VIRGIN BLUE SUBMISSION

IN RESPONSE TO

APPLICATIONS FOR AUTHORISATION

OF THE PROPOSED

QANTAS/AIR NEW ZEALAND/AIR PACIFIC

ALLIANCE

12 FEBRUARY 2003

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1. INTRODUCTION AND EXECUTIVE SUMMARY

1.1 Qantas Airways Limited (**Qantas**) and Air New Zealand Limited (**Air New Zealand**) (the **Applicants**) together with Air Pacific Limited (**Air Pacific**), propose to enter into a strategic alliance (**Proposed Alliance**[1]) to integrate their operations on trans Tasman, New Zealand and Pacific routes.

1.2 The stated rationale for the Proposed Alliance is the desire to integrate Qantas' and Air New Zealand's operations as they claim there is only room for one networked Full Service Airline. They claim the alternative is a five year battle for supremacy on trans Tasman, New Zealand and Pacific Routes with only one likely survivor. Virgin Blue does not consider that it is credible that both of Qantas and Air New Zealand would enter into a five year price war, where only one airline survives.

1.3 The Proposed Alliance removes the head to head competition of Qantas and Air New Zealand in the trans Tasman and New Zealand markets. It also removes head to head competition in Pacific markets (which is largely ignored by the Applicants). They will fully co-ordinate all their operations, jointly set prices and share profits. To address the anti-competitive effect of the Proposed Alliance, Qantas and Air New Zealand have relied on the prospective entry of Virgin Blue on key routes if the Proposed Alliance proceeds.

1.4 Virgin Blue has been actively considering establishing operations on these routes. With or without the Proposed Alliance, Virgin Blue will commence on these routes. Critically the timing and scale of Virgin Blue's entry will depend on the barriers to entry. There are two main barriers to establishing a substantial scale of operations:

(a) access to facilities (including for example, Sydney, Auckland and Christchurch airports) and commercial agreements for necessary ground support and handling. Air New Zealand and Qantas, through existing arrangements with airports, control key capacity at these and other airports. Further, Air New Zealand is the monopoly supplier of many ground support and handling services in New Zealand; and

(b) the threat of strategic capacity and pricing conduct by Air New Zealand and Qantas, particularly through their low cost operations, Freedom Air, Australian Airlines and entities within the Qantas brand with low cost structures such as Impulse and Jet Connect.

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[1] In this paper a reference to the Proposed Alliance includes a reference to the proposed acquisition by Qantas of an equity interest in Air New Zealand of up to 22.5% and the proposed Cooperation Agreement between Qantas, Air New Zealand and Air Pacific Limited.

1.5 The Proposed Alliance raises these barriers. That is, an additional anti-competitive effect of the Proposed Alliance is that it enables the Alliance parties to limit the scale and timing of Virgin Blue's entry and limit its competitive presence.

1.6 Under the Proposed Alliance, Air New Zealand and Qantas will not need to compete head to head but will be able to strategically target their combined fleets, and in particular their low cost operations, Freedom Air and Australian Airlines (and the low cost vehicles operating under Qantas branding, namely, Jet Connect and Impulse) to constrain the growth of Virgin Blue. Under the Proposed Alliance, Qantas and Air New Zealand have a greater incentive and capacity to target Virgin Blue, in order to deter and delay its entry.

1.7 This conduct is consistent with Virgin Blue's experience to date in Australia, for example, when Ansett first collapsed Mr Geoff Dixon, CEO of Qantas said:

> *We're going to draw a line in the sand, and we're going to stay there.*[2]

Mr Dixon also said that Qantas would take it as a failure on its part if Tesna and Virgin Blue both survived.[3]

1.8 It is also consistent with experience in New Zealand, where Air New Zealand established Freedom Air in response to entry by Kiwi in 1996, targeting specific routes operated by Kiwi. Kiwi's strategy was to provide direct services on routes out of provincial New Zealand cities to points in Australia that had not previously been served by Air New Zealand, Ansett or Qantas. With the collapse of Kiwi in 1997, Freedom Air was kept in operation on a limited basis as a strategic checking device for any new entrant. For example, in response to Virgin Blue's announced its intention to commence operations in New Zealand on 24 April 2001, Freedom Air announced three days later that it was expanding the fleet from two to four 737's, apparently to counter Virgin Blue's entry.[4] When Tasman Pacific failed and Qantas announced the commencement of its own operations in New Zealand in May 2001, Air New Zealand withdrew Freedom Air from Tasman services and re-deployed it on those domestic routes operated by Qantas. Now, Air New Zealand has re-deployed Freedom Air to operate out of Brisbane, the home base of Virgin Blue.

1.9 The Proposed Alliance raises a substantial risk that Virgin Blue's entry into New Zealand may not be as substantial as it otherwise would be. In any event, it is unlikely on current planning, that Virgin Blue would be able to provide the scale of operations, and in the

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2 Australian Financial Review, 22 February 2002.
3 ABC Television, "7.30 Report", 11 December 2002.
4 *Forgive the Cynicism,* New Zealand Evening Post, 30 April 2001, Editorial p.4.

time frame, on which the Applicants' case is founded. Without this entry, the Applicants cannot make their case.

1.10 Given the threat the Proposed Alliance poses to new entry, Virgin Blue submits that it should only be authorised if Virgin Blue (or someone else) has actually entered on a substantial scale on the trans Tasman and New Zealand routes prior to the Proposed Alliance coming into effect. The need for actual and substantive competition was acknowledged by Qantas as an essential pre-condition when it first announced its consideration of the proposal in May 2001.[5]

1.11 To enable a new entrant to enter on this scale and in a meaningful time-frame, a number of structural and other market changes would be required.

(a) Air New Zealand would need to divest Freedom Air. This would:

(i) remove a bullet from the Applicants' gun, that is, it removes a likely vehicle for a strategic capacity/pricing response from the Applicants;

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

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

(iv) off-set the anti-competitive effects of the rationalisation of capacity under the Proposed Alliance, ie 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;

(v) provide a vehicle from which a new entrant may expand; and

(vi) cause the Applicants to use their core brands and services in responding to entry by Virgin Blue, which should result in more broadly based reductions in price than may otherwise occur.

(b) To ensure that this outcome is not undermined through the establishment by the Alliance parties of a new low cost operator or the redeployment of an existing low

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5 "*Qantas also realised that the proposal could not proceed without the Ansett Group: commencing significant operations on the trans Tasman and some other competitive routes; starting a domestic airline within New Zealand*": Qantas ASX release issued by Qantas Public Affairs, 31 May 2001

cost operator, there should be appropriate restrictions on Air New Zealand and Qantas 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, New Zealand and Pacific routes for a period of three years.[6]

(c) New entrants must be provided access to terminal facilities on a level equivalent to that enjoyed by the Applicants, particularly during peak times. There are several affected airports[7] which have substantial capacity constraints, including to gates and check-in facilities. These include, without limitation, the key gateway ports of Sydney, Auckland and Christchurch. The Australian Competition and Consumer Commission (**Commission**) should also be satisfied that there are sufficient suitable peak time slots at constrained airports, ie Sydney and Auckland.

In critical respects, Air New Zealand, and to a lesser extent Qantas, control access to these facilities, particularly where they have contractual rights to the use of such facilities such as gates and check in counters. To the extent that Qantas/Air New Zealand cannot assign leases of facilities or enter into sub-leases, they should relinquish their rights of access to a new entrant, and facilitate that process with the airport operator.

(d) Air New Zealand must enter satisfactory commercial arrangements for maintenance services, spares and parts; ground handling services and equipment at all major airports; and route reprotection. Air New Zealand is currently the monopoly supplier of many of these services.

(e) 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.

1.12 Without these conditions, there can be no guarantee that there will be a sufficient level of competition to permit the Proposed Alliance to proceed. In this context, Virgin Blue has

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

7 Virgin Blue is currently considering the feasibility of operating services from a number of airports and expects there to be a number of airports with severe capacity limitations.

engaged Frontier Economics[8] to review the modelling of the detriments and benefits undertaken by NECG [9]. Frontier Economics conclude that NECG have:

(a) understated the detriments in that:

(i) the price increases and capacity decreases identified by the Applicants have been substantially understated, and the dead weight loss associated with the Proposed Alliance has been underestimated as a result; and

(ii) the Applicants have failed to identify a likely detriment in that the Proposed Alliance is likely to have a similar effect on freight services as it has on passenger services, namely to increase prices and reduce capacity;

(b) overstated the benefits. The principal reasons for this are:

(i) there is no basis for the tourism benefits the Applicants have alleged will occur should the Proposed Alliance proceed;

(ii) the cost savings are unsubstantiated and appear to be cost savings attributed to the Applicants failing to engage in inefficient and potentially unlawful conduct, which in any event is implausible;

(iii) the Applicants have not measured scheduling efficiencies arising between the factual and counterfactual scenario, but instead have compared the schedules if the Proposed Alliance were to proceed with the existing schedules, which has the effect of overstating the scheduling efficiencies; and

(iv) there is no reason why the Proposed Alliance should not result in any new direct services that otherwise would not have occurred.

1.13 Frontier concluded:

In this case, clearly the expected benefits identified by NECG as resulting from the proposed alliance would not outweigh the expected costs. The key factor that

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8 Critique of the NECG Report on the Qantas and Air New Zealand Alliance – a report prepared for Gilbert & Tobin dated February 2003 (**Frontier Report**). A copy of the Frontier Report is included at Attachment 1.

9 Report on the Competitive Effects and Public Benefits Arising from the proposed Alliance between Qantas and Air New Zealand dated 8 December 2002 (**NECG Report**).

may lessen that detriment caused by the lessening of competition would be the prospect of entry – providing that entry were on a scale that would effectively replace the rivalry that the proposed alliance is designed to destroy.

1.14 In any case, given the inherent risks to competition from the Proposed Alliance, it should not be authorised under any circumstances for more than three years.

2. VIRGIN BLUE

History of Virgin Blue

2.1 The Virgin Group announced the commencement of a low-fare airline[10] in Australia in November 1999. Virgin Blue commenced operations on 31 August 2000.

2.2 Virgin Blue's strategy was, and remains, to price air travel at a level that is readily affordable for most people – it will price its fares at levels that expand the overall demand for air travel by making it more affordable for those who otherwise could not afford to fly at all or as often.

2.3 Virgin Blue's experience, consistent with the experience with other low fare carriers around the world, is that offering widely available low fares, leads to a substantial increase in demand for travel. The increase in demand is typically in the order of 15-30% depending on the nature of the route.

2.4 The increase in demand is driven by the wide availability of low fares. For example, Virgin Blue offers what it calls fully flexible fares (that is a fare without any travel restrictions or similar conditions) which is equivalent to a full economy fare at prices which may be in the order of more than 50% below the standard full economy fare offered by Qantas or, at the time, Ansett.

2.5 The impact of Virgin Blue and Impulse on the volume of air travel in Australia is demonstrated by a 26% increase in passenger numbers travelling between Sydney and Brisbane between the year prior to Virgin Blue's entry on that route (August 2000) and the year of entry. On the Brisbane to Melbourne route there was a 30% increase during the same period.[11]

2.6 This experience is consistent with the experience in the United States[12] and Europe.

2.7 In order to offer widely available low fares, Virgin Blue's strategy (as with other low fare airlines) is to keep costs as low as possible. It does this by:

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10 The concept of a low fare airline is explained in more detail in the US Department of Transport's paper *The Low Cost Airline Service Revolution* dated 23 April 1996.

11 Based on Department of Transport passenger numbers, BNE/SYD (1999: 3,286,423; 2000: 4,427,797); BNE/MEL (1999: 1,707,840; 2000: 2,231,510).

12 The Department of Transport *The Low Cost Airline Service Revolution* dated 23 April 1996.

(a) maximising the efficient operation and utilisation of its aircraft, through operating a single class of jets, namely Boeing 737s, configured to a single seat class, and by adopting more efficient operating systems (including its revenue and reservation management systems) with efficient airport procedures minimising aircraft time spent on the ground; and

(b) not bundling costly customer services such as complementary meal services, frequent flyer programs or club lounges into its fares.[13]

2.8 Virgin Blue's start up strategy was to target short haul routes that were likely to have a strong increase in demand in response to low fares. Generally these were routes that were attractive for leisure customers, who are typically more cost sensitive than business customers, however, these were not necessarily leisure routes as such. Virgin Blue has also targeted routes that were not serviced or were under serviced by the incumbent airlines.

2.9 An integral part of the of Virgin Blue experience in Australia, as with other low-cost airlines, has been the response of Qantas to its entry. When Virgin Blue commenced operation in Australia, Qantas embarked on an aggressive campaign of substantial capacity expansions directed at the new routes operated by Virgin Blue. Qantas had the ability through its substantial fleet and financial backing to quickly redeploy significant capacity and to match or beat low fare offers on the new routes entered by Virgin Blue (albeit at below cost). Examples of Qantas' predatory strategy are discussed below.

(a) Signalling a substantial increase in domestic capacity prior to the start up of Virgin Blue and Impulse. For example, in February 2001, Qantas announced its half-yearly profit results. Commenting on these results, *The Sydney Morning Herald* reported that:[14]

> *"Qantas Airways has signalled it will escalate competition in the domestic aviation market after yesterday reporting a sharp drop in interim earnings and warning that there is little to suggest trading conditions will improve in the second half ...*
>
> *Chief executive-designate Geoff Dixon said Qantas would 'stand our ground' on domestic routes and continue its aggressive response to the new market entrants.*

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13 As discussed below Virgin Blue is considering offering similar services such as customer lounges and valet parking – but it will be on a user pays basis.

14 *Sydney Morning Herald,* "Qantas steps up fare war as profit dives 22pc", 23 February 2001, p. 21.

The fall in profit was concentrated in Qantas' eastern seaboard services, the routes targeted by discount operators Impulse Airlines and Sir Richard Branson's Virgin Blue.

In the six months to December, net profit fell 22.2 per cent to $262.9 million, reflecting a sharp deterioration in yields as revenue rose 13.1 per cent to $5.1 billion."

At the same time as Qantas announced it was experiencing a sharp drop in profits concentrated on those routes where there had been new entry, it also announced that it would suspend certain international routes in order to bring these large aircraft back to fly on domestic routes. In a press release this decision was stated to be as a result of a "comprehensive business review".[15] This same press release recorded this decision as:

"the redeployment of aircraft from suspended international services to meet new competition on key domestic routes."

Therefore, Qantas' response to declining profits on certain major routes as a result of matching the low fare airline's pricing was to further bolster capacity on these unprofitable routes. The aircraft to be brought back to add capacity to domestic routes were four Boeing 767-300 aircraft, which are wide bodied jets which seat 228 passengers. These aircraft are almost double the capacity of the 117 seat Boeing 717s then operated by Impulse and larger than the 162 seat 737-400s then operated by Virgin Blue. They are also designed for long-haul operations rather than the domestic trunk routes for which they were being used.

The Sydney Morning Herald noted that:[16]

"Concerns immediately turned to the prospect of another fare war after Qantas announced the job cuts and a decision to swing four Boeing 767-300 aircraft on to domestic routes, after suspending all services to China and Canada.

The redeployment will boost Qantas' domestic capacity by 11 per cent, compared with the market's 7.5 per cent rate of growth."

(b) Targeted increases in capacity on particular routes operated by Virgin Blue. For example, Qantas increased its capacity on the Adelaide/Brisbane route in response

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15 Qantas press release, "Qantas Results for the Half Year Ended 31 December 2000", 22 February 2001.
16 *Sydney Morning Herald, supra* note 14.

to Virgin Blue's entry on that route by 50%, the effect of which was to trigger a substantial reduction in fares, yields and load factors on that route. The Commission has subsequently commenced proceedings alleging a contravention of the misuse of market power provisions in relation to this incident.

Another example arose following the collapse of Ansett, where flights serving Canberra were severely disrupted. Despite appeals by Canberra Airport for Qantas to increase its services, Qantas only substantially increased capacity on the Brisbane-Canberra route, which was the only route into Canberra served by Virgin Blue. Qantas added 10 return flights per week, targeting the departure times of the Virgin Blue service. Qantas also added three return flights per week between Canberra and Melbourne, which amounted to less than 10% of the capacity lost when Ansett and Kendall exited the route.[17]

(c) Re-routing international services to include domestic sectors, which substantially increased effective domestic capacity. These services included Townsville to Singapore via Brisbane, Cairns to Singapore via Brisbane, Sydney to Osaka via Cairns and Adelaide to Singapore via Darwin. Qantas later announced that the Townsville services would be discontinued from March 2002 at which point it conceded that the service had been introduced to boost domestic capacity between Brisbane and Townsville.[18]

(d) Engaging in a strategy of pushing Virgin Blue off marginal routes. For example, prior to its collapse Ansett flew nine weekly flights between Brisbane and Mt Isa. Qantas had not had a regular service on that route since 1989. After the collapse of Ansett, Virgin Blue commenced a regular service on 18 September 2001 of five flights per week. On 19 September Qantas announced that it would re-commence a regular Brisbane-Mt Isa service with 12 Bae-146 flights each way per week, which exceeded the capacity previously used by Ansett to service that route. These aircraft had previously been used to target Impulse's Melbourne/Newcastle operations. Virgin Blue was forced to withdraw from the route.

2.10 Qantas' ability to impede the successful entry of a new entrant is supported by its vertically integrated operations. Qantas Business Travel (**QBT**) is the dominant provider of business travel agency services in Australia and also the dominant provider of travel agency services to the Australian Government. QBT has adopted a number of practices designed to limit the success of Virgin Blue in the business market. These include:

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[17] As advised by Canberra International Airport, 16 October 2001.

[18] *Townsville Bulletin* "Qantas Dumping International Flight" 15 December 2001.

(a) the practice of not booking the best available fare on the day for business clients, often contrary to contractual arrangements, where these fares are offered by Virgin Blue; and

(b) the practice of including a global financial offer which bundles low cost services with preferential rates on overseas and business class travel which is only available through Qantas. This significantly impacts upon the ability of other airlines, both international (such as United Airlines and Air New Zealand) and regional carriers (such as REX) who cannot offer the same scope of services to compete.

2.11 Qantas' response to Impulse's entry was similar. For example:

(a) it responded to Impulse's new regional service between Newcastle and Melbourne for $318 return, by increasing the size of its aircraft operating on the Newcastle-Melbourne route and offered return fares for $159 and $189. Impulse withdrew from the route. Following Ansett's collapse, Qantas removed these aircraft and placed them on the Brisbane - Mt Isa routes;

(b) following Impulse's announcement that it would commence services between Sydney, Melbourne and Brisbane, Qantas began offering restricted tickets at up to 75% off standard economy fares for travel between Sydney, Melbourne and Brisbane; and

(c) on 7 May 2000, Impulse introduced unrestricted fares of $139 each way between Sydney and Melbourne and $119 each way between Sydney and Canberra, commencing on Impulse's launch date of 5 June 2000. Qantas announced matching fares effective from 5 June 2000 "by two o'clock that day". [19]

2.12 It is noted that Air New Zealand has engaged in a similar strategic response to new entry, through Freedom Air which is, discussed at paragraph 4.19 below.

2.13 The response of Qantas to the entry of Virgin Blue and Impulse, in substantially expanding capacity, led to a fierce price war that placed enormous financial strain on the new entrants and Ansett (due to its inefficient operations and maintenance problems).

2.14 In May 2001 Impulse announced that it would cease operations in its own right and that it had entered into a wet-lease arrangement with Qantas (with an option for Qantas to

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[19] *Sydney Morning Herald*, "Dogfight Alert as Airlines Vie for Market", 9 May 2000.

acquire it). Qantas subsequently acquired Impulse which continues to operate as a separate airline operating company although it is branded as a Qantas operation.

2.15 In September 2001, Ansett was placed in voluntary administration and in March 2002 it ceased flying.

2.16 The collapse of Ansett and the purchase of Impulse by Qantas has had a profound effect on the success of Virgin Blue and Qantas. Since Ansett's collapse, both Qantas and Virgin Blue have expanded their domestic capacity. Qantas' market share initially rose from approximately 50% to almost 90% of a capacity constrained market. This was due principally to its ability to immediately redeploy international capacity following the September 11 attacks to service demand flowing from Ansett's collapse. Virgin Blue was not able to add additional capacity as quickly as Qantas. Since that time, the market share of Qantas has decreased given the growth of the market and the ability of Virgin Blue to slowly increase its capacity on key routes. Qantas now accounts for approximately 75% of domestic capacity. Virgin Blues was able to increase domestic trunk operations and now offers approximately 25% of the total domestic capacity.[20] In effect, Qantas was able to secure the overwhelming majority of Ansett's market share by moving first.

2.17 When Virgin Blue commenced operations in August 2000, it serviced the Brisbane-Sydney and Brisbane-Melbourne routes with four Boeing 737s. At the time of Ansett's collapse it operated approximately nine Boeing 737s and flew approximately five routes. Virgin Blue now operates 29 Boeing 737s on the routes set out in Table 1 with 1330 departures per week.

[20] There are other operators with limited operations on domestic trunk routes, such as Regional Express on Sydney-Canberra. However, these airlines do not operate on main trunk routes such as Sydney-Melbourne.

Table 1: Direct routes flown by Virgin Blue (schedule effective 28 April 03)

Origin	Destinations	No of Flights per week
Adelaide	Brisbane, Gold Coast, Melbourne, Perth, Sydney	14, 7, 40, 7, 28, (total 96)
Brisbane	Adelaide, Cairns, Canberra, Darwin, Mackay, Melbourne, Perth, Rockhampton, Sydney, Townsville	14, 21, 7, 7, 14, 59, 7, 7, 114, 14 (264)
Cairns	Brisbane, Melbourne, Sydney	21, 7, 7, (35)
Canberra	Brisbane, Melbourne, Sydney	7, 14, 14, (35)
Coffs Harbour	Sydney	7, (7)
Darwin	Brisbane	7, (7)
Gold Coast	Adelaide, Melbourne, Sydney	7, 21, 30, (58)
Hobart	Melbourne	27, (27)
Launceston	Melbourne	14, (14)
Mackay	Brisbane	14, (14)
Maroochydore	Sydney	9, (9)
Melbourne	Adelaide, Brisbane, Cairns, Canberra, Gold Coast, Launceston, Perth, Sydney	40, 59, 7, 14, 27, 14, 21, 126, (308)
Perth	Adelaide, Brisbane, Melbourne, Sydney	7, 7, 21, 21, (56)
Proserpine	Sydney	1, (1)
Rockhampton	Brisbane	7, (7)
Sydney	Adelaide, Brisbane, Cairns, Canberra, Coffs Harbour, Gold Coast, Maroochydore, Melbourne, Perth, Proserpine	28, 114, 7, 14, 7, 30, 9, 126, 21, 1, (357)
Townsville	Brisbane	14, (14)

2.18 In the context of the stark distinction between what are referred to as VBAs and FSAs by the Applicants, it is notable that:

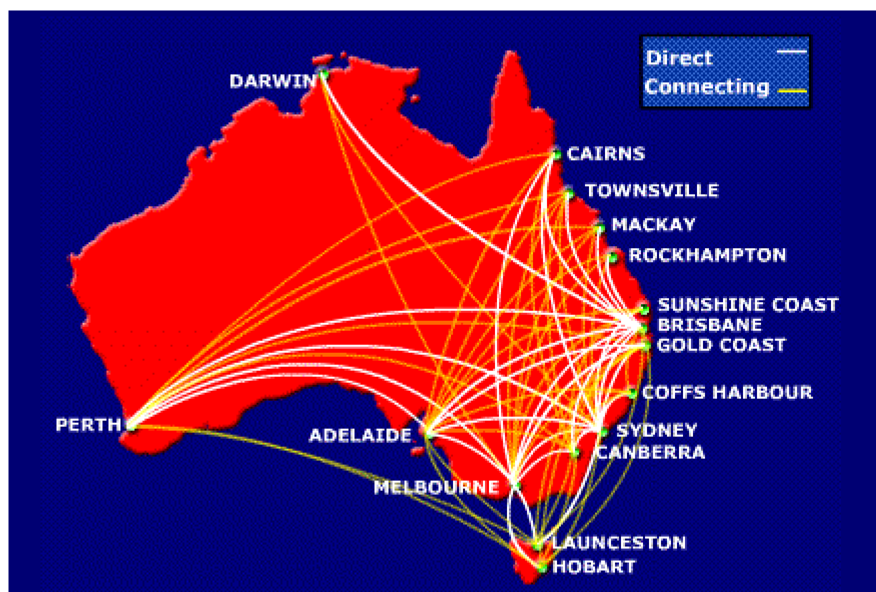
(a) Virgin Blue has a high frequency of operations on key routes. For example, it operates 18 flights in each direction per week day on Melbourne-Sydney, providing an frequency that is attractive to business customers;

(b) Virgin Blue actively targets business customers. For example, it is considering introducing a frequent flyer program, lounges and valet parking;

(c) Virgin Blue has an integrated network of operations, where its customers can book travel on interconnecting sectors. Virgin Blue currently offers 72 connecting services between cities it does not fly directly. Figure 1 illustrates the interconnected services offered by Virgin Blue; and

(d) Virgin Blue is actively pursuing negotiations with overseas carriers to provide domestic feeder services and has entered into an agreement with United Airlines for feeder traffic.

Figure 1 – Virgin Blue Destinations



source: www.virginblue.com.au

2.19 In addition, Virgin Blue is actively seeking opportunities to fly to international destinations. It has sought expressions of interest from Airports within the Asia/Pacific region that wish to be included in the Virgin Blue network. Virgin Blue has received expression of interest from 16 international airports and is giving due consideration to

each of these destinations. Virgin Blue wishes to provide services to New Zealand and within New Zealand (discussed further below).

2.20 In order to accommodate this expansion, Virgin Blue has recently signed an agreement with Boeing for the supply of 10 aircraft from August 2003 and granting options for the purchase of a further 40 aircraft. The value of the contract is potentially as much as AUD$5 billion.

New Zealand Expansion of Virgin Blue

2.21 Virgin Blue has long identified a desire to offer services across the Tasman and on New Zealand domestic routes. In general Virgin Blue considers that the trans Tasman and New Zealand domestic routes offer a substantial opportunity to Virgin Blue to enter, given its low fare model.

2.22 To date, Virgin Blue has not commenced operations on those routes in part due to its former ownership structure[21] and also due to its focus on establishing successful operations in Australia in a very difficult market. With the demise of Ansett, and the failure of the Tesna consortium in March 2002, Virgin Blue's focus has been on securing its position in the Australian market, in response to the rapid deployment by Qantas of capacity to absorb the market share of Ansett.

2.23 Virgin Blue's planning for entry on the trans Tasman and New Zealand routes is not complete. However, Virgin Blue has taken or is taking the following steps to commence such operations:

(a) commenced discussions with Auckland Airport over access to both international and domestic terminal facilities. It is also considering other potential options available to it in Auckland in the event that facilities cannot be made available to it at Auckland Airport on reasonable commercial terms;

(b) initiated the process for obtaining a New Zealand Air Operators Certificate, including identifying and interviewing key personnel for such operations; and

(c) written to Air New Zealand regarding the entry into commercial arrangements for ground handling. Virgin Blue will shortly seek to enter into negotiations in relation to route reprotection and maintenance and access to parts and equipment.

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21 Initially Virgin Blue was a foreign carrier and was not considered an Australian airline until Patrick Corporation Limited took a 50% equity stake in Virgin Blue in March 2002.

2.24 Virgin Blue's planning includes active consideration of a number of international routes and domestic routes. When determining whether it is feasible to offer a service in Australia, as a general rule, Virgin Blue believes that it is possible to provide services to any city that has a population of greater than 50,000. Virgin Blue believes that the same principle could be applied to New Zealand.

2.25 Virgin Blue has targeted a one third market share in the domestic Australian air services market. It believes that it is possible to achieve similar market penetration in the New Zealand and trans Tasman markets over time. However, this will depend upon the strategic response of the Proposed Alliance. In any case it does not believe that the growth of its market share will be achieved at the same rate at which it occurred in Australia.

3. RESPONSE TO APPLICANTS CASE FOR AUTHORISATION

Markets

3.1 Virgin Blue does not support the market definition proposed by the Applicants.

3.2 For the reasons set out in section 3 of the Frontier Report Virgin Blue believes that the relevant markets in which to analyse the Proposed Alliance are:

(a) a domestic New Zealand air services market. Virgin Blue has considered whether main trunk and provincial air services within New Zealand are separate markets, but on balance does not think that a separate market distinction is necessary to the analysis, provided that the different effects on main trunk as against provincial routes is taken into account in the competition analysis;[22]

(b) a domestic Australian air services market;[23]

(c) a trans Tasman air services market; and

(d) an Asia-Pacific air services market or markets and potentially a South Pacific air services market. This aspect of the Proposed Alliance is ignored in the Applicants' submission. However, the Proposed Alliance will have an anti-competitive effect, including the raising of strategic entry barriers, in these markets. The Commerce needs to consider the impact of the Proposed Alliance on Asia-Pacific destinations. Virgin Blue has not reached a concluded position on market definition on these routes.

3.3 This approach to geographic market definition is broadly consistent with that previously adopted by both the New Zealand Commerce Commission (**Commerce Commission**) and the Commission.

3.4 The product market definition adopted by Virgin Blue differs from the Applicants' who separate passenger and freight air services. Virgin Blue endorses the Frontier Economics

[22] This market is not a market in Australia and accordingly the Commission need not have regard to the detriment constituted by any substantial lessening of competition in these markets nor any benefits flowing to the public in these markets.

[23] This market is not a market in New Zealand and accordingly the Commerce Commission need not have regard to the detriment constituted by any substantial lessening of competition in these markets nor any benefits flowing to the public in these markets.

view that passenger and freight services are most usefully incorporated into one market definition. In adopting the separate product market definitions the Applicants have argued that there will be separate and contradictory competition effects in the relevant markets. The simplest way to avoid this error is to adopt a single product market definition of the air services market (which both a commercial and an economic approach would indicate is appropriate). However even if the Commerce adopts separate product markets, it must recognise the linkage between passenger and freight services when analysing the effects of the Proposed Alliance. This issue is particularly relevant when properly considering the benefits and detriments as modelled in the NECG Report which is discussed in more detail in section 6 below.

Vale Based Airline and Full Service Airlines

3.5 A critical feature of the Applicants' position is the sharp distinction they draw between two stylised airline business models, namely the VBA and the FSA models. It is a critical feature because the Applicants' position is premised upon the relevant market not being able to support two FSAs but being able to support a VBA and an FSA. Without establishing this clear distinction, the viability of a VBA and the prospects that it may ultimately retire from the market would be the same as Air New Zealand exiting in the counterfactual.

3.6 The entire counterfactual scenario (discussed below) is dependent on this distinction, which is used conveniently. The distinctions are emphasised where it is critical to underpin the plausibility of the counterfactual, but are largely ignored where it becomes important to emphasise the competitive constraint of Virgin Blue under the Proposed Alliance scenario.

3.7 While there are differences between the operating structure of Virgin Blue and the Applicants, the overall differences have been overstated. The service offering of a full service airline on short to medium haul routes is not that different to a low fare airline or VBA. Increasingly the bulk of the travelling public is not prepared to pay a substantial premium for the limited service level differences, such that there is pressure on full service airlines to abandon their full service model and adopt a value based or low fare airline model. This in turn requires a careful review of the operational structure of the airline. This is the prevailing commercial pressure in New Zealand and Australia and it is clear that both Air New Zealand and Qantas believe that it is necessary to adopt a value based or low fare airline model, or at least elements of that model.[24]

[24] Air New Zealand has moved to what has been described as a VBA+ model and also operates Freedom Air, a VBA that offers services on trans-Tasman routes. Further Qantas owns an aircraft operating company "Jet Connect" which is the vehicle through which Qantas supplies domestic services in New

3.8 The Applicants have sought to draw a distinction around the implicit value of the FSA model to customers, who in turn are implicitly critical for the successful operation of their overall network. Importantly, the distinctions that the Applicants seek to draw are either grossly overstated or cannot be sustained. For example, VBA's such as Virgin Blue can and do:

(a) operate high frequency schedules;

(b) target business customers;

(c) seek interlining arrangements;

(d) establish networked operations offering interconnectivity;[25] and

(e) provide additional service features, such as lounges and loyalty programs[26] although this may be on a different revenue model (eg pay as you go or provided by a 3rd party).

3.9 This much seems to be acknowledged in the NECG Report where it says:

> *VBAs come in many different shapes and sizes. They evolve as they grow, and the management models and route networks they adopt to handle greater traffic volumes and market share differ significantly. Even so, it is perhaps the most important feature of low cost carriers that they do not seek to provide full network interconnectivity.*[27]

3.10 However, even the claimed difference in relation to interconnectivity is overstated. As discussed in paragraph 2.18(c), Virgin Blue currently offers 72 connecting services between cities that it does not fly directly. Further, Virgin Blue currently has interlining

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Zealand. Virgin Blue understands Jet Connect has been established with a low cost structure similar to that of a VBA, but will remain branded as Qantas service. Qantas has also commenced a low cost airline, Australian Airlines to service international routes (mainly in Asia) which it has not found profitable to serve on a full service basis and has maintained Impulse as a separate operating company with its low cost structure under the Qantas brand. Qantas continues to operate Impulse aircraft through a separate operating company maintaining its low cost base.

25 See Figure 1.

26 Two prominent low fare airlines that offer loyalty programs are JetBlue (US) and Southwest (US). Southwest's is the more complex of the two. The points of difference with that of an FSA are that: - (a) all flights have the same earning value, but credits from partners make this somewhat more complicated; (b) the reward is a free round trip ticket to anywhere in the network; (c) availability is claimed to not be restricted. JetBlue's is very simple: – (a) earning points system (2, 4 or 6 points depending on distance); (b) no program partners; (c) points are redeemed for a round-trip ticket to anywhere in the network; and (d) availability is restricted.

27 NECG Report at page 10.

arrangements in place with United Airlines, has had negotiations with a number of other airlines including members of the Star Alliance and is continuing to seek interlining opportunities.

3.11 Virgin Blue, like any other airline, is constantly seeking to increase the amount of traffic it services and is keenly interested in any arrangements that will facilitate an increase in its traffic. It would value any arrangements to obtain feeder traffic. Virgin Blue expects that as its network grows, particularly when it commences offering international services, that the opportunities to offer interconnecting services will increase and accordingly the amount of feeder traffic it receives from its network will increase.

3.12 Further, nowhere is there any attempt to substantiate the value to customers of this "interconnectivity". If interconnectivity is, as it appears, relatively unimportant, then it does not provide a substantive basis upon which to sustain the FSA model.

3.13 In this regard, Virgin Blue notes that the desire to access feeder traffic from a particular route or market does not require that an airline has operations in all those places. Arrangements can be entered into with other airlines to obtain feeder traffic. Qantas flies to a number of international markets where it does not receive feeder traffic from its own flights within that market, for example, Europe, Japan, South Africa and the USA. In any event, in New Zealand international feeder traffic is unlikely to be significant.[28] As a general rule an FSA will only fly domestic routes within a country in its country of origin and in all other places receive its feeder traffic through other co-operative arrangements.

3.14 While it may be convenient to describe an airline as an FSA or as a VBA, ultimately this is an over simplification. Contrary to the NECG Report's sharp distinction between FSA and VBA carriers, air transport services are characterised by a range of competitive strategies.

3.15 The principal distinction is that low fare airlines are much more focused on keeping costs low to maintain a low fare structure. This key distinction is reflected in the manner in which they seek to maximise profits. A low fare carrier will seek to stimulate demand through the wide availability of low fares whereas an incumbent seeks to maximise its returns through a strategy directed to price discrimination, such as offering different classes, fare conditions, ticket conditions and restrictions. All these activities impose costs on their operations. A low fare airline, in contrast, does not seek to constrain demand to maximise profits, but in response to demand will expand output.

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[28] The Commerce Commission has previously found that international feed accounted for a relatively small amount of domestic traffic. *Bodas* at paragraph 272.

3.16 That is not to say that low fare airlines do not engage in yield management, they do, but from a completely different business model. A simplistic example of this difference is that where demand for seats on a route exceeds supply Virgin Blue would likely maintain its price structures and yield management practices but increase the capacity made available, However, an FSA would be more inclined to increase the average price paid through yield management rather than increase capacity.

Barriers to entry

3.17 As a preliminary point, Virgin Blue notes the Applicants have not addressed the issue of barriers to the market they have advanced. They chose to avoid the discussion as "…*there is scope for lengthy but inconclusive discussion on the extent and nature of barriers to entry*".[29] Instead they focus on barriers to *expansion*, that is, the ability of an existing market participant to expand its services and offer an effective competitive restraint to a firm tyring to use its market power.

3.18 The Applicants have submitted that the barriers to entry and expansion to the relevant markets are low. Virgin Blue considers that the Applicants have greatly understated the size and nature of barriers to entry and expansion.

3.19 When considering barriers to entry the Commerce should not simply consider the barriers to commencing operations but the barriers to commencing operations on a successful and sustainable basis. The litany of failed airlines in Australia[30] and New Zealand[31] is testimony to this distinction. Clearly the competition concerns raised by the Proposed Alliance will not be addressed if there was a new entrant, but that new entrant was to subsequently withdraw from the market.

3.20 There are two principal barriers to sustainable entry on the trans Tasman and New Zealand domestic routes:

(a) access to facilities and commercial arrangements on reasonable and competitive terms; and

(b) the sunk costs of entry particularly losses incurred due to the strategic response of incumbent airlines.

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[29] Air New Zealand and Qantas Limited Submission to the Australian Competition and Consumer Commission in Support of the Application for Authorisation dated 9 December 2002 (**Supporting Submission**) at paragraph 6.34.

[30] Impulse, Compass and Compass Mk II.

[31] Kiwi Air and Tasman Pacific.

Access to Facilities and Commercial Arrangements

3.21 Virgin Blue notes that it has substantial commercial issues to resolve prior to the commencement of any operations in New Zealand.

3.22 It is not correct, as the Applicants have stated, that access to terminal and ground services is not an impediment to entry or expansion in the relevant market.[32] In order for Virgin Blue to be able to provide a competitive service on trans Tasman and New Zealand domestic routes it will require significant terminal capacity at a variety of airports throughout New Zealand and Australia at peak times and on commercially reasonable terms. In many cases this will either require the construction of new facilities at the various airports, or the surrender by the Proposed Alliance of a proportion of capacity controlled by Qantas or Air New Zealand (unless other airports become available for use by Virgin Blue). The latter of these options is unlikely to occur through normal commercial negotiations and the former will be a difficult, expensive and long process, the cost of which would be borne by the new entrant.

3.23 Currently, there are significant space limitations at a number of key airports during peak times. For example, at Auckland Airport:

(a) no gates are available to Virgin Blue during peak times. Auckland Airport has indicated that the only way in which passengers could be unloaded at Auckland Airport during peak times would be by passengers disembarking onto the tarmac and then catching buses back to the terminals; and

(b) there are limited check-in counters. United Airlines has recently relinquished nine counters, but Virgin Blue understands that Air New Zealand has already applied to tie up that capacity for its own use.

3.24 Other airports which have space or other access constraints including, without limitation, Sydney and Christchurch, which are critical to building a trans Tasman or New Zealand domestic network.

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[32] Supporting Submission at Paragraph 6.50.

Strategic Response of Incumbents

3.25 Virgin Blue's experience is that the strategic response of incumbent airlines is a substantial barrier to successful and substantial entry for any new entrant airline. There are particular characteristics of airline markets that facilitate effective strategic conduct: [33]

(a) strategic capacity deployment. Incumbent airlines can shift resources rapidly in order to add capacity to routes threatened by new entry;

(b) yield management. Incumbents can price discriminate effectively which ameliorates the impact of declining prices for low fares. Figure 2 illustrates that in the period since the announcement of Virgin Blue and Impulse that they would enter the Australian market (November 1999) there has been a substantial decrease in discount fares, a modest increase in economy fares and a substantial increase in business fares;

(c) flexible price adjustments. The prices for airline tickets can be adjusted continuously and instantaneously in response to new entry and other demand characteristics, since they are sold directly by airlines or through travel agents with live access to the airlines' reservations systems. Qantas has on numerous occasions instantly decreased fares in response to new services offered by a low cost airline; and

(d) information on competitor activities. In order to operate each flight as profitably as possible, airlines must forward-book a high proportion of their seats and generally must advertise a new route and begin selling tickets at least a month in advance.

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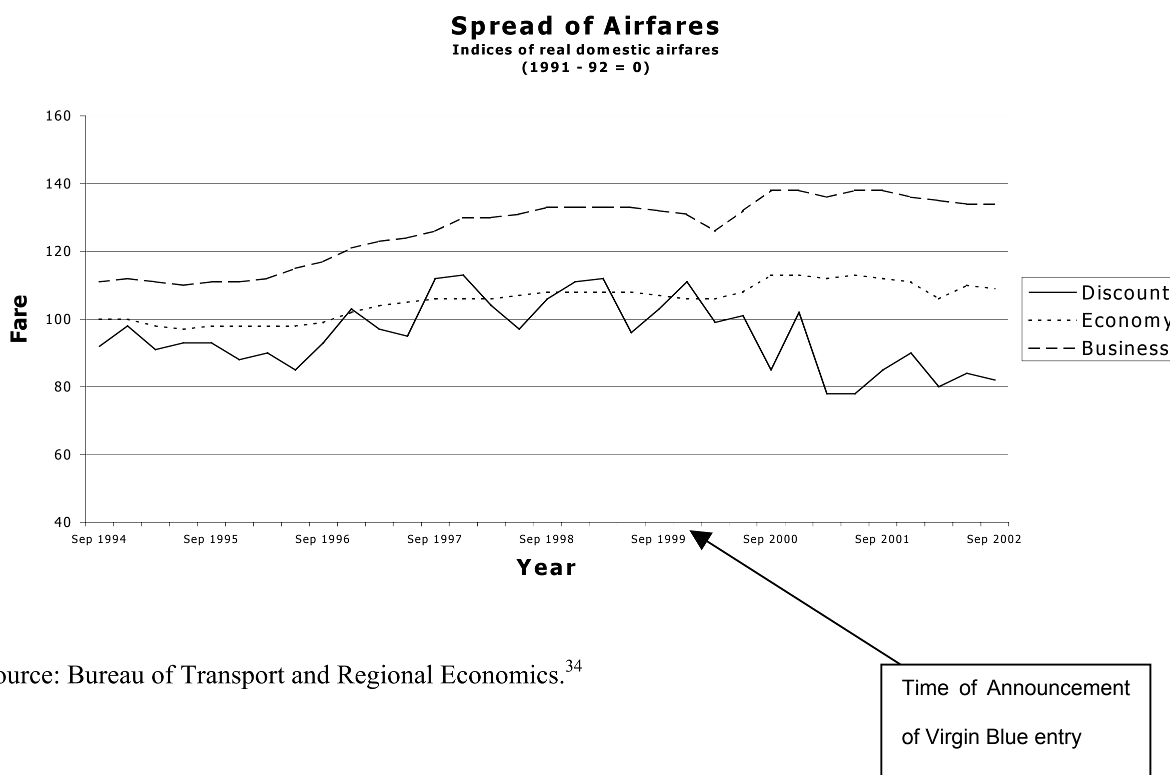
33 These characteristics are discussed in more detail in Virgin Blues submissions to the Dawson Inquiry which can be found at http://tpareview.treasury.gov.au/content/subs/159_Submission_VirginBlue.pdf

Figure 2: Spread of Air Fares



Source: Bureau of Transport and Regional Economics.[34]

3.26 It is well recognised that a typical strategic response of incumbent airlines to new entry is to engage in targeted expansion of capacity in order to reduce yields and load factors and undermine the financial viability of the new entrant.[35] The Commerce Commission has found that:

> *The incumbent is likely to seek to share that market expansion, through heavy fare discounting, and the addition of capacity. This might be achieved by the introduction of a rival value based airline, much the same way that Freedom has been established trans Tasman in response to Kiwi's entry. Sharing the expanded market will put pressure on the entrant by reducing its load factors and thus increasing the period of operating losses which it must sustain.*[36]

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34 http://www.dotars.gov.au/btre/docs/indicate/airfares.htm#Top. The data is based upon information obtained through SABRE Pacific's Computer Reservations System, a computer reservation system used by travel agents. Accordingly, this data will not include the effect of Virgin Blue prices as 90% of its sales are made through the Internet. This means that the graph understates the decreasing trend in discount airfares and as such will understate the overall spread of airfares.

35 See in particular US DoT, *Findings and Conclusions on the Economic, Policy and Legal Issues,* 17 January 2001 (**Findings and Conclusions**) and Canadian Competition Bureau *Enforcement Guidelines on the Abuse of Dominance in the Airline Industry* February 2001.

36 Commerce Commission Decision No 278 Determination Under the Commerce Act 1986 in the matter of a business acquisition proposal involving Air New Zealand Limited, Ansett Holdings Ltd and Bodas Pty Limited (**Bodas**) at paragraph 325.

The Commission, however, based on its understanding of previous examples of incumbent airlines reacting to entrants such as Compass, Kiwi and Ansett NZ, observes that it is likely that the incumbents would react aggressively in terms of price and capacity.[37]

3.27 Substantial costs can be incurred in withstanding the ensuing price war resulting from this strategy. These costs are sunk in the sense that if the new entrant fails or withdraws from a route, it is unable to recover the losses incurred during the price war. To this end Virgin Blue notes the evidence provided by Dr Trethaway on behalf of Qantas in *Bodas:*

Dr Trethaway, for Qantas, said that sunk costs in the aviation industry are very significant, and their magnitude would depend upon the scale of entry into the market, and subsequent growth. He said a significant proportion of sunk costs could be incurred by sustained operating losses which arise from operating for a considerable period of time after entry with load factors which are significantly less than break-even. [38]

3.28 Virgin Blue also supports the submission of Qantas to the Commerce Commission during the *Bodas* hearing that:

……..incumbents can act to increase start-up costs and sunk costs for a new entrant.[39]

3.29 These sunk costs are not symmetrical. Capital is more expensive and more difficult to obtain for new entrants since the capital lenders will factor in the risk of successful predation (given that there is likely to be only very weak, slow and imperfect enforcement of rules against predation).

3.30 There is a well established economics literature on the incentives of incumbents operating in multiple areas (e.g on multiple routes) to predate when a new entrant threatens to enter in any one area.[40] The Proposed Alliance will have a strong incentive to respond aggressively to entry by Virgin Blue on any given route to seek to deter it from commencing services on other routes and thereby protect its profits. This type of strategic response will substantially increase the sunk costs incurred by a new entrant in the market for air services.

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37 *Bodas* at paragraph 330.

38 *Bodas* at paragraph 246.

39 *Bodas* at paragraph 247.

40 See for example, Kreps and Wilson "Reputation and Imperfect Information" *Journal of Economic Theory*, 1982, and Milgrom and Roberts, "Predation Reputation and Entry Deterrence" *Journal of Economic Theory,* 1982.

3.31 Nor are these costs easily avoided by a new entrant. It is not an option available to new entrants to commence providing services on a route and then withdraw from that route if those losses become excessive and plan to re-enter later. As the US DoT has noted:

> *Contestability has proven inapplicable. (Levine, "Airline Competition in Deregulated Markets", at 405.) First, an airline entering a market incurs certain sunk costs that cannot be recovered if it exits, for example, advertising costs and the cost of setting up facilities at the new airport. Travellers will be reluctant to book an airline that exits and reenters a market, moreover, given the significant possibility that the airline may again leave the market before the date of their planned trips. As a result, airlines cannot freely enter routes.*[41]

3.32 Further, the incumbent may not even need to undercut the prices offered by the entrant, but rather it is sufficient that it offers fares at an equivalent price for the behaviour of the incumbent to pose a barrier to entry and expansion. In this regard Virgin Blue notes the position of Qantas in the *Bodas* proceedings, where :

> *Dr Trethaway, for Qantas, commented that the incumbent could drop fares across the board to match the entrant's fares. He pointed out the fares only have to be matched, not undercut, for passengers still to patronise the incumbent. The entrant might then drop fares further, increasing the magnitude of its operating losses during the start-up period.*[42]

3.33 The Applicants have, in the Supporting Submission, supported their contention that the barriers to entry caused by the strategic behaviour of an incumbent are low by pointing to the success of Virgin Blue in Australia.[43] However, it is clear that the fact that Virgin Blue withstood Qantas' strategic behaviour during its critical start up phase in Australia was, in large part, because it was better placed to withstand the actions of Qantas than Impulse and Ansett, which both collapsed.

3.34 Ultimately there is a high degree of inconsistency in the treatment of barriers to entry by the Applicants. For example, the following comments attributed to parties giving evidence on behalf of Qantas before the Commerce Commission in the *Bodas* decision:

> *Mr Davies, for Qantas, stated that the barriers to entry to the domestic market are very high, and would become even higher in a post acquisition situation. Dr Trethaway for Qantas said that individual barriers to entry, which might be solved on paper, might together form an insurmountable barrier, interacting in*

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41 US DoT, *Findings and Conclusions* at page 22.

42 *Bodas* at paragraph 328.

43 Supporting Submission at paragraphs 6.71 – 6.77

> *complex ways to preclude successful sustained entry. Mr Copeland, for Qantas, commented that if the barriers to entry were as low as Air NZ maintained, then Ansett NZ would not have lost as much as $200 million, and there would have been entrants to the aviation markets over the past few years.44*

3.35 Furthermore, the view that barriers to entry are low is inconsistent with the stated strategy of Qantas that without the Proposed Alliance it will engage in a costly "war of attrition" for supremacy in the relevant market.[45] In itself this is a predatory strategy. While Virgin Blue considers that the counterfactual is implausible, it would be rational to incur such losses only if there were to be some pay-off in terms of excessive profits in the future. If there were low barriers to entry, Qantas would not be able to raise its prices in order to earn these excessive profits as this will only encourage new entry.

3.36 Virgin Blue notes that the Applicants have quoted from the findings of the Commerce Commission in a very selective fashion and in such a way as to give the impression that *Bodas* is authority for the general proposition that there are low barriers to entry to the market it has proposed. Importantly, after a detailed analysis in *Bodas* the Commerce Commission concluded:

> *……that, together, the factors affecting entry as listed above indicate that a new entrant, whether as a value based airline of full service airline, must prepare for considerable practical and financial difficulty. This strongly suggests that, cumulatively, the barriers to entry to the domestic main trunk passenger air services market are such that entry is deterred. This is also evidenced by the fact that there has been no entrant of a type to constrain Air NZ and Ansett NZ since the entry of Ansett NZ in 1987, and that Ansett NZ's entry has been marked of years of sustained losses.* [46]

3.37 Further, while the Commerce Commission did state that there were low barriers to entry to the trans Tasman market, the analysis was understandably limited (focussing on regulatory barriers) no doubt due to the fact that it was clear that Air New Zealand would not acquire a dominant position in that market, in circumstances where Qantas held a 35% market share.[47]

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44 *Bodas* at paragraph 232.

45 Interestingly, Qantas' position in this regard has been inconsistent. In February 2002, for example, Qantas denied statements attributed to Geoff Dixon that he aimed to knock Air New Zealand out of the sky, *The Dominion,* 6 February 2002.

46 *Bodas* at Paragraph 337.

47 *Bodas* at paragraphs 377.

Virgin Blue's Views as to the Counterfactual

3.38 There is a high degree of uncertainty as to the state of the market over the next five years, with a reasonable degree of uncertainty in the short term which increases over time as one tries to predict a range of competitive responses of various parties. However, as discussed below, Virgin Blue considers that the particularly stark counterfactual scenario advanced by Qantas and Air New Zealand is implausible and unlikely.

3.39 Starting at this point in time, Virgin Blue considers the likely strategies of the three airlines without the Proposed Alliance are as follows:

(a) Air New Zealand would consolidate its presence in domestic and trans Tasman routes, and continue to operate other important, profitable, international routes;

(b) Qantas would maintain its presence on trans Tasman routes, and may *gradually* increase services on New Zealand domestic routes, perhaps particularly targeting those routes for which Virgin Blue chooses to commence services; and

(c) Virgin Blue will enter the trans Tasman and the New Zealand domestic markets. The timing and scale of entry will depend on its access to key bottleneck facilities and the extent to which Qantas and Air New Zealand respond to Virgin Blue's entry with strategic and predatory conduct. However, a general entry case is discussed at 2.22 to 2.24 above.

3.40 Each of these responses is discussed in more detail below.

Air New Zealand

3.41 Air New Zealand has strong brand value among New Zealand residents; and the Government of New Zealand is a committed majority shareholder. The New Zealand Government's strong political/nationalistic interest in seeing the continuation of the brand was demonstrated by its decision to invest in Air New Zealand in 2002. If the Proposed Alliance were not to proceed, the key question for the shareholders would be how best to use the brand to maximise returns to shareholders. Almost certainly, the answer would be to withdraw (over time) from some international routes which are net loss-making activities (taking into account the aggregate effects on revenue and costs of withdrawing from any route) but to consolidate Air New Zealand's presence on profitable international, domestic and trans Tasman routes.

3.42 Consolidating Air New Zealand's position on domestic routes may mean vigorously challenging the attempt by Qantas to capture sales on domestic routes. In this battle, Air

New Zealand has strong brand loyalty and first-mover advantages. So, although Qantas and Virgin Blue may make gains on these routes at the expense of Air New Zealand, it is highly unlikely that Air New Zealand would withdraw from these routes within the foreseeable future.

Qantas

3.43 In the event that the Proposed Alliance does not proceed, Qantas (like Air New Zealand) is likely to maintain something like its current presence on trans Tasman routes. The interesting question is what it would do on domestic New Zealand routes if the Proposed Alliance were not to proceed. Qantas says that it is losing money on these routes. It also said that a bigger operation might not be profitable either.[48] Because it enjoys less brand loyalty than Air New Zealand in the domestic New Zealand market, Qantas is likely to, and realise it would, suffer cash losses on these routes for some time. Qantas has shown that it is prepared to bear these short-term losses as an investment in brand loyalty that will yield a pay-off in the future. In the absence of the Proposed Alliance, Qantas is likely to continue gradually to expand its activities in the domestic New Zealand market. This moderate and gradual competitive response is to be contrasted, however, to the extreme and inefficient war of attrition described by the Applicants in the counterfactual which is discussed below.

3.44 Qantas' determination to service domestic New Zealand routes is likely to be strengthened by the entry of Virgin Blue on to these routes. Virgin Blue considers that Qantas is unlikely to sit back and watch Virgin Blue gain access to networking and interlining synergies that may advance its cause at the expense of Qantas.

Virgin Blue

3.45 Virgin Blue is actively developing plans to enter both the trans Tasman and the domestic New Zealand markets. Virgin Blue considers that there is substantial scope for a low fare airline to stimulate demand on trans Tasman and New Zealand domestic routes, as well as a number of other Pacific Routes.

3.46 Virgin Blue would be interested in operating on all the key trans Tasman routes, as well as certain underserviced or non-serviced routes, such as Auckland-Adelaide, which it has already made clear to the market. In addition, Virgin Blue would be actively interested in operating on all key domestic trunk routes in New Zealand. Virgin Blue is also currently considering a number of Pacific destinations.

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48 Geoff Dixon quoted in the *The Dominion* 6 March 2002.

3.47 Virgin Blue entered the Australian market with two incumbent operators, and the fact that there are two incumbent operators on the trans Tasman and the New Zealand domestic route would not of itself stop it from seeking to enter those routes.

3.48 For the reasons set out below, Virgin Blue does not believe that the proposed counterfactual scenario of a sustained five year capacity/price war between the Applicants is credible. In any event, the Applicants' contend that this war of attrition will be directed to high yield business customers who are important for network connectivity[49], and as such does not pose a direct threat to Virgin Blue. Furthermore, in a three way fight, Virgin Blue believes its cost structure and business model will succeed.

Virgin Blue's Observations on the Applicants' Counterfactual

3.49 Virgin Blue notes that it is not possible to fully assess and test the counterfactual scenario as the Applicants have claimed confidentiality in relation to Annexure D and F which sets out the counterfactual.

3.50 Quite apart from the inability of interested parties to assess it, Virgin Blue submits that the Commerce Commission should have some scepticism over a future scenario represented as fact by the Applicant which is entirely within the Applicants' control and happens to perfectly suit their arguments on the merits of the Alliance. The inconsistencies between the Applicants' position now and Qantas' previous statements to the Commerce Commission suggest that the Applicants are willing to take a convenient position on what the likely counterfactual might be.

3.51 In any case, it is important to carefully assess the claimed counterfactual as it appears that all the cost savings are attributed to the avoidance of an inefficient capacity war as opposed to any stand alone cost savings. In effect, the Applicants make a threat that if the Proposed Alliance is not authorised they will behave inefficiently and that therefore the Proposed Alliance should be authorised. The Commerce should be very wary of finding such savings to be a public benefit.

3.52 In this regard, Virgin Blue considers that it is simply not plausible that, if the Proposed Alliance were not approved, Air New Zealand and Qantas would enter a costly five year war of attrition whereby both Qantas and Air New Zealand would increase their capacity to gain supremacy over the other.

3.53 This would require the parties to incur losses (which are likely to be large) over a five year period, with a highly speculative uncertain outcome (while there is a thinly veiled

49 Supporting Submission at paragraph 6.8.

threat that Air New Zealand will retire from the market, nowhere is it said that that Air New Zealand will actually fail).

3.54 On the other hand, the threat of Air New Zealand's failure suggests that Air New Zealand will engage in irrational behaviour. The Applicants have stated that "*Air New Zealand is not well placed to win the battle nor does it have the financial resources to credibly signal to Qantas that it can successfully engage in a long term fight for market share*".[50] This suggests that Air New Zealand (and the New Zealand Government) would fund a five year war to the death that it cannot win.

3.55 In the counterfactual Qantas appears to be proposing to increase capacity by 60%[51] on domestic routes which are already operating at a loss. The NECG Report assumes that the competitive strategy of both Qantas and Air New Zealand will result in both airlines incurring losses on selected routes over the five year period.

3.56 A five year capacity war can only be a rational, profit maximising strategy if Qantas expects to drive competitors from the market and as a result earn above normal returns in the future. This would require Air New Zealand to withdraw and that either there be no entry by Virgin Blue or that Virgin Blue only provide a weak form of competition (which is completely inconsistent with the position adopted by the Applicants regarding the effective competitive restraint that Virgin Blue will impose on the Proposed Alliance).

3.57 The counterfactual overstates the likely success of Qantas in any war of attrition. As discussed above, Air New Zealand has a strong brand identity as a New Zealand company, similarly Qantas is strongly identified as an Australian company. In any battle for supremacy of the New Zealand domestic market, particularly if a national flag carrier is as important as the Applicants have suggested, then it can be expected that the New Zealand public and the New Zealand Government would provide considerable support and brand loyalty to Air New Zealand ahead of the interests of Qantas.

3.58 If the war of attrition placed pressure on the costs of Air New Zealand, a rational response of Air New Zealand would be to adopt many of the features typically associated with a VBA in order to decrease those costs. The Applicants have discarded this as a plausible response, principally upon the premise that the VBA and FSA models are distinct, mutually exclusive models.[52] However:

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50 Supporting Submission at page 4.

51 Supporting Submission paragraph 6.8.

52 *NECG Report at page 15* "One possibility is that of converting Air New Zealand as a whole into a VBA. We do not believe this strategy to be credible. Air New Zealand is fundamentally a network carrier. For its long haul operations to be viable, they must be based on interconnectivity with its

(a) as discussed above, there is nothing to suggest that by adopting elements of a low cost airline that an airline has to surrender interconnectivity or high yield passengers; and

(b) this is not consistent with what has occurred in practice. Air New Zealand and Qantas are both adopting elements of a low cost model in their New Zealand operations[53] nor is it consistent with their publicly stated intentions. [54]

3.59 The counterfactual scenario also appears highly contrived. If either Qantas or Air New Zealand were not to engage in the inefficient capacity war or to withdraw from the market earlier, then the "cost savings" under the Proposed Alliance scenario would not be achieved. However, without the prospect of Qantas or Air New Zealand leaving the market, there is no rational explanation for the conduct in the counterfactual scenario. The solution is to adopt a five year modelling period in which neither party withdraws, but it is intimated that some time thereafter one might.

3.60 The claim that New Zealand is critically important for Qantas, which would underpin its commitment to the war of attrition, also looks to be overstated and is not substantiated in any way. The Applicants have sated that "*For Qantas, abandoning New Zealand would be tantamount to abandoning Victoria*".[55] This comparison is clearly difficult to substantiate. According to the Applicants only five of Qantas' fleet of 194 aircraft (2.5%) currently operate in New Zealand and these operate at a loss. Further, Qantas first commenced operations in New Zealand in its own right in May 2001. Prior to that it only had a series of interlining arrangements with various airlines**.**

3.61 The counterfactual assumes that Virgin Blue will not commence trans Tasman services until year two of the Proposed Alliance and domestic New Zealand services until year three. This is wrong. Virgin Blue intends to commence trans Tasman and domestic New Zealand operations within that time frame.

3.62 The counterfactual is also premised upon the assertion that New Zealand and Australia are part of the one market and cannot sustain more than one full service network carrier with the presence of a VBA.[56] No analysis or evidence is provided by the Applicants to

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domestic network, and be able to draw on a customer base that includes the higher yield segments. Conversion into a VBA would prevent this, and hence would force Air New Zealand's withdrawal from long haul operations".

53 See discussion at footnote 24.

54 "We see Freedom as a growth platform going forward and would consider other opportunities for Freedom," Mr Ralph Norris "Meals go, jobs cut at Air NZ – Restructure for air carrier" *Daily Telegraph* 29/5/02.

55 Supporting Submission at page 44.

56 Supporting Submission at paragraph 6.4

support this assertion. There is an implicit suggestion that the demise of Ansett provides evidence for this, however, contrary to the suggestions of the Applicants, the entry of Virgin Blue did not cause the collapse of Ansett.[57] The party most culpable for the collapse of Ansett is Qantas.

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57 Virgin Blue commenced operations in August 2000, Ansett was placed in administration in September 2001 and ceased flying in March 2002. At the time of the demise of Ansett Virgin Blue was operating nine Aircraft over five routes. The scale of the competitive overlap indicates that Virgin Blue was not the cause of the collapse of Ansett. Indeed the cause of Ansett's demise was its inefficient cost structure which meant it was unable to sustain the losses incurred as a result of Qantas' dramatic expansions in domestic capacity following the entry of Virgin Blue and Impulse. Qantas also directly targeted Ansett when it considered it weak and vulnerable. For example, when Ansett's vulnerability became apparent Qantas increased operations on key Ansett routes such as Perth-Darwin. Ansett's vulnerability was exacerbated by the grounding of its aircraft during Easter 2001.

4. COMPETITION EFFECTS OF THE PROPOSED ALLIANCE

4.1 The main competition effect of the Proposed Alliance will be the reduction in the number of existing competitors in the trans Tasman and main trunk domestic markets from two to one. In the provincial New Zealand markets a similar effect may also occur – although Qantas is not currently active in that market, competition to Air New Zealand is provided by Origin Pacific, which has a feeder arrangement with Qantas. There will also be a reduction in competition on Asia/Pacific routes to and from Australia and New Zealand.

4.2 Under the Proposed Alliance the rivalry between Qantas and Air New Zealand for revenue in both the trans Tasman and the domestic New Zealand markets will cease. The two independent businesses will operate like a classic cartel. They will co-ordinate their key strategic decisions; set prices jointly; and they will share profits. The profit-sharing arrangements will have the effect of removing any incentive for either company to seek to expand its sales at the expense of the other. The Proposed Alliance is a prime example of "formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities".[58]

4.3 If the Proposed Alliance were not to proceed, Qantas and Air New Zealand would be independently fighting for revenue in the trans Tasman and in the domestic New Zealand market. As discussed further below, another consequence of the removal of this competition between Qantas and Air New Zealand, is that under the Alliance they will have an increased incentive and power compared to the individual airlines in the counterfactual to raise barriers to entry and to act in a predatory manner against any potential new entrant.

4.4 In order to address the substantial lessening of competition inherent in the proposal, the Applicants rely on the prospect of new entry. Virgin Blue is the only likely new entrant and is the only one cited. The Applicants claim that the Alliance will actually increase the prospect of new entry.

4.5 It is true that a reduction in head to head competition between Qantas and Air New Zealand resulting in higher prices and reduced capacity on key routes, represents an opportunity for Virgin Blue to expand its intended scale of operations.

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[58] *Queensland Co-Op Milling Assn Ltd and Defiance Holdings Ltd* (**QCMA**) (1976) ATP 40-012 at 17,246.

4.6 However, at the same time, the combined forces of Qantas and Air New Zealand have a greater incentive and capacity to target the low fare sector of the market, while keeping other fares high.

4.7 The Proposed Alliance appears to be a strategic response to Virgin Blue's prospective entry which is intended to enable Qantas and Air New Zealand to adopt a containment strategy, targeting routes that Virgin Blue may operate, even where the routes themselves are not profitable for them. It is clear, that incumbent airlines have engaged in strategic capacity and pricing conduct to hinder the growth of low fare airlines.

4.8 Compared with the future state of competition with the Proposed Alliance, retaliatory increases in capacity are less likely to be profitable, and may therefore be less likely to occur, without the Proposed Alliance. For example, if a market is shared between two incumbents, any incumbent that considers a retaliatory increase in capacity on a route will be faced with bearing the full cost of the extra capacity but may stand to gain only some proportion of the benefit of the increase in sales if the strategy is successful in getting rid of the new entrant. Each of the incumbents may delay, or reduce the extent of its retaliatory response in the hope that the other incumbent will retaliate and bear a greater proportion of the associated costs. So retaliatory increases in capacity would be less likely in the future without the Proposed Alliance than they would be with the Proposed Alliance.

4.9 Consequently an important barrier to entry is likely to be lower without the Proposed Alliance, encouraging Virgin Blue to enter faster and on a larger scale than it would if the Proposed Alliance proceeds.

4.10 Not only do the Applicants have the incentive under the Proposed Alliance to engage in a strategy of delaying and defeating new entry, they have an increased capacity to do so:

(a) on any given flight, the Proposed Alliance will have a higher proportion of high fare customers than the Applicants would have without the Proposed Alliance.[59] The consequence is that they are able to sustain the availability of more low fare tickets in a strategy designed to erode yield and load factors for Virgin Blue;

(b) the Proposed Alliance frees up capacity, providing the Applicants with more lower fare seats within the JAO Network, than would be available as individual competitors, which can be used to reduce Virgin Blues' yield and load factors;

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59 The counterfactual assumes that the war of attrition would be mainly targeted at high yield business class customers. See Supporting Submission at Paragraph 6.8.

(c) the Proposed Alliance enables Qantas/Air New Zealand to commence operation at times and on routes that individually may not be viable in order to block or deter the entry of Virgin Blue. There is already evidence of this with the proposal to commence Adelaide – Auckland flights in the event that it is approved. Virgin Blue has publicly indicated that it would consider flying this route. It is unlikely that Virgin Blue will fly this route in the presence of the Proposed Alliance;

(d) Qantas and Air New Zealand remove the risk that their competitive response to each other will erode their ability to directly compete with Virgin Blue. In particular, Qantas and Air New Zealand will not have to compete against each other for customers who are largely price inelastic and will be attracted by the service offering of the incumbent airlines, such as lounges, loyalty schemes and other service differentiators; and

(e) the combined financial resources of the Applicants *enhances* their capacity to sustain the operating losses incurred by strategic pricing and capacity conduct for periods of time far longer than that which Air New Zealand and Qantas could sustain individually, competing against each other.

4.11 Another key determinant of the degree of competition in the future without the Proposed Alliance will be Virgin Blue's access to essential inputs. The key inputs are:

(a) access to terminals during peak times at commercial terms comparable to those of the incumbent airlines. As noted at 3.21 to 3.24 above there are substantial limits on access to terminals ; and

(b) access to ground service, equipment spares and parts, ground handling services, maintenance and route reprotection on reasonable terms. Air New Zealand is currently the only supplier of many of these services in New Zealand.

4.12 Critically, Air New Zealand and to a lesser extent Qantas control these key inputs. For example, even in relation to access to airport facilities, these can be effectively controlled by Air New Zealand and Qantas simply by not releasing capacity. Air New Zealand can simply refuse to enter into commercial arrangements for ground support and handling services with Virgin Blue.

4.13 Virgin Blue's experience is that it is more likely to be able to conclude satisfactory agreements for the supply of these services, where there are multiple providers of a service. There is less prospect of Qantas and Air New Zealand refusing to agree to supply services to Virgin Blue than there would be if the Proposed Alliance were to proceed. If one of them has some unused capacity to provide the service, it is likely to reason that if it

does not provide the service to Virgin Blue, then the other party might. If the merger were to proceed, the bargaining power of Virgin Blue in seeking access to services that could be provided by the incumbent airlines would be drastically reduced.

4.14 Qantas and Air New Zealand have submitted that Virgin Blue is likely to be more successful and have a larger scale of operations with the Proposed Alliance than without. This appears to be based on the premise that the reduction in competition will provide a greater commercial opportunity for Virgin Blue. However, Qantas and Air New Zealand do not address their capacity to engage in strategic capacity dumping and to target the new entrant through their low cost operations without having to worry about each other competitive response. In fact the Proposed Alliance actually raises the risk Virgin Blue's entry will not be as substantial as it otherwise would be.

4.15 Furthermore, Virgin Blue does not expect to achieve the scale of operations that the Applicants have assumed in the NECG Report it will achieve through natural growth. The NECG Reports has assumed that under the factual scenario Virgin Blue will have operations in the trans Tasman services that equates to dedicating at least 6 aircraft in year 1, 15 aircraft in year 2 and 17 aircraft in year 3. Virgin Blue could not satisfy this aircraft demand under its arrangements with Boeing (which were only recently finalised) having regard to the natural attrition of the aircraft in its fleet, its plans to expand its Australian operations, its plans to commence domestic New Zealand services and its intention to fly a number of international routes other than to New Zealand.

4.16 To achieve this scale of operations would require Virgin Blue to put its Australian growth plans on hold and even withdraw from certain Australian domestic services. Virgin Blue will not do this. The only way in which Virgin Blue is likely to achieve the scale of capacity on which the Alliance scenario is based in the short to medium term is if the Applicants divest operational capacity.

4.17 It should also be recognised that it would take Virgin Blue time to achieve the scale of operations under the Proposed Alliance scenario, by which time the Proposed Alliance will be well entrenched. Virgin Blue would need to displace capacity from the Alliance parties, requiring that they withdraw capacity, to achieve the scale of operations suggested. The delay to market arising from natural growth significantly reduces Virgin Blue's ability to achieve the scale of operations the Applicants have suggested.

4.18 If the Proposed Alliance retains their strategic low cost operations such as, Freedom Air and Australian Airlines, these will provide a perfect vehicle to constrain the growth of Virgin Blue. These airline operating companies controlled by Air New Zealand and Qantas provide a fighting capacity to tackle Virgin Blue head on, while seeking to

maintain their high yield passengers. The experience in Australia, as illustrated by figure 2 on page 23, supports this as a likely outcome.

4.19 There is evidence of this already occurring. Freedom Air was originally established as a response to the entry of a low cost operator, Kiwi Air, which subsequently went out of business. With the collapse of Kiwi in 1997, Freedom Air was kept in operation on a limited basis as a strategic checking device for any new entrant. In response to Virgin Blue's announced commencement of operations in New Zealand on 24 April 2001, Freedom Air announced three days later that it was expanding the fleet from two to four 737's, apparently to counter Virgin Blue's entry.[60] When Qantas commenced operations in New Zealand in May 2001, Air New Zealand withdrew Freedom Air from trans Tasman services and re-deployed Freedom Air on those domestic routes operated on by Qantas. Now, given the relationship with Qantas, Air New Zealand has re-deployed Freedom Air to operate out of Brisbane, the home base of Virgin Blue. Brisbane is the logical point from which Virgin Blue would enter the trans Tasman market as it has a relatively high proportion of leisure travel customers and it is Virgin Blue's home base. Virgin Blue believes that this re-deployment is a response by Air New Zealand to the anticipated commencement by Virgin Blue of trans Tasman services.

4.20 The use of Freedom Air in this manner can only be described as strategic conduct. It has no other rational commercial explanation as a return on a route may often only occur after several years of operation on that route due to the large sunk costs associated with commencing operations on any route.

Other Competitive Restraints

4.21 As discussed above there is little prospect of Virgin Blue reaching the scale the Applicants have assumed by natural growth in the time period proposed by the Applicants.

4.22 The only competitive restraint other than Virgin Blue on the Proposed Alliance identified by the Applicants are fifth freedom carriers. The Applicants state:

> *The constraint imposed by fifth freedom carriers is growing. To date these carriers have focused on the AKL-SYD and AKL-BNE routes, although there is no impediments to their commencing AKL-MEL or other trans Tasman services in response to any price increases.*[61]

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60 *Forgive the Cynicism,* New Zealand Evening Post, 30 April 2001, Editorial p.4.

61 Supporting Submission at paragraph 6.88.

4.23 This misconstrues the nature of the fifth freedom carriers business and overstates their ability to respond to opportunities on the trans Tasman routes presented by increases in prices by the Proposed Alliance.

4.24 A fifth freedom carrier will establish a schedule of operations from its home market to Australia and New Zealand as part of an integrated schedule. The carrier seeks to combine New Zealand destination traffic and Australian destination traffic on one flight. Similarly, it seeks to aggregate New Zealand origin traffic and Australian origin traffic on one flight. This may leave unfilled capacity on the Australia – New Zealand leg, which can be made available under fifth freedom rights.

4.25 Critically, the fifth freedom carrier does not determine its schedule and its operations by reference to, and therefore does not competitively respond to, price and capacity signals on the trans Tasman route. Its decision is based upon the economics of the entire route, that is from its home market to Australia and New Zealand. This may mean that fifth freedom carriers take some portion of a trans Tasman route, but otherwise they place no competitive threat or discipline on that or any other trans Tasman route. Further Virgin Blue notes that fifth freedom carriers will only operate trans Tasman services and not domestic New Zealand routes.

4.26 Significant expansion on Asia/Pacific routes to and from New Zealand is also unlikely. Qantas has a significant shareholding in Air Pacific so any expansion by it cannot be considered a constraint. Other airlines are either too small to expand significantly (e.g. Polynesian Airlines) or are not driven by New Zealand market requirements but by scheduling requirements in their country of origin.

5. MARKET REFORM

Market reforms required to sustain substantial new entry

5.1 For the reasons set out below, Virgin Blue believes that behavioural undertakings will be of limited utility in fully addressing the competition concerns arising from the Proposed Alliance. These competition concerns can only be addressed if structural changes are made to the market in addition to imposing stringent and readily enforceable behavioural undertakings on the Proposed Alliance.

5.2 The Proposed Alliance should only be authorised if The Commerce Commission is satisfied that Virgin Blue (or someone else) is operating at a scale sufficient to offer a meaningful and sustainable competitive restraint on the Proposed Alliance. This can only be ensured if Air New Zealand divests Freedom Air. The divestiture of Freedom Air:

(a) provides a vehicle for a new entrant to immediately commence operations in New Zealand. As discussed above, any delay in entry by a new entrant after the formation of the Alliance will place it at a significant disadvantage in relation to the Proposed Alliance given the increased incentive and capacity of the Proposed Alliance to engage in strategic or predatory conduct;

(b) provides an immediate and substantial scale of operations, through four 737s, (similar in scale to Qantas' existing operations in New Zealand). As discussed above Virgin Blue will not reach the scale assumed by the Applicants through natural growth. The sale of Freedom Air would provide a vehicle from which a new entrant could reach the scale of operations outlined by the Applicants;

(c) off-sets the anti-competitive effects of the rationalisation of capacity under the Proposed Alliance, ie as more capacity remains in the market than otherwise and a greater share of that capacity is independent of the Proposed Alliance;

(d) removes from the Proposed Alliance's arsenal the more likely vehicle through which it would engage in strategic or predatory conduct; and

(e) is likely to result in the Applicants responding to entry by Virgin Blue using their core brands and services, which should result in more broadly based reductions in price that may otherwise occur.

5.3 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 alternative 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 and aircraft from its low cost operating vehicles (Impulse and Jet Connect) on trans Tasman, New Zealand and certain Pacific routes for a period of three years.

5.4 Virgin Blue believes that there should also be a number of other quasi structural or behavioural reforms imposed upon the market. These should, at the very minimum, address the following issues:

(a) delaying giving effect to the Proposed Alliance until new entry has occurred. Actual entry is a more effective competitive restraint than potential entry[62] and this will ameliorate the first mover advantage that the Proposed Alliance has ;

(b) equivalent access to terminal facilities is provided to the new entrants as that enjoyed by the Alliance, particularly during peak times. There are several airports which have substantial capacity constraints on gates and check-in facilities, including, without limitation, Sydney, Auckland and Christchurch. In critical respects, Air New Zealand, and to a lesser extent Qantas, control access to these facilities, particularly where they have contractual rights to the use of such things as gates and check in counters. A new entrant should have equivalent access rights, in terms of quality[63] and quantity, without that new entrant being obliged to finance new facilities at an Airport. At capacity constrained Airports this can only occur if the Proposed Alliance is required to relinquish some of its rights of access to the new entrant;

(c) sufficient suitable peak time slots and airside facilities at capacity constrained airports, for example, Sydney and Auckland are available to the new entrants such as Virgin Blue. In order to achieve a scale necessary to offer an effective competitive constraint on the Proposed Alliance, a new entrant will ultimately require a significant amount of slots and airside facilities at peak times. In order to achieve this the Proposed Alliance will need to relinquish a significant amount of its existing rights;

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62 Virgin Blue supports Qantas' position in the *Bodas* proceedings where Dr Trethaway submitted that the threat of entry is a much less powerful constraint on incumbent airlines than was hoped 15-20 years ago. See *Bodas* at paragraph 467.

63 For example, to overcome capacity constraints at some airports buses are offered as an alternative to aerobridges. It would be unacceptable if a new entrant was relegated to use buses instead of aerobridges, unless a significant cost advantage is offered to the new entrant.

(d) finalisation of satisfactory commercial arrangements with Air New Zealand and Qantas for maintenance services, spares and parts, ground handling services and equipment at all major airports and route reprotection; and

(e) an undertaking to limit the capacity response to new entry. The undertaking should prevent the Proposed Alliance from increasing capacity for a period of two years on any route following new entry.

5.5 Finally, given the inherent risks to competition of the Proposed Alliance, authorisation should not be granted under any circumstances for a period greater than three years.

General Comments – The Limits of Behavioural Undertakings

5.6 The Applicants have proposed to address certain competition concerns and the achievement of certain public benefits through enforceable undertakings. The Applicants have proposed to address certain competition concerns and the achievement of certain public benefits through enforceable undertakings. It is not clear how the Applicant intends to formulate such undertakings. The Applicants submitted a proposal to the Commerce Commission headed "Undertakings to be Provided to the ACCC". It is not clear whether the Applicants intend these to be applicable to any authorisation by the Commerce Commission (if granted). If this is the Applicant's approach, there are questions of jurisdiction and enforceability that need to be addressed.

5.7 In terms of applications to the Commerce Commission, structural undertakings to divest part of the merged business are clearly possible as the Proposed Alliance involves a merger. Virgin Blue believes that, wherever possible, market arrangements that limit the anti-competitive detriments from the Proposed Alliance should be effected through commercial arrangements or, failing that, divestment undertakings.

5.8 However, the Applicants have principally proposed behavioural undertakings, although there are some limited quasi-structural undertakings. Behavioural undertakings do not exist in New Zealand per se. Conditions under section 61(2) could be considered roughly analogous to behavioural undertakings. It is unclear whether the Applicant intends to propose conditions that might be imposed by the Commerce Commission if the Proposed Alliance were authorised.

5.9 Even if behavioural undertakings can be effected in New Zealand (through conditions or otherwise) Virgin Blue considers that there are a number of issues that are relevant to any consideration of such undertakings, including those identified by the ACCC in its *Merger Guidelines* as follows:

(a) behavioural undertakings may well interfere with the ongoing competitive process through their inflexibility and unresponsiveness to market changes;

(b) the duration of such undertakings is highly problematic – such undertakings should not be perpetual, yet it is often impossible to identify with any certainty a time in the future when they will no longer be required;

(c) they are extremely difficult to make certain and workable in detail, particularly in the short time frames in which mergers are considered;

(d) they require continuing monitoring, and where breaches are detected they are often dependent on enforcement after the event; and

(e) there are substantial associated costs to The Commerce Commission of compliance and enforcement.

5.10 Each of the difficulties with behavioural undertakings identified by the ACCC in its Merger Guidelines will be relevant to any consideration by the Commerce Commission of the undertakings offered by the Applicants. Many of these difficulties will be magnified by the complex and often opaque nature of pricing and capacity allocation in the aviation industry.

Comments on proposed Undertakings provided to Commission

5.11 Virgin Blue is unsure of the status of the undertakings submitted to the Commerce Commission and has therefore not commented on them in detail in this submission. However, more detailed comment is provided in Virgin Blue's submission to the ACCC at section 5.8.

6. THE APPLICATION OF THE AUTHORISATION TEST

6.1 The Applicants have sought authorisation of the Proposed Alliance pursuant to sections 58 and 67 of the Commerce Act on the grounds that the public benefits of the Proposed Alliance outweigh the public detriments.

6.2 The assessment of the public benefits and detriments must be undertaken from the perspective of the jurisdiction in question. Accordingly, a public benefit to Australia may in certain circumstances be a public detriment to New Zealand and vice versa.

6.3 In New Zealand, while the two formulations of the test for authorisation of acquisitions and restrictive trade practices differ, in effect they are likely to be substantively similar.

6.4 In order to authorise the agreements underpinning the Proposed Alliance, The Commerce Commission must be positively satisfied that giving effect to the Alliance will, in all the circumstances, result or be likely to result in a benefit to the public which would outweigh the lessening in competition that would result, or be likely to result or is deemed to result, if the Alliance was given effect.

6.5 In order to authorise the acquisition by Qantas of up to 22.5% of the equity in Air New Zealand, the Commerce must be positively satisfied that the proposed acquisition will result, or be likely to result, in such a benefit to the public that the acquisition should be allowed to take place.

6.6 The approaches to the benefits/detriments analysis in Australia and New Zealand are broadly aligned but differ in some material respects, particularly with regard to transfers. In both jurisdictions public benefit covers a broad range of benefits with an emphasis on efficiency, although there is a greater emphasis in New Zealand on the quantification of such benefits and detriments.

6.7 Virgin Blue engaged Frontier Economics to review the NECG Modelling of the benefits and detriments of the Alliance. That Report is enclosed at Attachment 1. In summary, Frontier Economics found that the Applicants have:

(a) understated the detriments;

(i) the price increases and capacity decreases identified by the Applicants have been substantially understated, and the dead weight loss associated with the Proposed Alliance has been underestimated as a result; and

(ii) the Applicants have failed to identify a likely detriment in that the Proposed Alliance is likely to have a similar effect on freight services as it has on passenger services, namely to increase prices and reduce capacity;

(b) overstated the benefits. The principal reasons for this are:

(i) there is no basis for the tourism benefits the Applicants have alleged will occur should the Proposed Alliance proceed;

(ii) the cost savings are unsubstantiated and appear to be cost savings attributed to the Applicants failing to engage in inefficient and potentially unlawful conduct, which in any event is implausible;

(iii) the Applicants have not measured scheduling efficiencies arising between the factual and counterfactual scenario, but instead have compared the schedules if the Proposed Alliance were to proceed, which has the effect of overstating the scheduling efficiencies; and

(iv) there is no reason why the Proposed Alliance should not result in any new direct services that otherwise would not have occurred.

6.8 As a final point, the NECG model includes no allowance for losses in productive and dynamic efficiency. Virgin Blue notes that in *Bodas*, the Commerce Commission concluded that allowing there to be a dominant firm in the market would result in:

(a) increases in productive inefficiency to levels between 1-10% of current costs; and

(b) losses in innovative efficiency of between 1% and 2.5%.

ATTACHMENT 1

FRONTIER REPORT