VIRGIN BLUE

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

NON CONFIDENTIAL VERSION

SUBMISSION IN RESPONSE TO DRAFT DETERMINATION

20 JUNE 2003

1. INTRODUCTION

1.1 This submission responds to the New Zealand Commerce Commission's (**Commission**) draft determination dated 10 April 2003 (**Draft Determination**) in the matter of an application for authorisation of a business acquisition and in the matter of an application for authorisation of certain restrictive business practices (together the **Applications**) involving Qantas Airways Limited (**Qantas**) and Air New Zealand Limited (**Air New Zealand**) (together the **Applicants**).

1.2 Virgin Blue provided a substantive submission in relation to the Applications (**Submission**) which the Commission has considered in its Draft Determination. Virgin Blue has considered the Draft Determination. Virgin Blue broadly agrees with the findings of the Commission and only wishes to make further submissions to the Commission on a limited aspect of the Draft Determination, namely, the ability of Virgin Blue to act as an effective competitive constraint on the Proposed Alliance in circumstances where suitable undertakings were made by the Applicants or conditions imposed on the approval of the Applications.

2. SUMMARY

2.1 It is clear that the Applications have failed at the draft stage before the Commission because of the substantial anti-competitive detriment which would be likely to flow from the Proposed Alliance and the relatively low level of public benefits.

2.2 A key cause of the anti-competitive detriment is that competition between Air NZ and Qantas would be lost and other competitors would generally offer limited competition, and there would be no significant value based airline (VBA) entry.[1] Virgin Blue generally agrees with this assessment.

2.3 However, Virgin Blue believes that with suitable conditions or undertakings in place it will offer an effective competitive restraint on the Proposed Alliance and thereby reduce the competitive detriment of the Proposed Alliance. Without suitable conditions or undertakings in place it is unlikely to be able to offer an effective competitive restraint within a reasonable time frame.

2.4 The undertakings proposed by the Applicants are inadequate to address the competitive concerns expressed by the Commission as they are behavioural and do not address the

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[1] at page 12 of the Draft Determination.

structural competitive problems of the markets that will arise as a result of the Proposed Alliance.

3. KEY FINDINGS OF THE DRAFT DETERMINATION

3.1 For the purposes of this submission, it is convenient to summarise the key findings of the Commission in the Draft Determination as:

(a) the only viable entrant to the trans-Tasman and main trunk markets is Virgin Blue;

(b) while Virgin Blue will enter this market, the scale of its entry is not considered to be large or quick enough to provide a sufficient competitive constraint on the Proposed Alliance;

(c) there are impediments to Virgin Blue's entry and success. These include:

(i) access to facilities; and

(ii) the strategic response of Qantas and Air New Zealand to its entry, including capacity dumping;

(d) behavioural undertakings to facilitate Virgin Blue's entry in relation to:

(i) access to facilities; and

(ii) capacity dumping,

while important, are not as desirable or as likely to address the competition concerns of the Commission as structural undertakings;

(e) as the Applicants have not offered the Commission any specific structural undertakings, the Commission has not given substantive consideration to undertakings to divest assets or shares, however, a third party acquisition of Freedom Air, would appear to be likely to bring about the early entry of a value based airline to the Tasman market and that this in turn might serve as a platform to enable further entry or expansion into the domestic New Zealand market.

3.2 In general, Virgin Blue agrees with this analysis.

3.3 Virgin Blue considers that the Commission has every right to be concerned with the anti-competitive nature of the Proposed Alliance. Competition is the key to affordable and efficient air travel. The only manner in which to ensure that the interests of consumers are adequately protected is to ensure that there will be effective and sustainable competition in the relevant markets.

3.4 Virgin Blue believes that with suitable undertakings and conditions in place it can impose a competitive constraint on the Proposed Alliance sufficient to significantly reduce the anti-competitive detriment identified by the Commission. These conditions and undertakings were described in its Submission and are:

(a) new entrants must be provided with access to terminal facilities and slots at a level equivalent to that enjoyed by the Applicants, particularly during peak times. An effective undertaking in this regard is paramount;

(a) the divestiture by Air New Zealand of Freedom Air. Virgin Blue has been identified as the only viable new entrant. Accordingly, for the purposes of this submission Virgin Blue has assumed that Freedom Air has been divested to it. The divestiture of Freedom Air should be made a condition of the authorisation becoming effective. This would:

(i) remove a bullet from the Applicants' gun. That is, it deprives the Applicants of a likely vehicle for an anti-competitive capacity/pricing response;

(ii) provide a vehicle for Virgin Blue to immediately commence operations in New Zealand. Time to market is critical in establishing a substantial competitive response to the Proposed Alliance;

(iii) provide Virgin Blue with an immediate and substantial scale of operations, through four B737s, (the same scale as Qantas' existing operations in New Zealand); and

(iv) off-set the anti-competitive effects of the rationalisation of capacity under the Proposed Alliance. That is, it ensures that more capacity remains in the market than otherwise, and that a greater share of that capacity is independent of the Proposed Alliance;

(b) to ensure that this outcome is not undermined through the establishment by the Applicants of a new low cost operator or the redeployment of an existing low cost operator, there should be appropriate restrictions on Air New Zealand and Qantas from establishing another low fare airline, and Qantas should be restrained from flying Australian Airlines in addition to Impulse and Jet Connect aircraft on the trans-Tasman, man trunk and Pacific routes for a period of three years;[2]

(c) Virgin Blue must be able to enter into satisfactory commercial arrangements for maintenance services, spare parts and ground handling services at all major airports and route reprotection; and

(d) the Applicants should provide an undertaking to limit their capacity response to new entry. The undertaking should prohibit them from increasing capacity for a period of two years on any route following new entry.

4. SCALE OF VIRGIN BLUE WITH PROPOSED UNDERTAKINGS AND CONDITIONS

4.1 For the purposes of analysing the scale which Virgin Blue might achieve if the Commission grants the undertakings and conditions proposed by Virgin Blue, it has prepared a hypothetical schedule (**Hypothetical Schedule**) based on the following assumptions:

(a) Virgin Blue acquires Freedom Air (4 B737s);

(b) there are no capacity constraints at relevant airports (both in terms of slots, terminal and other facilities) at least in the first three years of operation; and

(c) the ability of the Proposed Alliance to engage in predatory or strategic conduct is constrained.

4.2 The Hypothetical Schedule is listed in Annexure 1. In order to produce the Hypothetical Schedule a number of additional assumptions needed to be made. These are listed in the Hypothetical Schedule. The most important of these is the assumption that the schedules of existing carriers in both the trans Tasman and main trunk routes (including Freedom Air) remain constant during the three year period. Such an outcome in reality will not occur. However, it is not possible to predict with any certainty the nature of the scheduling changes. Accordingly it was assumed that there would be no change.

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2 This is in line with the Canadian regulatory response to the Air Canada acquisition of Canadian Airlines.

4.3 Virgin Blue believes that the Hypothetical Schedule, having regard to the circumstances in which it has been developed is reasonable. However, Virgin Blue is confident that its performance will exceed that contemplated in the Hypothetical Schedule having regard to its achievements in the Australian domestic market.

4.4 Virgin Blue analysed the market share (in terms of capacity) of the trans Tasman and main trunk markets that the Hypothetical Schedule would provide to Virgin Blue. These are listed on a route by route basis and as an aggregated total for each of the trans Tasman and main trunk markets in Annexure 2.

4.5 This analysis suggests that by year 3, Virgin Blue would have approximately **[deleted]** market share of the trans Tasman and main trunk markets. If the market share of fifth freedom airlines on the trans Tasman routes are not taken into account, this amounts to about **[deleted]** of the trans Tasman market. Virgin Blue is confident that this market share will continue to grow after year 3. Virgin Blue submits that taking into account the nature of competition between a low cost operator and an FSA, which is discussed below in more detail, if it were to achieve the scale contemplated in the Hypothetical Schedule it would amount to an effective competitive constraint on the Proposed Alliance.

4.6 The Hypothetical Schedule contemplates a significant growth in Virgin Blue's trans Tasman and main trunk business in the first three years of its operation. However, Virgin Blue believes its ability to achieve this growth is evidenced by its growth in the Australian domestic market. Virgin Blue commenced operations in Australia on 31 August 2000. In that time it has obtained a 26.2% share of the total domestic air services market in Australia,[3] measured on a per passenger basis, and a 32.1%[4] share of the market measured on a per passenger basis when only those routes upon which it offers services are taken into account.

4.7 Virgin Blue's growth has been largely due to its low cost structure and its ability to stimulate demand through wide availability of low fares. Virgin Blue acknowledges, however, that its growth has been strongly assisted due to specific factors including the collapse of Impulse and Ansett. The Commission may consider that, as these factors are not present in the trans-Tasman market and main trunk markets, Virgin Blue's growth will not be as marked in these markets as it has been in the Australian domestic market. However, Virgin Blue considers that the undertakings and conditions proposed by Virgin

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[3] Department of Transport and Regional Services. DOTARS provides Virgin Blue with information concerning its share of passengers on certain routes.

[4] DOTARS

Blue will assist it in achieving similar growth on the trans Tasman and main trunk markets. For example:

(a) when it commenced operations in Australia there were significant limitations on access to facilities at airports. This was a significant constraint on its ability to grow its market share. However, with appropriate access to facilities as proposed by Virgin Blue this will allow it to grow at a rate that would have otherwise been unachievable;

(a) just as the demise of Ansett left substantial unsatisfied demand and provided scope for Virgin Blue to rapidly expand, the divestiture of Freedom Air would have the same effect (although to a smaller degree). It would move market share (approximately 11%)[5] away from the Proposed Alliance and provide a significant initial market share to Virgin Blue. While this initial market share will be in the trans Tasman market only, it will provide Virgin Blue with a solid platform to quickly develop its main trunk services; and

(b) Qantas' strategic and predatory conduct has been a significant impediment to Virgin Blue's growth in the Australian domestic market. However, with the sale of Freedom Air to Virgin Blue and suitable capacity undertakings in place, the ability of the Proposed Alliance to engage in predatory or strategic conduct will be reduced.

4.8 Absent the appropriate undertakings, it is difficult to predict with certainty the size of Virgin Blue operations in the trans Tasman and main trunk markets in the time period contemplated in the Hypothetical Schedule. This is because there is uncertainty surrounding Virgin Blue's ability to gain access to facilities at airports and the extent and success of the strategic conduct of the alliance. That is, it is easier to produce the Hypothetical Schedule as key uncertainties have been removed. However, there is one certainty – namely that Virgin Blue will not achieve the same scale it would achieve with the undertakings or conditions in place if those undertakings or conditions were not in place.

5. EFFECTIVENESS OF VIRGIN BLUE AS COMPETITIVE CONSTRAINT

5.1 Virgin Blue believes that the scale it will achieve and the time period in which it will achieve that scale with the appropriate undertakings and conditions in place in the trans

5 Table 9.1 of the Draft Determination of the Australian Competition and Consumer Commission dated 10 April 2003.

Tasman and main Trunk markets will be sufficient to impose an effective competitive constraint on the Proposed Alliance even though the market share of the Proposed Alliance will be significantly larger than that of Virgin Blue.

5.2 This view is supported by evidence of the effectiveness of Virgin Blue as a competitor with Qantas in the Australian domestic market.

5.3 The competitive constraint that Virgin Blue applies on Qantas in Australia is due principally to the low cost model adopted by Virgin Blue. As previously discussed in its Submission, a low cost airline's business plan is premised upon offering low fares to generate demand in order to grow the market and ensure a large volume of customers. The price of its fares, therefore, are determined primarily by the desire to stimulate demand and increase volume. This means that Virgin Blue will tend to offer prices significantly lower than the prices of a FSA on a route regardless of the level of competition on that route, in order to stimulate demand in the manner required by Virgin Blue to support its business model. Therefore, even if the Proposed Alliance is the only competitor on a route, there will be upon entry by Virgin Blue significant price competition. The impact of low cost airlines and the competitive constraint they impose on incumbent FSAs is widely acknowledged.[6]

5.4 This much is evidenced by a comparison of prices, particularly economy and discount fares, since the collapse of Ansett in September 2001 where Virgin Blue and Qantas have been the only carriers on non-regional domestic services and the period during which Ansett and Qantas were the only carriers on non-regional domestic services.

5.5 In real terms prices are significantly lower in the period that Virgin Blue has been the principal competitor of Qantas. The Bureau of Transport and Regional Economics found that real discount fares in November 2002 were 23% cheaper than the real discount fares in November 1999.[7]

5.6 Virgin Blue's own analysis also demonstrates that there has been a significant decrease in Qantas' prices since prior to the entry of Virgin Blue to June 2003. Set out in Annexure 3 is an analysis of Qantas' pricing on selected routes. This analysis demonstrates that there has been a consistent decrease of between 20-30% across the various fares analysed in Qantas' pricing from the period in which Qantas' principal price competition was from Ansett to the period where Qantas' principal price competition was from Virgin Blue.

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6 See for example "*A way out of the Wilderness*" The Economist print edition 1 May 2003.

7 http://www.btre.gov.au/docs/avline/avline_3.htm#Top. See also Figure 1.

5.7 Virgin Blue has been able to exert this competitive pressure on Qantas even though its total market share has not exceeded 30%.

5.8 This evidence suggests Virgin Blue would be able to offer an effective competitive restraint on the Proposed Alliance even though it may have a significantly smaller market share than the Proposed Alliance.

6. UNDERTAKINGS OFFERED

6.1 Virgin Blue has reviewed the undertakings proposed by the Applicants (**Proposed Undertakings**). It believes they are fundamentally inadequate as they do not provide a structural resolution to the competition issues raised in the Draft Determination and the behavioural commitments are inadequate and flawed.

6.2 Virgin Blue makes the following brief comments in relation to the Proposed Undertakings.

Facilities Access

6.3 An effective undertaking in relation to facility access is absolutely critical and of fundamental importance to the development of sustainable competition if the Proposed Alliance were to proceed. Without such an undertaking, any other undertaking would achieve little.

6.4 The undertakings proposed by the Applicants in this regard are somewhat confusing and it is difficult to ascertain exactly what the Applicants are proposing. In part this is because there is no clear distinction between services supplied by the Applicants (ground handling etc) and services that are provided by the various airports (principally access to terminal and other facilities).

6.5 Notwithstanding this confusion, Virgin Blue notes that any undertakings regarding access to terminals and other facilities should at the very least have the following features:

(a) the complete surrender of any first rights of use the Applicants have to use an amount of terminal and other facilities capacity sufficient to allow Virgin Blue and other new entrants to have dedicated facilities (for example, branded terminal space including gates and counters) at the relevant Airports and the re-allocation of that capacity by the airports to Virgin Blue (or other new entrants);

(b) the amount of capacity surrendered should be determined by the amount of first right of use capacity required by new entrants within a particular time period. This surrender should be unqualified and should not have regard to changes to the Applicants' schedules. Virgin Blue expects that it will require first rights of use over between 20-25% of terminal and check in counter facilities. Although, this will require arrangements to be put in place with third parties (Airports) Virgin Blue is confident that these arrangements could be implemented with little difficulty;

(c) the Applicants should have no control over how and when these facilities would be used by the new entrants; and

(d) the facilities subject to the undertaking should not be defined exhaustively. While specific facilities should be identified there should be a residual requirement that allows additional facilities to be included in the undertaking having regard to the requirements of a new entrant to commence and maintain operations.

6.6 Further, any authorisation should be conditional on satisfactory access arrangements actually being implemented prior to the commencement of operations under the Proposed Alliance.

Freedom Air and Aircraft Lease

6.7 The Proposed Undertakings seek to address these concerns in part by imposing constraints on the operation of Freedom Air together with a commitment to lease aircraft. However, they do not adequately address the competition concerns identified by the Commission and Virgin Blue. For example:

(a) they do not provide for the divesture of capacity/market share to an independent new entrant. Accordingly, the Proposed Undertakings do not address market concentration concerns of the Commission. The divestiture of Freedom Air is the only mechanism that Virgin Blue can see that will ensure significant capacity/market share is independent of the Proposed Alliance. Leasing aircraft is simply no substitute to the divestiture of operational capacity;

(b) they are premised upon the assumption that new entrants would only wish to offer services between the primary Australian cities (Brisbane, Sydney and Melbourne) and the primary New Zealand cities (Auckland, Wellington, Christchurch). This is incorrect. As Virgin Blue has already pointed out in its submissions, a common entry strategy of new entrants, particularly low cost airlines is to target under serviced routes between secondary cities. In any case Virgin Blue notes a large portion of Freedom Air's current services are between the Australian cites and secondary airports in New Zealand (including all Freedom Air services out of Sydney and Melbourne) and accordingly the undertakings proposed would make little, if any, practical difference. In fact, the proposed undertakings are consistent with a strategy of using Freedom Air to contain Virgin Blue's entry and growth on secondary airport routes; and

(c) they are behavioural and require ongoing compliance monitoring and enforcement.

6.8 The Proposed Alliance should only be authorised on condition that Freedom Air is divested by Air New Zealand as a pre-condition to the commencement of the Proposed Alliance. Such a condition, which is structural, would require no ongoing monitoring or compliance, and would:

(a) provide a substantial immediate transfer of capacity/market share to an independent new entrant enabling it to immediately commence operations in New Zealand;

(b) reduce the Applicants ability to engage in an anti-competitive capacity/pricing response to new entry;

(c) provide Virgin Blue with an immediate and substantial scale of operations, through four 737s, (the same scale as Qantas' existing operations in New Zealand); and

(d) off-set the anti-competitive effects of the rationalisation of capacity under the Proposed Alliance, as a greater share of capacity in the market is independent of the Proposed Alliance.

6.9 Finally, Virgin Blue does not accept that it would be commercially difficult to divest Freedom Air as is suggested by Air New Zealand. It is a separate entity that has been deliberately operated as a separate entity in order to ensure that it achieves and maintains a low cost structure. Its sale or divestiture would be no more difficult than any other sale of a business or division of a business. Certainly, relative to the complexity of the Proposed Alliance it is a simple transaction.

6.10 Virgin Blue submits that the Commission should make it clear that the Proposed Alliance could only be authorised consequent upon adequate structural solutions to the competition concerns being implemented, which would include, for example, the divestiture of Freedom Air.

Capacity Ceiling

6.11 In theory, an undertaking restricting the Proposed Alliance from increasing capacity on routes in response to new entry is appropriate. However, the undertaking proposed by the Applicants is deficient in a number of regards. Any capacity ceiling undertaking ultimately accepted by the Commission should have the following features:

(a) the nature of the restriction should be absolute. The Proposed Alliance should not be entitled to increase available seat kilometres for any reason, including the upgrading of aircraft with more capacity (a B737-800 has considerably more capacity than a B737-300);

(b) the undertaking should operate on all trans Tasman and New Zealand domestic routes regardless of whether the Applicants provide services on that route. It is inadequate that the undertaking be limited to only those routes on which the Proposed Alliance would be the monopoly provider. This may have the effect of the Proposed Alliance being prevented from offering certain new services, but Virgin Blue believes that, at least for a limited period of time, this is appropriate;

(c) the ceiling should be set by reference to the lesser of the schedule operated by the Applicants prior to the commencement of the Proposed Alliance or on the commencement of operations under the Proposed Alliance; and

(d) the Capacity Ceiling commitment should prevail over the commitment to increase capacity in clause 5.2.

6.12 These issues would need to be carefully addressed in any final undertakings.

Other Undertakings

6.13 Virgin Blue would question whether commitments to commence operating on certain routes and to undertake certain tourism related expenditures are appropriate. In the event that these matters are feasible under the Proposed Alliance, they may constitute public benefits. However they do not simply become public benefits because the parties, through undertakings, in effect contract to provide something which they otherwise would not. Nor do they address any particular competition concern identified by the Commission. Accordingly, these undertakings do not appear to be appropriate.

Monitoring and Compliance

6.14 Not all circumstances can be foreseen in advance. Accordingly any undertakings should have in place a mechanism for the Commission to issue binding compliance directions to the Applicants in order to ensure compliance with or resolve disputes arising under the Proposed Undertaking.

Conclusion on Undertakings

6.15 As stated above, Virgin Blue believes that the Proposed Undertakings are inadequate to address the competition concerns that the Commission has identified in its Draft Determination. Virgin Blue has identified those undertakings/conditions that it believes have the best prospects of addressing the competition concerns of the Commission and considers that there is little prospect of the Commission's competition concerns being addressed unless these undertakings/conditions are offered by the Applicants. These undertaking are not onerous on the Applicants having regard to the benefits that will flow to them under the Proposed Alliance nor are they unorthodox proposals to address competition concerns. In these circumstances, the refusal of the Applicants to offer these undertakings, including the divestiture of Freedom Air, means that the Commission could reasonably conclude that the Applicants have overstated the commercial and strategic imperatives of the Proposed Alliance.

Non - confidential Version

ANNEXURE ONE

HYPOTHETICAL SCHEDULE

[DELETED]

ANNEXURE TWO

MARKET SHARE ANALYSIS

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ANNEXURE THREE

QANTAS AIR FARE ANALYSIS

NOTE: All care has been exercised to make like to like comparison between fares. However significant changes have taken place to the fare structure which makes comparisons difficult.

QF Fare Change July, 2003 relative to March, 2000

BNE-SYD	Fare Levels		Variance	
Fare Description	Mar-00	Jul-03	$	%
Cheapest Publically available fare	141	93	-48	-34
Cheapest Advance Purchase (14days)	152	121	-31	-20
Cheapest Flexible Fare	315	217	-98	-31

SYD-MEL	Fare Levels		Variance	
Fare Description	Mar-00	Jul-03	$	%
Cheapest Publically available fare	135	93	-42	-31
Cheapest Advance Purchase (14days)	152	122	-30	-20
Cheapest Flexible Fare	287	210	-77	-27

BNE-MEL	Fare Levels		Variance	
Fare Description	Mar-00	Jul-03	$	%
Cheapest Publically available fare	219	142	-77	-35
Cheapest Advance Purchase (14days)	241	181	-60	-25
Cheapest Flexible Fare	450	320	-130	-29

SYD-PER	Fare Levels		Variance	
Fare Description	Mar-00	Jul-03	$	%
Cheapest Publically available fare	333	245	-88	-26
Cheapest Advance Purchase (14days)	377	310	-67	-18
Cheapest Flexible Fare	720	620	-100	-14

BNE-CNS	Fare Levels		Variance	
Fare Description	Mar-00	Jul-03	$	%
Cheapest Publically available fare	208	167	-41	-20
Cheapest Advance Purchase (14days)	241	204	-37	-15
Cheapest Flexible Fare	438	369	-69	-16

BNE-MKY	Fare Levels		Variance	
Fare Description	Mar-00	Jul-03	$	%
Cheapest Publically available fare	181	139	-42	-23
Cheapest Advance Purchase (14days)	208	177	-31	-15
Cheapest Flexible Fare	330	328	-2	-1