Blue notes that concerns have been expressed that the divestiture of Freedom Air may have limited practical effect in circumstances where Qantas has already established JetConnect, a low cost carrier such as Virgin Blue but branded as Qantas, which has publicly announced it is about to start flying trans-Tasman routes.

Virgin Blue accepts that the divestiture of Freedom Air is a less effective means of addressing the proposed Alliance's strategic conduct than previously thought, given the entry of JetConnect on to the trans Tasman market. This is because, there are now effectively two bullets in the gun (Freedom Air and JetConnect) and as such the divestiture of Freedom Air would not be "*removing the bullet from the gun*".

The Commission in this context has sought clarification of whether Virgin Blue considers that it is a necessary precondition to its ability to provide a competitive response to the Alliance parties that Air New Zealand divest Freedom Air.

Virgin Blue considers that the divestiture of Freedom Air would enhance its competitive position and would remove competitive uncertainty in relation to its long term position. However, the divestiture of Freedom Air would not be as effective a mechanism to address the Alliance's strategic responses to its entry as it was previously. Provided that Virgin Blue's concerns as to access to facilities and strategic capacity increases on relevant routes are addressed it is of the view that it will be able to quickly reach a scale sufficient to provide an effective competitive constraint to the proposed Alliance.

In this regard, Virgin Blue notes that it has taken steps to establish operations on the trans Tasman and domestic routes and is now confident that it will be able to commence operations relatively quickly. Given the elapse of time since the proposed Alliance has been under review, Virgin Blue believes that the time-to-market factor is progressively becoming a less critical issue as 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.

In summary, the divestiture of Freedom Air is still desirable and beneficial to Virgin Blue's competitive position but it is not as critical in order for Virgin blue to enter the trans-Tasman and New Zealand domestic markets where there are effective constraints on the Alliance increasing capacity on relevant routes and suitable facility access undertakings are in place.

Virgin Blue looks forward to discussing these issues with the Commission at the upcoming conference in August.

Virgin Blue
21 July 2003