

CHAPTER 3

VBA ENTRY

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INTRODUCTION

3.1 This Chapter provides an assessment of:

- the likelihood of timely, constraining VBA entry on domestic New Zealand and Tasman routes; and
- the market impacts of VBA entry.

3.2 As discussed in Chapter 2 of this Submission, aviation passenger markets and the nature of competition within those markets have changed irrevocably. The VBA model and its impact on markets are no longer surrounded by mystique or uncertainty. The established models of VBAs such as Southwest, easyJet, Ryanair and more recently Virgin Blue are well documented and well understood. Likewise, the impacts of successful VBA entry are also well understood. Today, entry by an existing or “greenfield” VBA which adopts the well established VBA models and is properly resourced rarely fails.

3.3 Passengers, with either elastic or inelastic demand, support the entry of the VBA model on the basis that it provides a ‘real’ choice based on price. While certain passengers still require services only available from FSAs and therefore make choices between competing network carriers, the choice made available by the VBA model has resulted in a significant volume of passengers basing their purchasing decisions solely on price and choosing their preferred airline accordingly. Because Air New Zealand and Qantas are network carriers that need to retain connectivity, they cannot chose to become a full VBA *and* yet still retain international networks.

3.4 The Commission has received submissions related to the likelihood of constraining VBA entry from the Applicants, Virgin Blue, travel wholesalers and the public generally. This Chapter provides empirical support for the Applicants’ submission in relation to VBA entry, rather than merely discussing VBAs and VBA entry in the abstract, or seeking to extract maximum concessions as a condition of regulatory authorisation. It sets out, by reference to VBA entry worldwide, when VBAs enter and the impact that entry has on fares in the marketplace. It draws extensively on analysis carried out by APG¹ of the impact of VBA entry into a variety of markets all around the world, including in Australia.

3.5 Virgin Blue’s recent application to the Australian International Air Services Commission (**IASC**) for the right to operate “unlimited” services to New Zealand is validation of the conclusions reached in this Chapter. Virgin Blue is committed to flying outside domestic Australia and has ear-marked an initial 6 planes for the purpose. In its application to the IASC it states that “international operations form a very important part of Virgin Blue expansion and as such has the full support of Board and Management to make it a success.”

3.6 Virgin Blue’s Tasman and domestic New Zealand expansion plans are described as representing “a relatively straightforward extension and enhancement of its Australian network” by aviation analysts, Centre for Asia Pacific Aviation in a report

¹ APG is an aviation consulting firm based in the United States with secondary offices in London.

dated 18 June 2003 entitled "Virgin Blue - The Luckiest Little Airline Alive? Where To Next?"²

- 3.7 The empirical analysis contained in this Chapter supports the conclusion that a VBA will enter Tasman and domestic New Zealand routes in a timely, constraining fashion.

SUMMARY

Applicants' view

- 3.8 Air New Zealand and Qantas have consistently asserted that constraining VBA entry will occur in a timely manner on domestic New Zealand routes (**New Zealand VBA Routes**) and on routes between New Zealand and Australia (**Tasman VBA Routes**), (collectively the **VBA Routes**). This view is based on the following factors:

- the characteristics of the VBA Routes make them conducive to VBA entry (appropriate population catchments, sector length, point to point traffic density and the opportunity for demand stimulation);
- VBA operations on the VBA Routes will be profitable – more profitable with the Alliance than without;
- any barriers to entry/expansion on the VBA Routes are low and, in any event, are not a material deterrent to entry/expansion;
- Virgin Blue is well positioned to enter the VBA Routes and has publicly stated it will do so, with or without the proposed Alliance; and
- among other outcomes, VBA entry will constrain the Alliance across all customer types.

Commission's preliminary view

- 3.9 The Commission's preliminary quantification of the benefits and detriments of the Alliance assumes no VBA entry on the VBA Routes by Year 3 in the Factual. As a result, the Commission's economic modelling overstates the anti-competitive effects of the Alliance and consequently the productive, allocative and dynamic efficiency losses arising as a result of the Alliance.

- 3.10 The defects in the Commission's preliminary analysis can be summarised as follows.

- It placed insufficient weight on the characteristics of the VBA Routes, which make them attractive to VBA entry.
- It placed insufficient weight on its own modelling, and NECG's modelling, which showed VBA entry would be significantly more profitable in the Factual than in the Counterfactual.

² The Report is attached as Appendix I.

- It overstated the relevant barriers to entry/expansion faced by a VBA, in particular the ramifications of Air New Zealand’s ownership of Freedom (which occurs in the Factual and the Counterfactual).
- It placed insufficient weight on Virgin Blue’s very successful method of entry onto the Australian domestic routes in the face of two FSAs (Qantas and Ansett) and one VBA (Impulse), and the impact of that entry. In particular, it failed to take into account that expansion by Virgin Blue onto the VBA Routes is far less costly, and risky, than Virgin Blue’s successful greenfields entry into domestic Australia.
- It placed insufficient weight on Virgin Blue’s submission and public statements that it will enter the VBA Routes “with or without the Proposed Alliance”.
- It placed insufficient weight on the constraint currently imposed on Qantas and Air New Zealand in respect of the VBA Routes by the threat of VBA entry, which was a key factor behind Air New Zealand’s re-configuration of its domestic services to the lower fare “Express” class.
- It failed to explain:
 - why VBA entry would occur on Tasman routes and New Zealand domestic routes in the Counterfactual but not in the Factual despite prices being modelled by the Commission to be 48% and 56% *lower* respectively, in the Counterfactual; and
 - in any event, why the Commission’s modelled price increases under the Alliance of 56% on New Zealand Main Trunk routes, and 48% on Tasman routes, would not result in VBA entry.

The cost of Virgin Blue’s expansion onto Tasman and domestic New Zealand routes is far lower than the cost of its entry into Domestic Australia

3.11 This Chapter sets out the evidence supporting the Applicants’ response that:

- contrary to the Commission’s preliminary view, VBA entry will occur on the VBA Routes in the Factual in accordance with the Commission’s LET Test;
- VBA entry will constrain the Alliance; and
- the Alliance will not impede the entry of, the extent of constraint, or the continuing presence of the VBA.

Evidence

3.12 The majority of the evidence advanced in this Chapter has been compiled by APG. APG staff have held senior level positions with many major airlines, including: United Airlines; American Airlines; Delta Airlines; Northwest Airlines; US Airways; and Swiss Air. APG’s clients include airports, aviation industry participants, and airlines such as:³

- Air Jamaica;
- Hawaiian Airlines

³ <http://www.apgnet.com/clients/index.html>.

- AirTran Airways;
- Alitalia
- All Nippon Airways
- Air New Zealand
- ACA
- British Midland–bmi
- Delta Air Lines
- DHL
- Qatar Airways
- Reno Air
- Singapore Airlines
- South African Airlines
- Thai Airways International
- Trans World Airlines
- United Airlines
- US Airways.

3.13 The data utilised by APG to compile the various analyses includes comprehensive and publicly available data from the U.S. Department of Transportation (**USDOT**). It is based on domestic U.S. routes and includes the following, which all U.S. carriers must submit to the USDOT:

- flown airline coupons whose ticket number ends in a “0”. This 10% sample provides passenger and fare information on an itinerary level for any given O/D where a given segment of that O/D has been flown on a U.S. carrier;
- onboard passenger and capacity data for every segment flown by that carrier; and
- quarterly financial statements.

3.14 In many instances, APG has utilised data provided by OAG. OAG specialises in collecting, processing and distributing airline schedules and related data and states it has the most comprehensive and up-to-date schedules database in the world. OAG’s data services include: data supply to the world's global distribution systems and airline reservation systems; data analysis tools and services; online timetables for airlines and airports; and content for Internet travel portals.⁴

3.15 Unless otherwise specified, the analysis underlying the figures in this Chapter have been compiled by APG.

3.16 In several sections below, there is specific analysis of individual VBAs, including: Virgin Blue; Southwest Airlines (**Southwest**), AirTran Airways (**AirTran**), Frontier Airlines (**Frontier**) and jetBlue Airways (**jetBlue**)(U.S.); and Gol Transportes Aeros (**Gol**) (Brazil):

- Virgin Blue (approximately $\frac{3}{4}$ the size of Air New Zealand in terms of number of seats operated) and Southwest are reasonably well known by the Commission.
- AirTran is one of America's largest low-fare airlines – employing more than 5,000 professional crew members and serving 488 flights a day to 43 destinations. The airline's hub is at Hartsfield Atlanta International Airport, the

⁴ <http://oagdata.com/overview.asp>.

world's busiest airport (by passenger volume), where it is the second largest carrier operating 188 flights a day. AirTran never requires a roundtrip purchase or Saturday night stay, and offers an affordable Business Class, assigned seating and easy online booking and check-in.⁵

- jetBlue is a New York-based domestic airline. It operates a fleet of more than 40 A320s and offers leather seats and satellite TV, while maintaining low fares by keeping other costs to a minimum. It has recently placed a US\$3Bn order for 100 new mid-sized jets to assist its expansion onto smaller, shorter regional routes.
- Frontier is a Denver based low cost carrier, founded in 1994. It operates a fleet of 36 aircraft, including 16 B733s, 3 B732s and 17 A319s. It services 37 U.S. cities and 2 cities in Mexico.
- Gol is Brazil's major VBA airline and is based in Sao Paulo. Gol commenced operations in January 2001 following the deregulation of Brazil's aviation market. Gol's business model is based on the business models adopted by Southwest and Ryanair. To this end, Gol flies only B737 and B738 aircraft and provides services in Sao Paulo, Belo Horizonte, Brasília, Campinas, Curitiba, Florianópolis, Porto Alegre, Recife, Rio de Janeiro and Salvador.

OUTLINE OF THE VBA MODEL

3.17 The VBA model, as outlined in Chapter 2, is a permanent fixture in today's aviation markets. The Commission itself concluded in the Draft Determination:

“There is also the reality that VBAs are not a transitory phenomenon, but are here to stay and are sustainable”.⁶

3.18 Airlines adopting the VBA model operate short-haul (generally less than 5.5 hours), point to point services using a single or very limited class of aircraft (frequently B737s). Few, if any, “frills” such as food and beverages are included in the ticket price. VBA's main product differentiation is their provision of on-time low fare services. Their “product” is price.

3.19 Although the Applicants have adopted the term “Value Based Airline” or “VBA” because of its common usage, and continue to use it in this Submission, the Applicants note the term is potentially misleading because it suggests that airlines adopting a low-cost, no-frills business model offer less value to passengers than airlines adopting other business models. The success of low-cost airlines worldwide proves this is not the case – airlines adopting the low-cost model provide significant value to passengers in terms of low fares and the removal of less valued “frills” from the ticket price. The term “Value Based Airline” also risks suggesting that the services provided by FSAs are not valued by passengers, which is also incorrect. Rather, the advent of the low-cost model has allowed passengers to choose the airline that most closely matches the service offerings valued by each particular passenger.

⁵ <http://www.airtran.com/aboutus/investor/index.jsp>.

⁶ Draft Determination, paragraph 142.

3.20 To avoid this potentially misleading terminology, experts often adopt the term “Low Cost Carriers” or “LCCs” to reflect the essence of the low cost business model.

MARKET CHARACTERISTICS ARE CONDUCTIVE TO ENTRY

General

3.21 The suitability of the VBA Routes to VBA entry is confirmed by Virgin Blue’s announced intention to enter “with or without the Proposed Alliance”.⁷

3.22 The key factors that determine the viability of VBA services on a particular route are:

- population base of cities served;
- sector length;
- volume of point to point traffic; and
- the ability to stimulate new demand.

3.23 Notwithstanding that Virgin Blue’s announcement it will enter with or without the Alliance is alone confirmation that the VBA Routes suit the VBA model, this section undertakes an objective review of the suitability of the VBA routes to VBA entry. It concludes that the VBA routes have the population, sector length, volume of point to point traffic and ability for demand stimulation to support sustainable, substantial and timely VBA entry.

Population

3.24 The population of a city is relevant because it can serve as a proxy for potential demand. Virgin Blue’s submission stated that in Australia, as a general rule, it can provide services to cities with populations of greater than 50,000 and that the same principle could be applied to New Zealand.⁸

3.25 Table 1 below lists New Zealand⁹ and Australian¹⁰ centres that meet Virgin Blue’s 50,000 threshold:

Table 1

Auckland: 1,087,000	Wellington: 342,825
Christchurch: 342,285	Dunedin: 110,757
Hamilton: 167,325	Napier/Hastings: 116,211
Tauranga: 90,906	Palmerston North: 73,845

⁷ Virgin Blue Submission, 12 February, Paragraph 1.4. Although Virgin Blue has claimed there are some impediments to the timing and scale of its entry, namely the presence of Freedom and access to facilities, neither is related to the actual characteristics of the routes.

⁸Virgin Blue Submission, 12 February, paragraph 2.24.

⁹ www.stats.govt.nz.

¹⁰www.abs.govt.au.

Virgin Blue’s confirmation it will enter is evidence the Tasman and domestic NZ routes suit Virgin Blue’s model, and therefore the VBA Model.

Rotorua: 56,304	Nelson: 55,569
Sydney 4,250,100	Melbourne 3,610,800
Brisbane 917,216	In excess of 50 other NSW and Queensland cities meet the Virgin Blue threshold.

Route/stage length

3.26 The focus of the VBA model is on “short haul” routes of less than 5.5 hours, i.e. routes that, on the basis of existing technology, can be operated by narrow-body aircraft such as the B737 or the A320.

3.27 All New Zealand VBA Routes and Tasman VBA Routes are “short-haul”.

Volume of point to point traffic

3.28 The absolute volume of point to point passengers on a particular route is an important determinant of the viability/profitability of VBA entry. This view is supported by the Commission’s statement at paragraph 140 of its Draft Determination that:

“VBAs concentrate on having limited networks with the main focus on point-to-point (or origin-destination (“OD”)) routes of no more than four to five hours flying time. The profitability of each route is assessed on a stand-alone basis, without regard to possible feed traffic.”

3.29 Point to point traffic is measured in terms of the number of point to point passengers on a one-way sector (referred to as Passengers per Day Each Way (**PDEW**)). For example, the number of Auckland-Wellington PDEWs would include all passengers travelling solely between Auckland and Wellington. It would not include:

- passengers travelling from, or going to, points beyond Auckland or Wellington, for example passengers on the Auckland-Wellington sector of a Los Angeles-Wellington flight via Auckland (these passengers would be counted as Los Angeles-Wellington PDEWs)¹¹; or
- passengers on the Wellington-Auckland flight, who would be included as Wellington-Auckland PDEWs.

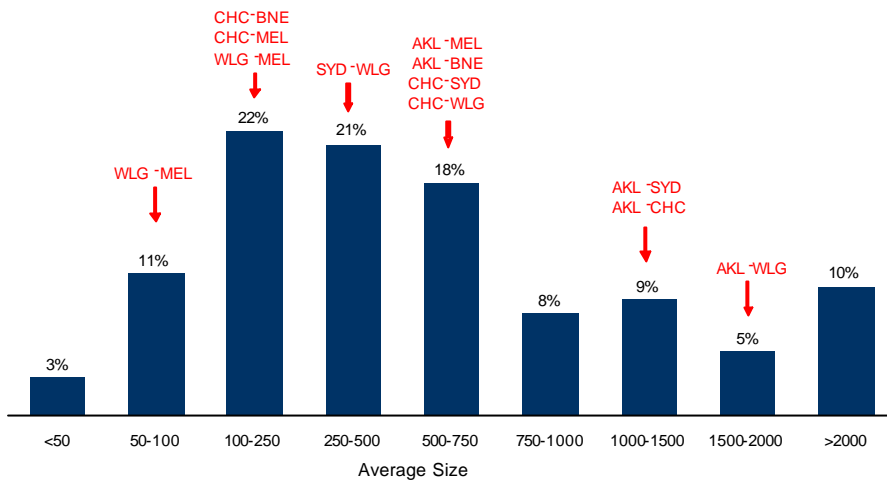
3.30 Figure 1 below illustrates the proportion of total VBA entry occurring at various levels of PDEW passenger volumes for those routes entered by jetBlue, AirTran, Frontier, Southwest, Virgin Blue and easyJet between January 2002 and June 2003.¹²

¹¹ The Los Angeles passenger travelling Auckland-Wellington would be included as an Auckland-Wellington PDEW if the Auckland-Wellington sector was not a direct connection.

¹² The OAG data derives from a sample week for each month.

Figure 1

Average Size of Routes Entered Into by VBA
(Passengers per Day Each Way)



The volume of point to point traffic on NZ and Tasman routes fits the VBA model

Source: OAG, NZ Market Size, all routes VBAs entered since January 2002; metro areas combined
Includes: B6, F L, F9, WN, DJ, U2

3.31 The blue columns in Figure 1 represent the proportion (marked as a percentage above each column) of all VBA entry occurring at that level of PDEWs. For example, 21% of all VBA entry occurred on routes with 250-500 PDEWs, 18% on routes with 500-750 PDEWs etc. Figure 1 also indicates the volume of PDEWs on major domestic New Zealand and Tasman routes. For example, the level of PDEWs on the Auckland-Melbourne, Auckland-Brisbane, Christchurch-Sydney and Christchurch-Wellington routes is between 500-750.¹³

3.32 Although a lower proportion of total VBA entry occurs on relatively dense routes, such as Auckland-Sydney, Auckland-Christchurch and Auckland-Wellington, these routes are, nevertheless, attractive to VBA entry. For example, Virgin Blue successfully entered the Brisbane-Sydney and Sydney-Melbourne routes, which have PDEW volumes of 2,142 and 4,765 respectively. The lower incidence of VBA entry on dense routes simply reflects the fact there are fewer routes with this level of PDEW traffic worldwide.

3.33 Figure 1 confirms that the volume of point to point traffic on the major domestic New Zealand and Tasman routes is consistent with the level of point to point traffic on routes where VBAs have successfully entered elsewhere.¹⁴

¹³ Note that at least one incumbent was present, on average, prior to entry on all routes with more than 50 PDEW.

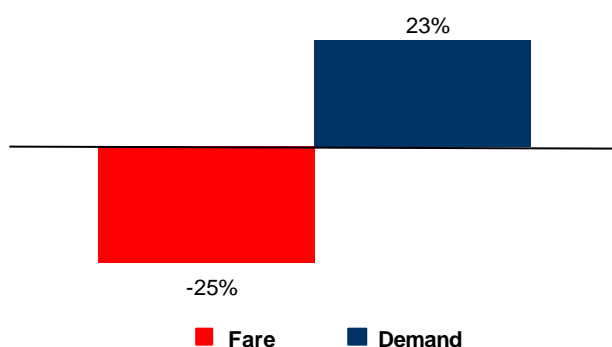
¹⁴ The apparent inconsistency between New Zealand's relatively small population and the comparable level of point-to-point traffic on the VBA Routes and overseas routes, is explained by the high concentration of traffic on only a few Domestic New Zealand and Tasman routes.

Ability to stimulate demand

- 3.34 In the event a VBA entrant is not satisfied the volume of *existing* PDEWs justifies entry, the extent to which additional demand can be stimulated by lower fares (i.e. by leveraging the VBA's lower cost base) is relevant.
- 3.35 APG analysed all 44 routes entered by jetBlue, AirTran and Southwest in 2001. APG compared fares and demand on these routes in the second quarter of 2002 with the second quarter of 2000. Figure 2 illustrates that demand was stimulated by 23% as a result of a 25% fare reduction (on average) following VBA entry.

Figure 2

Percent Change in Average Fare and Demand Following VBA Entry



Source: OAG, US DOT, sample of all 44 routes entered by B6, FL, and WN in 2001, APG analysis based on 2Q 2002 vs. 2Q 2000; metro areas combined

- 3.36 The Commission has expressed a preliminary concern that the pricing adopted by NZ Express has “already taken up some of the potential for growth in the main trunk market”.¹⁵ As described in more detail below, VBAs are not in fact deterred from entry by the existence of an FSA-owned VBA. In any event, the relevant enquiry is the likely reaction of existing and potential competitors to an attempted *exercise* of market power. The Commission’s concern is inconsistent with the potential for demand stimulation that would occur if fares increased as predicted by the Commission’s own modelling.¹⁶ Obviously, if there are no price increases, the detriment associated with the Alliance is minimal.
- 3.37 Further, the Commission reached the preliminary view that the most likely counterfactual was incremental entry by Virgin Blue on the Tasman and possible expansion to domestic New Zealand,¹⁷ despite the Counterfactual exhibiting even lower fares and hence *less* scope for a VBA entrant to stimulate demand on entry.
- 3.38 Finally, the successful entry of jetBlue on low fare U.S. routes confirms that, in the event fares did not increase, VBAs can nevertheless leverage their lower cost base to offer even lower fares. A more detailed analysis of jetBlue’s successful entry

¹⁵ Draft Determination, paragraph 416.

¹⁶ Email from the Commission to the Applicants dated 11 June 2003 attaching “Further revised calculations from David Gillen”.

¹⁷ Draft Determination, paragraph 300.

onto routes already subject to downward pressure on fares is contained from paragraph 3.151 below.

Conclusion

The evidence demonstrates that the VBA Routes have the population, stage length, volume of point to point traffic and potential for demand stimulation required for successful VBA entry.

Provincial routes

- 3.39 The discussion regarding VBA entry to date has concentrated on Tasman and domestic New Zealand Main Trunk routes. However, two important developments in the last month support the view that VBA entry onto provincial routes would occur in response to the necessary incentives.
- 3.40 JetBlue has recently identified an opportunity to serve smaller, shorter routes in the U.S. On June 10 it announced it had placed an order for 100 new EMBRAER 190 jet aircraft, with options for an additional 100 new aircraft. David Neeleman, CEO of jetBlue said “through this new agreement with Embraer, jetBlue will bring its superior product and award-winning customer service to the many mid-sized markets desperately in need of low fares and high quality service.”¹⁸
- 3.41 Virgin Blue has identified an opportunity to serve regional airports in Australia. It has recently entered into an arrangement with Australian Regional carrier REX to offer services, using smaller REX aircraft, to regional ports where Virgin is unable to land a B737. This suggests Virgin Blue is confident its success on the larger Australian domestic routes can be replicated on routes serving smaller regional centres. For similar reasons, there is no reason why a VBA, such as Virgin Blue, would not:
- commence services to New Zealand regions that could accommodate B737 aircraft (which include Hamilton, Dunedin, Palmerston North, Tauranga, Invercargill and (once planned runway strengthening is complete) Rotorua);
 - enter into an arrangement with a regional carrier, such as Origin Pacific, to offer services into regions where it could not operate its own aircraft; or
 - acquire smaller aircraft and operate its own aircraft to smaller centres in a similar fashion to jetBlue.

BARRIERS TO ENTRY AND EXPANSION

Introduction

- 3.42 Case law and the Commission's Business Acquisitions Practice Note state that when barriers to entry or expansion are such that entry or expansion is likely in response to an attempt to increase price or decrease quality or standards of service, then there can be no market power, and, therefore, a substantial lessening of competition is unlikely.

¹⁸ <http://www.jetblue.com/learnmore/pressDetail.asp?newsId=179>.

3.43 The New Zealand Court of Appeal has confirmed that market power requires the presence of barriers to entry and expansion and has recognised that low barriers to entry or expansion will constrain an incumbent with a high market share:

"Whatever the size of the merged entity's market share, it is elementary that its market power will not be insufficiently constrained unless there are barriers to entry or expansion which protect it from effective rivalrous reaction to the exercise of its market power."¹⁹

3.44 A barrier, properly defined, is a cost borne by an entrant not borne by the incumbent(s). Barriers to entry or expansion have been identified by the Court of Appeal as:

"[a]nything...[that] amounts to a significant cost or limitation which a person has to face to enter a market or expand in the market and maintain that entry or expansion in the long run, being a cost or limitation that an established incumbent does not face. The height of the barrier is a function of the degree of the differential. A barrier to entry or expansion reflects the extent to which an established firm can, in the long run, raise price above marginal cost (supra-competitive pricing) without inducing potential competitors to enter or expand in the market".²⁰

3.45 Barriers to entry and expansion are only relevant to the extent they assist in assessing the constraint imposed by the threat of entry or expansion.

3.46 Viewed in this light, the assessment of barriers to entry and expansion must proceed in the context of Virgin Blue's successful greenfields entry in domestic Australia and stated intention to enter Tasman and domestic New Zealand routes regardless of whether or not the Alliance proceeds. The real world view of the height of barriers to entry or expansion must be judged by reference to the lack of obstacles facing Virgin Blue if the Alliance is authorised. Upon examination, these obstacles are not material.

3.47 Indeed, Virgin Blue's confirmation it will enter the relevant routes regardless of the Alliance is confirmation it does not view any barriers to entry as material. This is not surprising. VBAs worldwide are faced with these conditions of entry on routes they enter. These conditions have clearly not prevented VBAs becoming established and a competitive force elsewhere.

Many conditions of entry faced by a FSA are not relevant to a VBA

Commission's assessment

3.48 The Commission accepts the most likely entrant is a VBA.²¹ This acceptance by the Commission has important ramifications for the assessment of barriers to entry and expansion because, as the Commission's discussion makes clear, many conditions relevant to FSA entry/expansion are not relevant to VBA entry/expansion. The Commission's Draft Determination confirmed that the following conditions do not amount to a barrier to entry for a VBA:

- access to feeder traffic – "feed is not generally an issue for VBA's because they generally operate point-to-point networks" (para 396);

19 The Southern Cross Medical Care Society v Commission CA89/01 21 December 2001, Court of Appeal, Auckland, Richardson P and Tipping J, para 86

20 The Southern Cross Medical Care Society v Commission CA89/01 21 December 2001, Court of Appeal, Auckland, Richardson P and Tipping J, para 68.

21 Draft Determination, paragraph 325.

- access to CRS/GDSs – no significant barriers and a VBA could access systems (para 403);
- access to catering services – two major providers exist and, in any event, VBAs do not require catering services (the Commission incorrectly treated Air New Zealand as continuing to own a catering business) (para 405);
- availability of pilots – widely available (para 417);
- availability of aircraft – widely available (para 418); and
- brand reputation – “low” for Virgin Blue and fifth-freedom carriers (para 412). Although the use of the “Virgin” name outside domestic Australia is conditional on Singapore Airlines’ approval, Virgin Blue’s application to the IASC confirms it does not perceive that as a *barrier* to its international expansion. Virgin Blue entered and expanded in Australia as a greenfields entrant. The company and one of its major shareholder, Richard Branson, are capable of generating significant publicity.

3.49 The remainder of this section addresses the conditions of entry and expansion the Commission considered amounted to a barrier for VBAs as well as for FSAs.²²

Access to Capital

3.50 Access to capital can only amount to a barrier to the extent an entrant is forced to pay a risk premium.²³

3.51 The Commission accepts that Virgin Blue (a well resourced company contemplating a public offering this year) is a likely entrant. Virgin Blue is 50% owned by the Virgin Group and 50% owned by Patrick Corporation. On May 15 2003, Virgin Blue announced a full year trading profit of AUD\$158 million profit before tax for the year ended 31 March 2003, representing a three-fold increase on the previous year's profit. Brett Godfrey, Chief Executive of Virgin Blue said:

"Virgin Blue has demonstrated the potential of our low fare model. It is the industry's high-growth sector and it continues to deliver acceptable returns despite challenging operating conditions. While our local competition is Qantas, we benchmark ourselves globally against the leading low cost carriers as they have demonstrated their growing dominance in the short-haul aviation market."²⁴

3.52 Godfrey also stated that Virgin Blue has been “relatively well insulated” from the war in Iraq, Bali and SARS and that Virgin Blue considers “critical to continue to build up our ‘war-chest’ for unforeseen circumstances and therefore, all profits will be reinvested in the airline to allow for future acquisitions or event risk.”

3.53 VBAs are valued considerably higher than FSAs by investors worldwide – Southwest’s current P/E is 71.4 and AirTran’s is 40.86.²⁵ In comparison, Air New Zealand’s current P/E is 7.7²⁶ and Qantas’ is 8.7.²⁷ Because Virgin Blue is not

Virgin Blue is well funded, highly profitable and has been able to raise sufficient capital to fund a major fleet expansion

²² Chapter 7 also discusses the Commission’s preliminary views on barriers to entry from an economic perspective.

²³ Capital required to sustain any initial operating losses is more properly considered in terms of incumbent response.

²⁴ Virgin Blue press conference at Adelaide Airport, 15 May 2003 at 10am, Rehome transcript.

²⁵ www.nyse.com, 19 June 2003.

²⁶ www.stockwatch.co.nz, 19 June 2003.

publicly listed, its P/E ratio is not publicly available. However, Virgin Blue's EBITDA per aircraft is \$5.3m, which it is claimed exceeds jetBlue's, Ryanair's and Qantas'.²⁸ Virgin Blue's ability to raise capital to fund expansion is confirmed by its commitment to acquire 10 new B737 aircraft and options for a further 40.

3.54 Virgin Blue confirmed its ability to expand in its most recent submission to the ACCC of 16 April that:

"...we could probably double [Freedom's] size within a few months. This will be made possible by the 10 aircraft that we have ordered for delivery from Boeing in the year beginning August 2003, together with our options for a further 40 aircraft over 8 years."

3.55 In these circumstances, the evidence confirms Virgin Blue's ability to raise the necessary capital to fund expansion onto the VBA Routes.

Sunk Costs

3.56 As an initial observation, most of those costs nominated by the Commission as potential sunk costs are of the start-up variety which Air New Zealand and Qantas have both had to incur (and which can equally have been regarded as sunk at the time they were incurred). Such costs do not therefore represent a disadvantage that a new entrant *inherently* faces over the incumbents.

3.57 The Applicants have submitted that sunk costs are appreciably less for an incumbent Australasian air service provider as it would already have brand recognition, operating manuals, existing computerised information and reservation systems, and "potentially" under-utilised aircraft that could be diverted to the new routes. The Commission referred to this submission at paragraph 344 of its Draft Determination and responded that:

"...these points are not correct as VBAs typically do not have excess capacity due to high aircraft utilisation and flying point-point services. If an aircraft has moved from one route to another there is an opportunity cost of foregoing revenue and 'disappointing' the market."

3.58 The Commission focussed only on the claim that VBAs would *potentially* have under-utilised aircraft. It did not contest the other claims. As the Commission itself acknowledges at paragraph 418 of its Draft Determination, access to aircraft is not a barrier to entry.

3.59 Having regard to the above, the only potential sunk costs identified by the Commission that could plausibly apply to a VBA entrant such as Virgin Blue are the costs of terminal facilities, advertising costs, painting aircraft and financial penalties from early termination of aircraft leases. None of these are sufficient to deter constraining entry from a VBA. More importantly, none of these costs constitute a barrier to entry as accepted in orthodox antitrust/competition law analysis and as reaffirmed by the Court of Appeal in *Southern Cross*.

3.60 Engineering services for aircraft utilised in New Zealand would most likely be contracted out to Air New Zealand or, in the case of Virgin Blue, relocated to Virgin Blue's Australian engineering base as profitable Tasman flights. In terms of

Sunk costs for existing airlines are materially lower than for de novo entry

²⁷ www.tradingroom.com.au/apps/qt/quote.ac?code=QAN, 16 June 2003.

²⁸ Virgin Blue press conference at Adelaide Airport, 15 May 2003 at 10am, Rehome transcript.

aircraft, Virgin Blue is already committed to acquiring 10 B737s by August 2004 and has options for an additional 40. This existing aircraft commitment, coupled with its ability to redeploy aircraft used on VBA Routes to other routes that it services, materially reduces Virgin Blue's sunk costs related to aircraft.

- 3.61 Virgin Blue might chose to advertise in excess of the degree to which the incumbents advertise. However, this commercial decision cannot be represented as a sunk cost, as it is not a cost the new entrant is "required to face" in order to enter. There is also no evidence that the cost of terminal space would materially exceed that which the incumbents are required to pay for similar facilities.
- 3.62 Virgin Blue's unequivocal statement that it will enter with or without the proposed Alliance (and therefore, its implicit concession that it does not require conditions to enter) confirms it does not view the above costs as material. Virgin Blue certainly did not see sunk costs as an issue when it entered domestic Australia and competed against Qantas, Ansett and Impulse from a greenfields base – i.e. without the benefit of leveraging existing facilities and assets onto incremental routes, as would be the case in respect of the VBA Routes.

Loyalty schemes

- 3.63 The Commission concludes that "loyalty schemes, given their importance to business passengers in particular, are barriers to customers switching to a new entrant."²⁹
- 3.64 International experience indicates that frequent flyer programs do not prevent or limit market entry and expansion by VBAs. British Airways, Lufthansa and Air France (Europe); American Airlines and United Airlines (U.S.); Air Canada (Canada) and Qantas (and formerly Ansett) operate comprehensive programs with many members, yet this has not prevented the rapid growth and success of Ryanair, easyJet, Southwest, jetBlue, AirTran, Frontier, WestJet and Virgin Blue.
- 3.65 Having regard to international experience, particularly experience in Australia, the Applicants' frequent flyer programmes will not affect the expansion of a VBA such as Virgin Blue on the VBA Routes.

Access to facilities

- 3.66 The Commission reached the preliminary view that access to terminal/space and landing slots at Auckland Airport would amount to a barrier to entry.
- 3.67 The undertakings the Applicants have offered to the ACCC and are willing to have imposed by the Commission as a condition of authorisation fully address any issues. These conditions are set out in detail in Chapter 14. However, in summary, the conditions facilitate the required access for a period of up to five years from the commencement of the Alliance so that a new entrant could operate a five aircraft schedule on the Tasman and a five aircraft schedule between Auckland, Wellington and Christchurch. They provide access to:
- departure and arrival slots;
 - airport gates;

²⁹ Draft Determination, paragraph 409.

- airport counter facilities;
- line maintenance services (including spares and parts as part of those services); and
- ground handling services.

Regulatory

- 3.68 The Commission did not consider regulatory conditions amounted to a barrier to entry/expansion. It stated that maintenance requirements are “achievable”³⁰ and regulatory requirements relating to engineering services are “achievable and transparent”.³¹ There is absolutely no reason, under the Open Skies arrangements between Australia and New Zealand, for an Australian-based operator to encounter any particular difficulty in gaining CAA approval to fly on the relevant routes, nor has Virgin Blue suggested there would be.
- 3.69 With respect to maintenance requirements the Applicants note that all participants in the market must undergo regular ‘A’ and ‘C’ checks. That all major engineering facilities in New Zealand are owned by Air New Zealand does not constitute a barrier to entry – Air New Zealand has always made its engineering facilities available to airlines on commercial terms. In any event, as discussed, an Australian-based airline such as Virgin Blue, operating Tasman VBA Routes, could simply have its aircraft serviced at its own Australian engineering base if it wished.

Access to Travel Distribution Services

- 3.70 The Applicants dispute that access to travel distribution services is a barrier to entry or expansion for any airline. Distributors currently provide services to all carriers that wish to transact with them on commercial terms. Indeed, the more airlines a distributor represents, the more valuable it is to passengers.
- 3.71 The Commission did not assess the extent to which access to travel distribution would be problematic for a VBA, nor the extent to which a VBA would require such access, presumably because VBA sales are predominantly via direct booking. Indeed, internet bookings alone (i.e. ignoring call centres) account for 94% of Ryanair’s bookings,³² more than 90% of easyJet’s³³ and 90% of Virgin Blue’s total bookings.³⁴ The Commission acknowledged that “a VBA could choose to bypass the travel agents by booking direct”.³⁵ Notwithstanding these observations, the Commission reached the preliminary view that access to wholesale travel distribution services is likely to amount to a barrier to entry.
- 3.72 The Commission accepts that the most likely entrant is a VBA. The ease or otherwise of access to intermediate travel distribution services is irrelevant to their consideration of entry conditions. Therefore access to these services is not even a *condition* of entry let alone a *barrier* to entry.

30 Draft Determination paragraph 348.

31 Draft Determination paragraph 350.

32 www.ryanair.com/investor/Q3mar2003_files/frame.html.

33 www.wasjet.co.uk/EN/about/infopak_internet.html.

34 Virgin Blue Submission dated, 12 February, 2003. Footnote 34..

35 Draft Determination, paragraph 390.

Size of Market

- 3.73 The Commission states that an entrant would need a large share of the New Zealand domestic market to be viable and notes Qantas' statement that it would require 40% of the domestic New Zealand market to be profitable.
- 3.74 The market share required for a full service network carrier such as Qantas to achieve profitability is greater than the share required by a low cost point to point carrier such as Virgin Blue. The low cost point to point carrier can "cherry pick" a few profitable routes and operate them on a discrete, point to point basis. This can be achieved by capturing a relatively low share of the overall market. To the contrary, a FSA such as Qantas is more likely to need a market share of around 40% so that it can operate sufficient frequencies to minimise its city presence and connectivity disadvantage and, hence, the gap between its revenue and capacity share.
- 3.75 At paragraph 415 the Commission stated the Main Trunk market "would be considered to be a small market" and that an entrant would need to see the opportunity to grow the market. The Commission was concerned NZ Express had already taken up some of the potential for growth. In response, the Applicants make the following points:
- as set out in Figure 1 above, the Main Trunk routes are not small in terms of routes entered by VBAs elsewhere – to the contrary, Auckland-Wellington and Auckland-Christchurch are larger than 75% of all routes entered by jetBlue, AirTran, Frontier, Southwest, Virgin Blue and easyJet between January 2002 and June 2003, Christchurch-Wellington was larger than 50% of the routes entered;
 - the Commission has provided no evidence as to why an entrant would need to *grow* the market to be viable, rather than leverage its low cost to capture share *from* the incumbents. To the contrary, international experience suggests that incumbents ultimately surrender material capacity to the VBA entrant (see paragraph 3.105 and following below); and
 - there is no reason why the VBA cannot capture market share from the incumbents. Virgin Blue certainly captured significant market share from Ansett. WestJet captured share from the incumbent in Canada, easyJet in Europe, as did Southwest, jetBlue, AirTran and Frontier in the U.S.
- 3.76 Further, the Commission's preliminary conclusion that the extent or even existence of Virgin Blue's entry is threatened in the absence of a "hole" in the market is inconsistent with Virgin Blue's assertion it would be a more significant competitor in the Counterfactual, in which there is greater Qantas and Air New Zealand capacity.
- 3.77 Finally, the Applicants reiterate the point made in paragraph 3.37 above that, in the event prices increased, scope to grow the market would present itself.

Scale and scope of entry

- 3.78 The Commission reached the preliminary conclusion that:

“...any new entrant to the main trunk market, whether FSA or VBA, would need to match the frequency of the incumbent Alliance in order to capture the business market and provide a constraint on the Alliance”.³⁶

- 3.79 It is clear that over time, a VBA would seek to expand its frequencies so as to secure a larger and wider share of the market. Indeed, this is the strategy Virgin Blue pursued in Australia. However, it is incorrect to conclude that entry needs to occur on the same scale as the incumbents for such entry to be effective.
- 3.80 Rather, international experience consistently demonstrates that a VBA does not need to match the capacity of an incumbent in order to constrain that incumbent. Empirical studies by the USDOT,³⁷ among others, have shown that even a low level of entry by a VBA (such as Virgin Blue) has a significant effect, far greater than its market share may suggest³⁸ and greater than entry at the same scale by a FSA would have.³⁹ The APG analysis, set out in Figure 13 on page 37 below, confirms the significant effect VBA entry has on market fares, even where the VBA achieves as little as a 5% share.
- 3.81 Further, in defining its Counterfactual, the Commission has implicitly rejected the Applicants’ arguments – and Qantas’ commercial judgment – that in order to compete effectively with Air New Zealand, Qantas needs to more closely match its capacity. The Commission cannot logically argue that:
- a VBA entrant, such as Virgin Blue, would need to match the Applicants’ capacity to compete effectively;⁴⁰ and
 - Qantas, a FSA (for whom city presence and connectivity are paramount), would *not* need to more closely match Air New Zealand’s capacity to compete effectively.⁴¹
- 3.82 As discussed in Chapter 5 (Counterfactual), as a network carrier competing on the same basis, Qantas’ profitability is related to the extent Air New Zealand’s frequency in domestic New Zealand exceeds its own. The evidence above and analysis in paragraph 3.144 and following confirm that a VBA does not have to match the incumbents’ capacity in order to compete effectively and provide a competitive constraint.
- 3.83 Accordingly, scale and scope of entry does not amount to a barrier to entry or expansion for a VBA entrant, nor does a lower scale of entry support a finding that VBA entry would not provide sufficient competitive disciplines.

36 Draft Determination, paragraph 375.

37 Applicants’ submission dated 9 December 2002, paragraph 6.103: “In noting the sharp decreases in prices that typically resulted from VBA entry, the United States DOT noted that this indicated ‘that the type of competition, not the density in the absence of competition, determines fare levels’.”

38 Applicants’ submission dated 9 December 2002, page 65. See also Robert J. Windle and Martin E. Dresner, “The Short and Long Run Effects of Entry on U.S. Domestic Air Routes” 1995 Transportation Journal, Vol. 35, pp. 14-25.

39 NEEG report, pages 104-105; see also “Actual, Adjacent, and Potential Competition: Estimating the Full Effect of Southwest Airlines”; By Morrison, Steven A.; Journal of Transport Economics and Policy, May 2001, v. 35, iss. 2, pp. 239-256. Morrison is a leading world aviation economist.

40 Draft Determination, paragraph 375.

41 Draft Determination, paragraph 300.

Incumbent Response

Introduction

3.84 The Commission reached the preliminary view that incumbent response would be a greater barrier to entry under the Factual. The essence of the Commission's preliminary view is that the Alliance partners will be more profitable and hence in a better position to mount a competitive response to the VBA entrant. The Commission believed that NZ Express in domestic New Zealand and Freedom on the Tasman would be used to compete against an entrant.⁴²

3.85 The Applicants reject that a competitive response by them to VBA entry creates a barrier to entry or expansion. The following passage from the United States Court of Appeals for the Ninth Circuit judgment in *US v Syufy*⁴³ (a decision cited in *Southern Cross*) supports that view:

“But when a producer deters competitors by supplying a better product at a lower price, when he eschews monopoly profits, when he operates his business so as to meet consumer demand and increase consumer satisfaction, the goals of competition are served, even if no actual competitors see fit to enter the market at a particular time.”

3.86 This section supports that view by providing evidence that:

- VBA entry occurs more frequently on routes serviced by a single incumbent than on routes serviced by multiple incumbents;
- VBAs are not deterred from entering routes against profitable FSAs;
- the operation of Freedom and NZ Express (which occur in the Factual and Counterfactual) will not materially deter the scale, timing or scope of VBA entry;
- while incumbent capacity typically increases slightly in response to VBA entry to test the VBA's resolve (which in the current case is prevented by the conditions proffered), incumbent capacity ultimately decreases to, on average, approximately 25-30% lower than pre-entry levels by the third year following VBA entry; and
- in any event, the Applicants have proffered simple conditions that restrict the deployment of Freedom (and in some cases remove its presence altogether). In respect of “Air New Zealand” and “Qantas” branded operations, the Applicants have proffered capacity ceilings which prevent the Applicants deploying additional capacity in response to low cost entry.

Number of incumbent airlines on routes entered by VBAs

3.87 The Commission noted concerns from third parties that the Alliance makes it less likely that VBA entry would occur in the Factual.

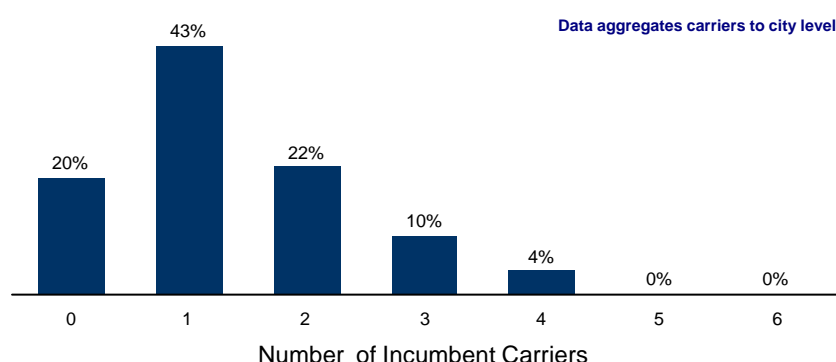
⁴² The Commission also noted the Alliance would have enlarged CRS displays, which it said would increase bookings on the Applicants' flights by travel agents. The Commission cited a 1995 paper as support for this proposition. As set out at paragraph 3.64 above, VBAs do not rely on travel agents. Certainly, CRS display screens have not prevented the successful growth of, for example, Ryanair and easyJet in the UK.

⁴³ 903 F.2d 659 (1990) at 668.

- 3.88 As an initial observation, it is important to note that Virgin Blue’s established presence in domestic Australia provides it with a natural platform from which to expand its network.
- 3.89 In light of the Commission’s preliminary view, APG analysed all 50 routes entered by jetBlue, AirTran, Frontier and Southwest in the period January 2002 – June 2003. This analysis shows that 43% of all VBA entry in the APG sample occurred on routes with one incumbent, almost twice as much as entry on routes with two incumbents.⁴⁴ (Figure 3)

Figure 3

**Number of Incumbent Carriers
US Routes Entered by VBA**



Source: OAG, sample of 50 U.S. routes entered by B6, F9, FL, WN since January 2002

Financial strength of the Incumbents

- 3.90 The Commission noted that the Alliance would be more profitable than the Applicants acting independently and the Applicants could therefore “devote more profits to subsidising price reductions and/or capacity dumping on routes that an entrant enters on.”⁴⁵
- 3.91 Worldwide, well resourced incumbent airlines with significant networks have consistently faced VBA entry. Virgin Blue’s successful entry into domestic Australia and subsequent expansion is one such example.

Presence of low cost subsidiary

Freedom Air

- 3.92 Air New Zealand will operate Freedom in the Factual and the Counterfactual. Virgin Blue claims it will enter in a material manner in the Counterfactual (and would have factored its prediction of incumbent response into this decision) but, without logical reasoning, demands the divestment of Freedom and access to

44 The APG material aggregates segments to the city level.

45 Draft Determination, paragraph 368.

facilities to justify material entry in the Factual. Virgin Blue's conflicting arguments are difficult to reconcile. On the one hand, Virgin Blue says it needs aircraft and Freedom to gain a 'kick-start' but on the other hand fails to develop a plausible reason why it needs Freedom to achieve this. Virgin Blue seeks aircraft but later (submission to the ACCC of 16 May) boasts of its aircraft availability and ability to "probably double [Freedom's] size in a few months".

3.93 Notwithstanding this inconsistency, this section outlines why Air New Zealand's ownership of Freedom will not amount to a material disincentive for Virgin Blue, or any other VBA, to enter the VBA Routes.

3.94 Freedom was formed in 1995 and is a wholly owned subsidiary of Air New Zealand. Freedom was developed as a concept by Air New Zealand with the intention that it would be deployed as a VBA in domestic Australia in 1992. However, deployment was prevented by the Australian Government withdrawing its previously promised "Open Skies" access to domestic Australia. In order to secure a domestic Australian presence, Air New Zealand was effectively forced to acquire a 50% interest in Ansett Australia, which it did in September 1996. The VBA "space" that Air New Zealand once looked to fill has now been filled by Virgin Blue.

3.95 Freedom exists as part of Air New Zealand's day to day business strategy. It is not a substitute for Air New Zealand branded services, but rather a complement to them. Freedom is integrated within the broader Air New Zealand Group:

- Freedom reports to the Chief Operating Officer (accountable for network and product);
- there is cross pollination of pilots between Freedom and Air New Zealand for seniority in pilot contracts; and
- Freedom sources significant inputs from Air New Zealand Group service providers.

3.96 Freedom operates within the same geographic footprint as its parent and is under the constraints of parent group economics. These two factors have implications for the nature and scope of Freedom's operations and accordingly, its ability to grow. The greatest implication is that Freedom's expansion is limited by the extent to which that expansion results in unacceptable cannibalisation of "Air New Zealand" revenue.

3.97 Cannibalisation is the net effect of two factors that act to reduce overall Air New Zealand Group revenue, being:

- declining overall Group revenue resulting from diversion of "Air New Zealand" traffic to the lower fare "Freedom" aircraft (**Revenue Cannibalisation**); and
- the wider network implications resulting from diversion of passengers from "Air New Zealand" aircraft to "Freedom" aircraft – that is, a reduction in Air New Zealand traffic leads to a reduction in load factors and, hence, the number of departures/frequencies and level of connectivity it can provide (**Network Cannibalisation**).

The fact Freedom operates within the same geographic footprint as its parent has significant implications for its growth

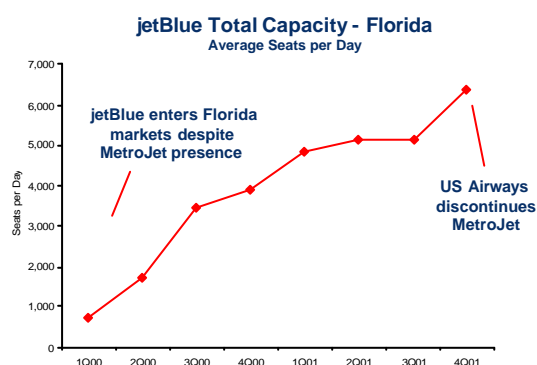
- 3.98 Revenue and Network Cannibalisation are the key reasons why the growth prospects for low cost subsidiaries operating within the FSA parent's geographic footprint are limited. For example, British Airways privatised Go three years after deployment. Go has since been acquired by easyJet.
- 3.99 To date, Air New Zealand's deployment of Freedom has been crafted to ensure that additional Freedom revenue more than offsets Revenue and Network Cannibalisation. The increased cannibalisation effect of wider deployment limits the extent to which Freedom can be deployed in response to VBA entry/expansion.

International experience

- 3.100 Internationally, VBAs have not been deterred by the presence of FSA owned/controlled VBAs. The following three examples illustrate the point.
- 3.101 US Airways introduced MetroJet in 1998 as “a low-fare unit to compete in the Eastern United States”.⁴⁶ Despite the presence of MetroJet, jetBlue entered JFK – Florida routes in 2000. As Figure 4 graphically illustrates, it grew rapidly – increasing its capacity 7-fold in only two years. Ultimately, it was MetroJet that was forced to withdraw.
- 3.102 Delta's deployment of a low cost brand to deter AirTran expansion was similarly unsuccessful. As Figure 5 illustrates, Delta's introduction of Delta Express to combat AirTran in 1996 was unsuccessful. Indeed, AirTran's capacity doubled in the period Delta Express operated. Again, it was the FSA subsidiary brand that was forced to withdraw. Even when Delta withdrew Delta Express and deployed a new VBA brand called “Song”, AirTran's capacity continued to grow.

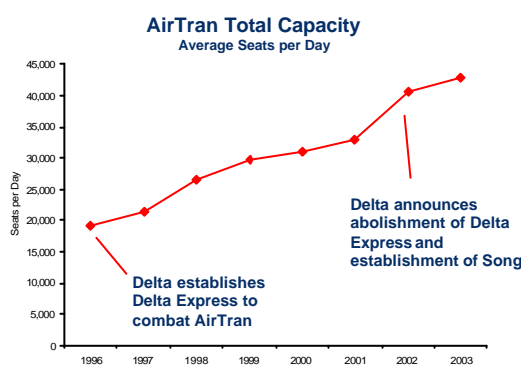
**FSA-owned
VBAs have not
prevented the
strong growth of
VBAs worldwide**

Figure 4



Source: US DOT

Figure 5



Source: US DOT

- 3.103 Air Canada's introduction of subsidiary VBAs, Zip and Tango, did not prevent successful expansion by WestJet. (Tango was specifically targeted at deterring WestJet's entry into Toronto – which did not work.) WestJet currently operates 58 routes, an increase of 34 routes from the 24 it operated in 2000.
- 3.104 For similar reasons to those set out in paragraphs 3.101, 3.102 and 3.103, the impact of NZ Express has likewise been overstated by the Commission. In

46 http://www.usairways.com/about/corporate/profile/history/company_history.htm.

addition, it is important to note that NZ Express' cost base is impacted by its retention of many elements of the FSA model.

Capacity response

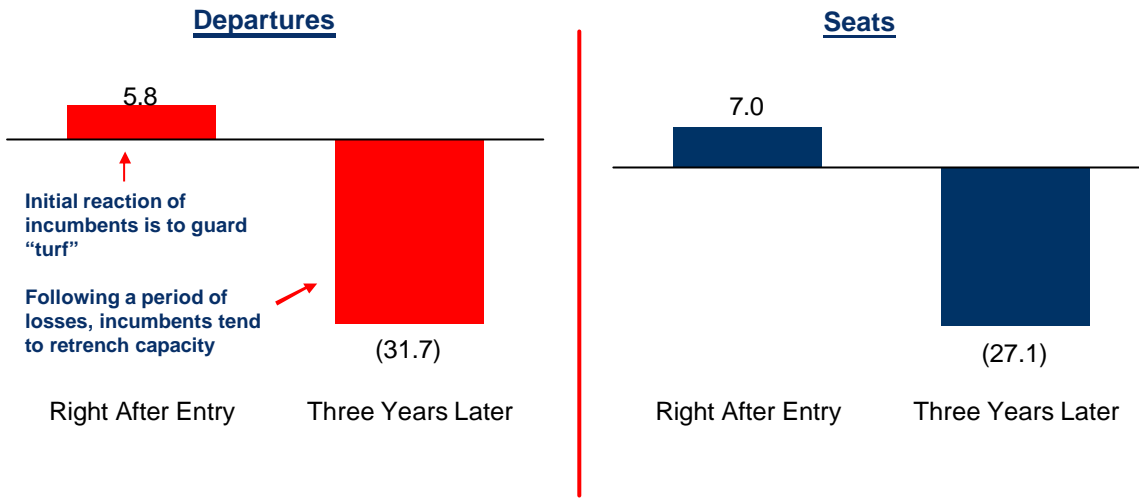
- 3.105 The Commission acknowledged the Applicants' argument that the ability of incumbents to decrease price is tempered by the incumbent's higher cost base.⁴⁷ In response, the Commission argued that the incumbent, rather than decreasing price, could increase capacity to deprive the entrant of break-even load factors. However, this argument ignores the fact that fares would have to decrease in order to generate acceptable load-factors, leading to similar financial hardship for the higher cost incumbents as would result from a direct fare reduction.
- 3.106 Quite apart from the capacity ceilings proffered by the Applicants, international experience confirms that a capacity response by the incumbents is unlikely to deter entry. APG assessed the response of incumbents to VBA entry by Virgin Blue, AirTran, Southwest, Gol, Frontier, jetBlue and easyJet entry in 2001 and 2002. The analysis shows that a capacity increase as predicted by the Commission would, ultimately, be inconsistent with the historical evidence of incumbent response to VBA entry.
- 3.107 As illustrated below, incumbent airlines on the routes reviewed by APG typically react to VBA entry by initially deploying additional capacity – which is prevented by the capacity ceilings in the current case – to test the resolve of the new entrant. However, with the exception in certain cases of the defence of “fortress hubs” (none of which exist in New Zealand or Australia⁴⁸) and, in very few cases, “point to point incumbent capacity”, by the end of year 3 incumbent capacity post-entry falls below capacity that existed pre-VBA entry. Figure 6 and Figure 7 illustrate that, even when “fortress hubs” and “point to point incumbent capacity” are included, VBA entry has forced incumbents to materially scale back capacity – by, on average, approximately 25-30% by year 3. The same result occurred in Australia, where the reduction in incumbent FSA capacity was due to the exit of Ansett.
- 3.108 The analysis demonstrates that VBAs capture significant traffic from incumbents, in addition to stimulating additional demand by offering lower fares.

⁴⁷ Draft Determination, paragraph 354.

⁴⁸ An explanation of “fortress” hubs is contained in Appendix II. Essentially, fortress hubs require a high proportion of total capacity controlled at the hub city, a large number of connections at the hub city and a high proportion of connecting traffic at the hub city. Neither currently nor post-Alliance do any Air New Zealand or Qantas hubs meet these requirements. The category “point to point incumbent capacity” should not be confused with traffic that has a point to point O/D. Rather, it represents services provided between two points without a hub at either end, e.g. Air New Zealand's SYD-LAX service post the demise of Ansett.

Figure 6

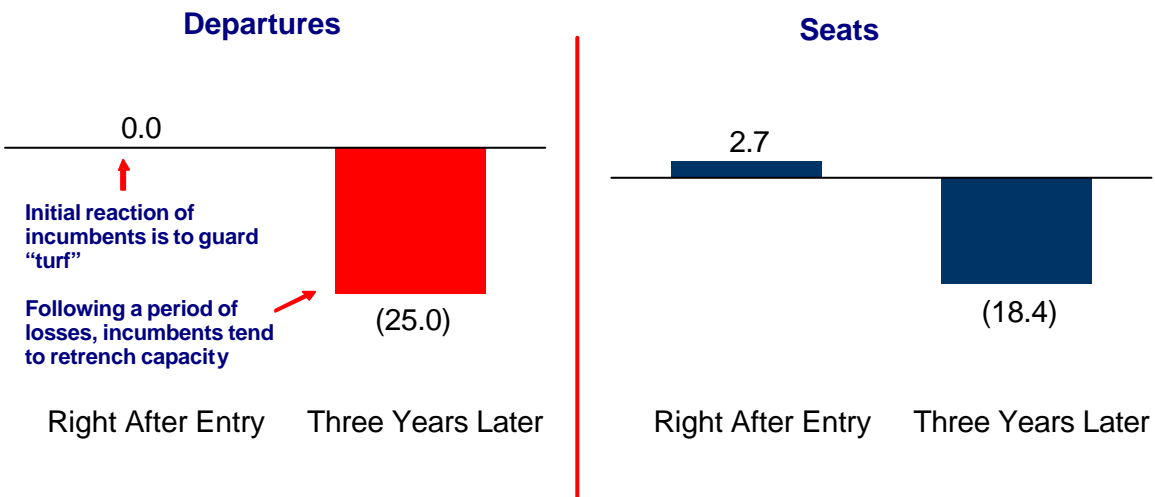
**Percent Change in Incumbents Departures and Seats Following VBA Entry
(VBA Markets Entered in 2000)**



Source: OAG; sample of all markets VBAs entered during 2000

Figure 7

**Percent Change in Incumbents Departures and Seats Following VBA Entry
(VBA Routes Entered in 2001)**



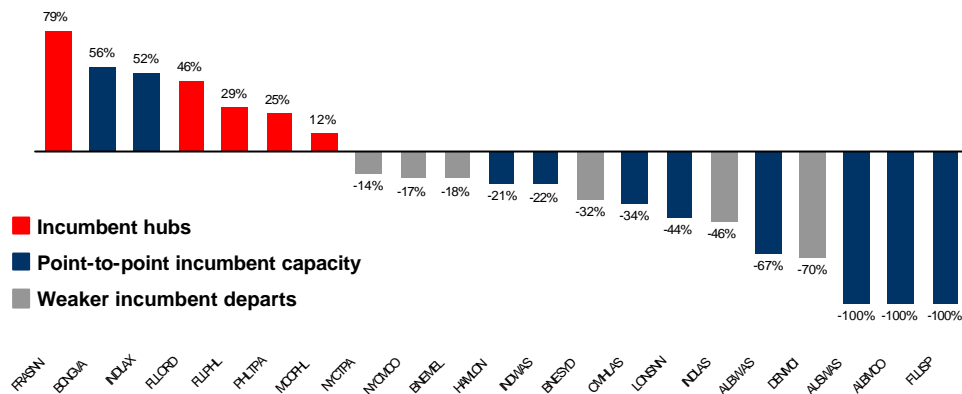
Source: OAG; sample of all markets VBAs entered during 2001 (2004 figures are an estimate)

3.109 Figure 8 below demonstrates that while, as a general rule, incumbent departures and capacity reduce substantially by year 3, there are exceptions. (Note that neither Brisbane, Melbourne nor Sydney qualify as “Fortress Hubs”.)

Figure 8

Incumbent Change in Total Seats Three Years Following VBA Entry

All Routes VBAs entered in 2000



Source: OAG, sample of all routes VBAs entered with incumbent capacity in 2000

3.110 An outline of incumbent response to specific VBA entry is discussed further in Appendix III. The results in Appendix III reflect the broader analysis set out above but do so by examining each route entered by each of jetBlue, AirTran, Gol, easyJet and Southwest in 2001. It confirms that the general impact of VBA entry on incumbent capacity described above:

- is reflective of outcomes on individual routes; and
- applies regardless of the VBA business model deployed.

3.111 As evidenced in paragraphs 3.21 to 3.38 above, New Zealand VBA Routes and Tasman VBA Routes have similar characteristics to routes identified in the forgoing examples. Accordingly, this international experience whereby incumbent capacity is ultimately reduced in response to VBA entry is equally applicable to the VBA Routes.

Conclusions

- **On average, VBA entry stimulates a relatively low level of initial growth in capacity by incumbents which over a period (certainly no longer than three years) is reduced to well below pre-entry levels**
- **VBA entrants adopting and maintaining proven successful VBA models in respect of markets which satisfy the VBA model will survive and grow at the expense of incumbents**

Conditions

3.112 Even if, contrary to international experience and the limitations imposed by Revenue and Network Cannibalisation, the Commission has residual concerns that possible strategic response impedes constraining VBA entry, the conditions the Applicants have offered to the Commission should address these concerns. These conditions are set out in detail in Chapter 14 but, in respect of removing the potential for incumbent response, include:

- in respect of each of Brisbane, Melbourne and Sydney, Freedom will only operate Tasman services from secondary airports in New Zealand from the date a new entrant commences services between New Zealand and the relevant Australian city for three years;
- from the date a new entrant commences Tasman services, Freedom will not grow its Tasman schedules by more than one aircraft each calendar year for three years;
- Freedom will not operate on domestic main trunk New Zealand routes for three years from the date of the Alliance; and
- the Applicants' combined capacity on any regulated route will not increase for 18 months following an entrant announcing its intention to enter the route.

3.113 Conditions of the kind proposed above have been accepted by merger regulators overseas. These conditions are simple and can, and will, be easily policed by entrants.

3.114 The Applicants' revised conditions are specifically tailored to meet the concerns expressed by the Commission and third parties. The condition whereby Freedom will fly only secondary routes (once an entrant commences services on the relevant city pair) and not operate on domestic New Zealand routes, are both designed to ensure that the Applicants do not use Freedom to create barriers to entry by targeting new entrants on the applicable routes (assuming this is possible, which the Applicants reject). These simple conditions are perfectly suited to achieve this end. The capacity ceiling ensures "Air New Zealand" and "Qantas" branded capacity is likewise constrained.

Conclusion – Barriers to Entry

Conclusions

The barriers to VBA entry/expansion are minimal and will not deter constraining VBA entry.

In particular, the ability of the Alliance to deploy additional capacity in response to VBA entry is severely curtailed by:

- **the Revenue Cannibalisation and Network Cannibalisation that Freedom deployment would inflict on Air New Zealand and Qantas – damaging each airline's overall profitability;**
- **the VBA entrant's low cost base; and**

THE LET TEST

Preliminary

- 3.115 The Commission accepts that potential competition can act as a constraint on a firm that might otherwise be able to exert market power.⁴⁹ The LET test assumes that the incumbent is seeking to exercise market power, either by raising price or reducing output or quality. This approach is consistent with case law, and also conventional economic and regulatory practice. However, the Draft Determination at times drifts into an analysis that assumes *current* market conditions are relevant rather than a market where the Applicants attempt to increase price, restrict capacity or decrease quality.
- 3.116 A clear example is the Commission's concern that NZ Express has already foreclosed some of the potential for a VBA to grow the market on entry. This assertion, which relies on the persistence of *current* market conditions for its validity, is clearly at odds with the opportunity an attempt by the Applicants to exercise market power and increase fares would create for the entrant.
- 3.117 Similarly, the comments by third parties about the likelihood of VBA entry are also guilty of assuming current market conditions and do not address the likelihood of constraining entry in circumstances where the Applicants seek to exercise market power by raising price or reducing capacity or quality.
- 3.118 In light of the above comments, and prior to applying the LET test, the Applicants wish to address some material, unexplained inconsistencies in Virgin Blue's (and to a lesser extent the Commission's) claims of greater likelihood, scale and timeliness of VBA entry in the Counterfactual than in the Factual, despite the presence of restrictions on Freedom, capacity ceilings, guaranteed access to facilities and higher prices in the Factual.
- 3.119 Virgin Blue and the Commission attempt to reconcile these inconsistencies by claiming that the deterrent effect of incumbent response is greater in the Factual. Central to this argument is the ability of the Alliance to deploy Air New Zealand subsidiary, Freedom, in response to VBA entry. Out of pure self interest, Virgin Blue demands a divestment of Freedom and guaranteed access to facilities in order for it to be a constraining competitor in the Factual. The basis for this claim is entirely inconsistent with its view that it intends to enter and will be a material constraint in the Counterfactual. In the Counterfactual, Virgin Blue will not be able to engineer guaranteed access to facilities and cannot lobby for a divestment of Freedom.
- 3.120 The argument that Virgin Blue's entry on New Zealand and Tasman routes in the Factual will be of a lesser extent than in the Counterfactual cannot be plausibly supported for the following reasons.

It is post-Authorisation market conditions that are relevant to assessing the extent of constraining entry

❖ **Virgin Blue has claimed there are difficulties in accessing the required facilities**

⁴⁹ Commerce Commission Practice Note 4

- **Factual:** Confirmed access to services via undertakings proffered to the ACCC and conditions proffered to the Commission.
- **Counterfactual:** No confirmed access to services.

❖ Incumbent response/Freedom

- **Factual:**
 - Freedom significantly constrained and its presence removed from key routes via undertakings proffered to the ACCC and conditions proffered to the Commission.
 - Capacity ceilings proffered.
 - Air New Zealand is in a considerably stronger financial position within the Alliance and, quite apart from the conditions, the detrimental cannibalisation effects will outweigh the benefits of increased Freedom revenue – Air New Zealand's survival will not be secured by a deployment of Freedom to capture the VBA space.
- **Counterfactual:**
 - Freedom available to operate unrestricted on all VBA Routes.
 - The growth of the strongest FSA in the region in its core markets coupled with Virgin Blue's entry from a lower cost position, would cause Air New Zealand significant concern, particularly in light of the fate of Ansett, which was "squeezed" between the same airlines in Australia.
 - In response to the prospects of a "squeeze", Air New Zealand would be likely to **[CONFIDENTIAL]** in a final struggle for survival.

❖ Fare levels

- **Factual:** Fares are 4.7% and 4.5% higher (as modelled by NECG) and 56% and 48% higher (as modelled by the Commission's economist) on Domestic New Zealand and Tasman routes respectively than in the Counterfactual – strongly encouraging new entry.
- **Counterfactual:** Fares are 4.7% and 4.5% lower (as modelled by NECG) and 56% and 48% lower (as modelled by the Commission's economist) on New Zealand and Tasman VBA Routes respectively when measured against the Factual – making entry less attractive.

Likely

3.121 Virgin Blue has unequivocally declared its intention to enter on New Zealand and Tasman VBA Routes, with or without the proposed Alliance. In the Factual Virgin Blue says it will provide constraining and timely entry if it is given certain advantages. The conditions offered to the Commission by the Applicants resolve the issues raised by Virgin Blue in another way. Continuing demands by Virgin Blue are merely examples of it, quite understandably, trying to "milk" the Applicants

for every market advantage it can achieve. Virgin Blue's changing, self-interested and unsound arguments are evidence of that motive.

3.122 Schedule 1 sets out some examples of statements by Virgin Blue confirming its intention to operate Tasman and domestic New Zealand services if the Alliance proceeds. For example, Brett Godfrey stated in the Dominion Post on 13 February 2003 that:

"The only matter that we have not resolved is determining when to enter and, more importantly, whether we should simply "cherry pick" a few safe routes or offer the entire region access to the same sustainable low fares and great service that we have built our reputation on throughout Australia."

3.123 The ACCC also noted that Virgin Blue has stated "unequivocally" to the ACCC that it will enter on Tasman routes (the only short-haul routes relevant to the ACCC's assessment).⁵⁰

3.124 In respect of the Tasman, Virgin Blue formally confirmed its intention to enter on 12 June 2003 when it applied to the IASC for rights to operate "unlimited capacity" to New Zealand effective from October 2003. Virgin Blue's application to the IASC states that:

"Virgin Blue has dedicated significant resources and personnel to complete all milestones on set deadlines so that the flights could be launched as planned. The international operations form a very important part of Virgin Blue expansion and as such has the full support of Board and Management to make it a success."

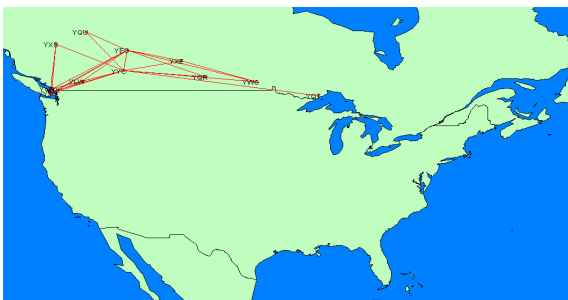
Virgin Blue's international operations have the "full support" of its Management and Board

Extent

3.125 Worldwide, VBAs have proven their ability to enter and expand to a significant size in a variety of markets. As Figure 9 graphically illustrates, WestJet, despite the presence of Air Canada and its wholly owned VBAs Tango and Zip, has enjoyed significant growth in Canada to the clear financial detriment of Air Canada, which has recently filed for bankruptcy protection.

Figure 9

June 2000 24 Routes

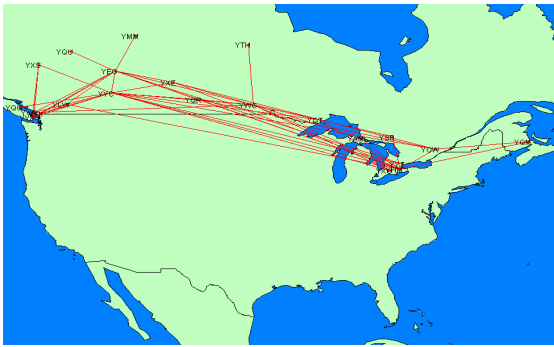


June 2001 – 35 Routes

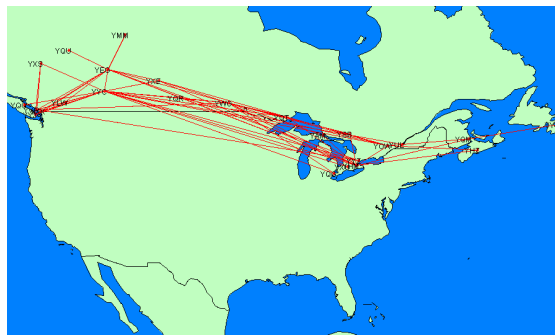


⁵⁰ ACCC Draft Determination, para 9.94.

June 2002 – 51 Routes



June 2003 – 58 Routes

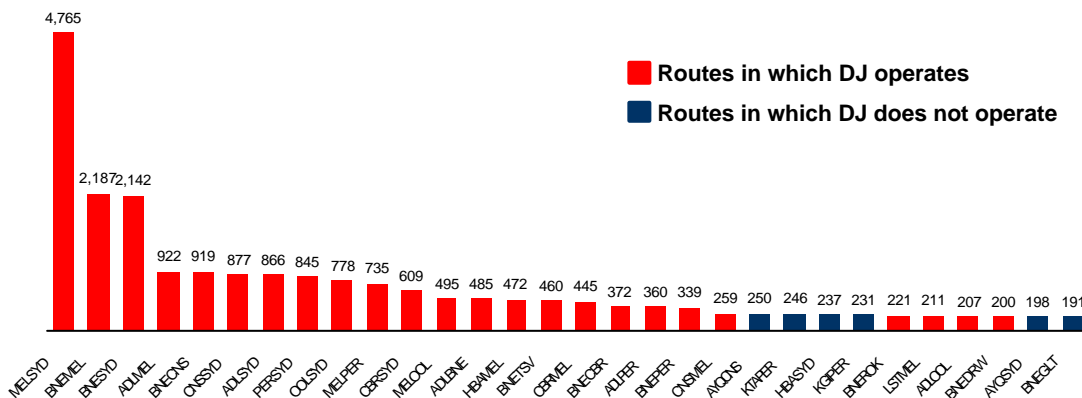


3.126 The growth of Virgin Blue's Australian operations has also been significant. Virgin Blue has grown to an airline that, in terms of seats, is 75% the size of Air New Zealand (including Freedom), which has existed for over 60 years.⁵¹ It has achieved a significant share of high yielding business traffic. For example Amanda Bolger, a spokeswoman for Virgin Blue, is quoted as saying that "business travellers now form the largest group of customers on Virgin Blue, ahead of leisure travellers and people travelling to visit friends and family."⁵²

3.127 In under 3 years, Virgin Blue has entered 24 of the 30 largest domestic Australian sectors (see Figure 10) and has achieved a market share in excess of 27%, with a claimed 10% increase in market share in the last 12 months alone.

Figure 10

Largest Routes in Australia by Passenger Volume
Passengers per Day Each Way for November 2002



Source: OAG, NZ Market Size

51 Given Air New Zealand's long-haul routes, on an ASK basis, Virgin Blue is estimated to be a little over 40% the size of Air New Zealand.

52 In the 13 June edition of The Australian (in its Business Surveys Series: Business Travel), at page 9.

3.128 Figure 11 illustrates the rapid expansion of Virgin Blue's route structure. Its route coverage has expanded even further since this analysis as a result of its relationship with Australian regional carrier, Regional Express (REX), announced on 10 June.

Figure 11

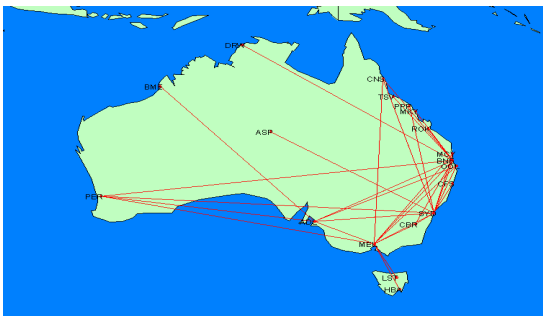
June 2001 – 4 Routes



June 2002 – 17 Routes

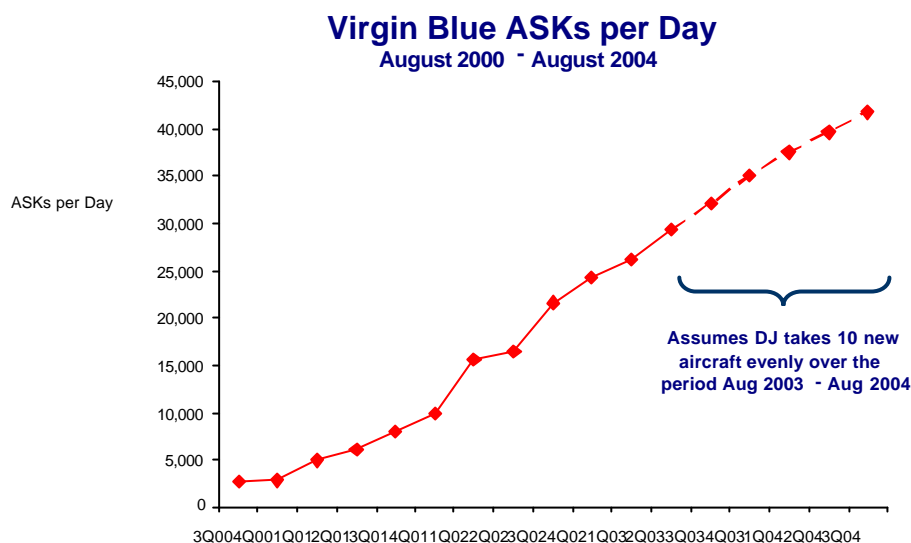


June 2003 – 27 Routes



3.129 In addition to its significant geographic expansion, the number of seats offered by Virgin Blue has also grown significantly.

Figure 12



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

3.130 In its May 9 submission to the ACCC, Virgin Blue described its Australian growth in the following terms:

“In the last year we have grown to nearly a third of the domestic jet market in Australia. Along with Virgin Group, we are now backed by a well-established major shareholder in Patrick Corporation. We are taking on hundreds of corporate accounts and our network has now gone national. Access to the former Ansett terminals has allowed us to implement a nearly three-fold growth plan in under a year. We are a very different carrier than what we used to be. Our presence in Australia today is ensuring far greater competition and consumer benefit than prevailed under the old FSA duopoly.”

3.131 Virgin Blue currently operates 29 B737s (each ideally suited to the VBA Routes) and is taking delivery of a further 10 B737s in the year commencing August 2003. It has options to acquire a further 40 B737 aircraft.

3.132 The 17 June edition of the Australian Financial Review reports that Brett Godfrey has said that 6 of Virgin Blue’s 10 new aircraft are ear-marked for international services. Indeed, Virgin Blue has requested rights to operate 1260 seats per week to Fiji and 720 per week to Vanuatu – which would account for 1 B737. That leaves at least 5 aircraft available to operate on Tasman and domestic New Zealand routes. Its options for a further 40 give it significant scope to expand even further. Virgin Blue’s request to the IASC seeks “unlimited” capacity to New Zealand from October 2003.

3.133 In terms of services outside Australia, Virgin Blue has confirmed on several occasions it will “cherry pick” the most profitable of the VBA Routes if the Alliance proceeds. Given the concentration of traffic on routes between Auckland,

Wellington and Christchurch, and those cities and Brisbane, Sydney and Melbourne (the last three of which it already services), Virgin Blue could “cherry pick” 54% and 89.6% of the domestic New Zealand and Tasman routes respectively simply by establishing a presence only at Auckland, Wellington and Christchurch airports. In terms of frequency, once Virgin Blue has commenced operations on a particular route there is only minimal cost to it increasing frequency in response to demand.

3.134 The Commission’s preliminary view that Virgin Blue will enter in the Counterfactual but not the Factual is not only counter-intuitive (the Factual has higher prices, guaranteed access to facilities, less incentive to deploy Freedom in response to VBA entry and capacity ceilings), it is also inconsistent with:

- the example of WestJet, AirTran and jetBlue’s rapid growth in the face of competition from an FSA’s VBA subsidiaries;
- the growth of Virgin Blue in domestic Australia;
- Virgin Blue’s stated intention that it will enter the Tasman and domestic New Zealand with or without the proposed alliance.

Timeliness

3.135 While it is difficult to predict with absolute certainty when Virgin Blue will enter the VBA Routes, the Applicants believe that Virgin Blue will enter on both Tasman and New Zealand VBA Routes in the Factual within 12 months. Ultimately, the timing of Virgin Blue’s entry will be governed by its incentive to enter. If prices increase (i.e. as forecast by the Commission and to a far lesser extent by NECG in the Factual), Virgin Blue’s entry is likely to be sooner rather than later.

3.136 First, on 20 June 2003, David Huttner was quoted as saying Virgin could start flying here relatively soon – “without planning our life around what Air New Zealand and Qantas do.”⁵³

3.137 Secondly, as stated above, Virgin Blue has announced publicly that it intends to enter the Tasman and New Zealand domestic routes in the Counterfactual, while under the Alliance, Virgin Blue will have the opportunity to take advantage of the conditions proffered by the Applicants to the Commission and the ACCC. As noted above, Virgin Blue has formally applied for the right to operate unlimited Tasman capacity from October 2003.

3.138 Thirdly, Virgin Blue has committed to acquiring 10 new B737 aircraft in the year beginning August 2003. Accordingly, Virgin Blue has the capacity to expand onto the VBA Routes immediately. At Virgin Blue’s 2003 results announcement, Virgin Blue’s CEO Brett Godfrey stated “[w]e do believe we’ll have our first international flight by Christmas”.⁵⁴

3.139 Fourthly, on 11 February 2003, Virgin Blue approached Air New Zealand seeking ground handling services for both international and domestic services. Air New Zealand responded by letter dated 3 March 2003, and this letter was forwarded to the Commission on 27 March 2003.

⁵³ National Business Review, 20 June page 9

⁵⁴ Virgin Blue press conference at Adelaide Airport, 15 May 2003 at 10am, Rehome transcript.

3.140 Finally, Virgin Blue's entry and expansion in Australia has demonstrated its ability, and willingness, to enter routes that are served by other carriers and to expand quickly. Virgin Blue has built a strong financial and operational base in Australia and faces no material barriers to expansion from its Australian base on to the VBA Routes, which gives it the flexibility to make entry and expansion decisions to suit its own commercial timetable when opportunities present themselves. From that base it can expand at will.

IMPACT OF VBA ENTRY

Introduction

3.141 This section examines the impact that VBA entry has upon markets previously serviced by FSAs and in some cases serviced also by an existing VBA. The analysis in this section confirms that (in addition to forcing a scaling back of incumbent capacity, as set out above) VBA entry has two major impacts:

- fare reductions that disproportionately exceed the VBA entrant's market share; and
- demand stimulation.

3.142 This section examines both impacts by reference to APG's analysis of a large number of instances of VBA entry. More detailed evidence of the impact of entry by AirTran, Southwest and easyJet is also provided, based on routes four quarters prior, and four quarters post, entry. As discussed in paragraph 3.16, each of these VBAs adopts a slightly different business model. The examination of these individual VBAs illustrates that fare decreases and demand stimulation occur irrespective of the precise "VBA" business model adopted.

3.143 This section also examines, again drawing on APG's analysis, instances of VBA entry that are particularly relevant to the Commission's analysis of the VBA Routes, namely:

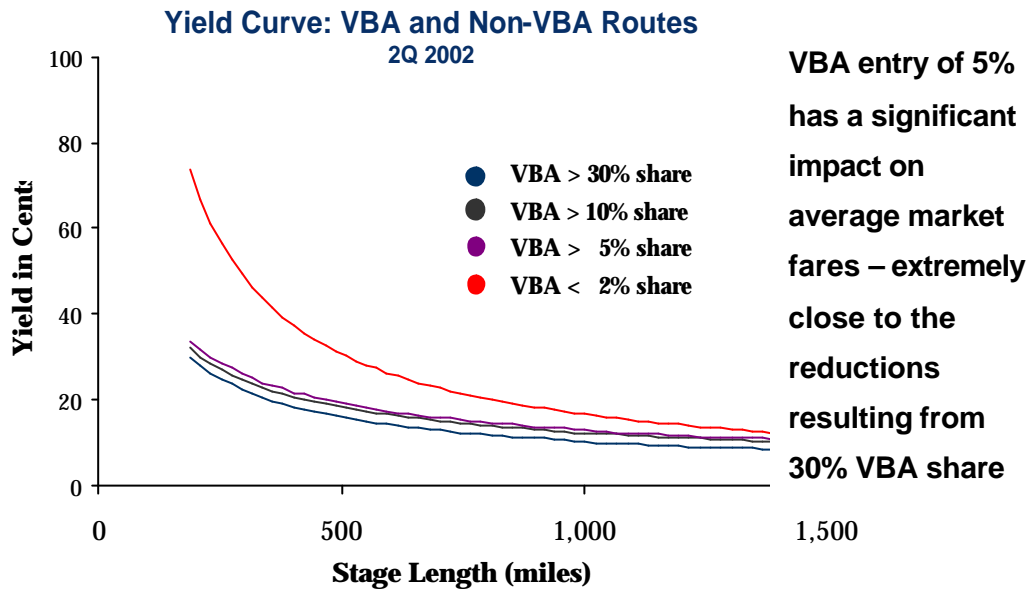
- the successful entry of jetBlue, which illustrates that VBA entry can further reduce fares and stimulate additional demand on routes that are already experiencing downward pressure on fares; and
- the successful entry into domestic Australia of Virgin Blue, the most likely entrant onto the VBA routes.

International Experience

Fares

3.144 Figure 13 below shows the fare (yield) impacts of a VBA presence where the VBA accounts for 30%, 10% and 5% of the route respectively. The graph is based on the largest 100 U.S. routes (by revenue) where jetBlue, AirTran or Southwest are present. The red line represents the average fare on those routes where a VBA is not present (or has less than a 2% share).

Figure 13



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

3.145 The purple line represents average yield on routes where a VBA achieves 5-10% share, the green line where the VBA achieves a 10-30% or greater share and the blue line where the VBA achieves a share of 30% or greater.

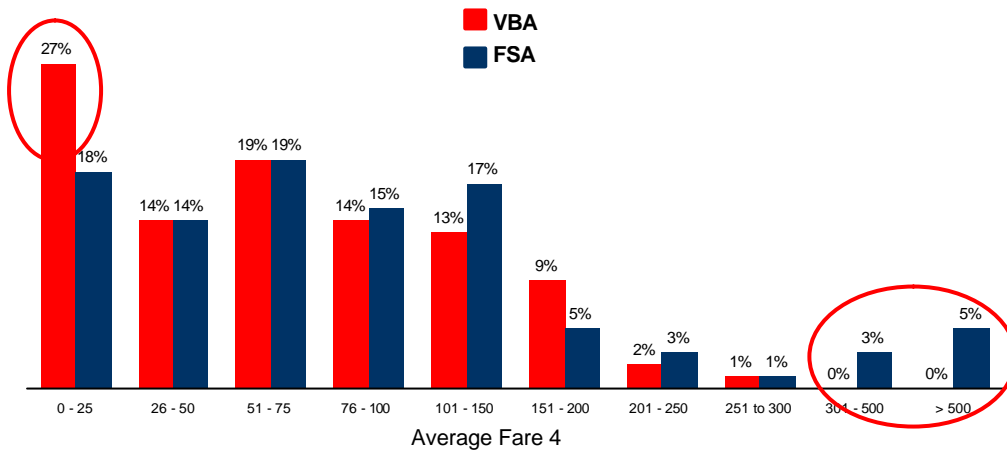
3.146 As Figure 13 illustrates, the fare decreases when the entrant achieves a 5% share are extremely close to the fare decreases resulting from a 30% VBA share. The reduction in fares results from:

- the low fares offered by the VBA on entry; and
- the competing fares offered by the incumbent FSA, which is forced to match the VBA's low fares to the extent its cost base permits.

3.147 Figure 14 below shows the percentage of total seats sold in various fare classes by VBAs and FSAs in the 44 routes entered by jetBlue, AirTran and Southwest in the second quarter of 2001.

Figure 14

Fare Distribution- VBA vs FSA in Routes Entered by VBA
2nd Quarter 2002; all fares one way; \$US



Source: OAG, US DOT, sample of all 44 routes entered by B6, FL and WN in 2001 Excludes taxes.

3.148 As illustrated, FSAs are forced to match VBA fares following VBA entry. The two exceptions (circled) are:

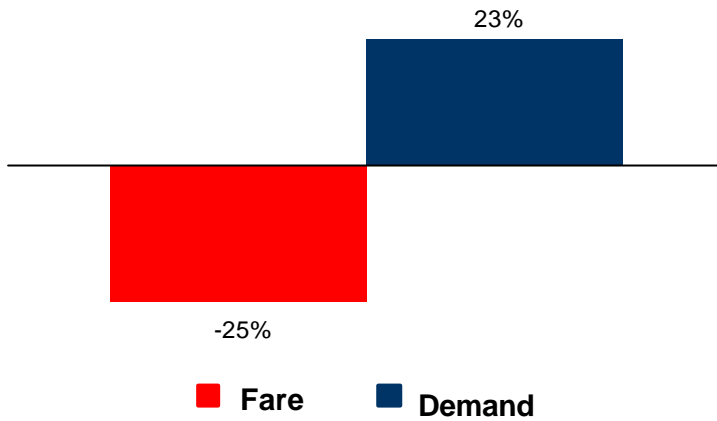
- the small percentage of high priced fares offered only by FSAs, to reflect the cost of providing particular amenities sought by a particular group or class of passengers, e.g. business class seats; and
- the inability of FSAs to offer as high a proportion of seats in the lowest fare class as VBAs, due to their higher cost structure.

Demand Stimulation

3.149 As illustrated in Figure 2 above (reproduced as Figure 15 below) the low fares offered by VBA entrants stimulates considerable additional demand. It is important to note that the demand increase of 23% is more than offset by the fare decrease of 25%.

Figure 15

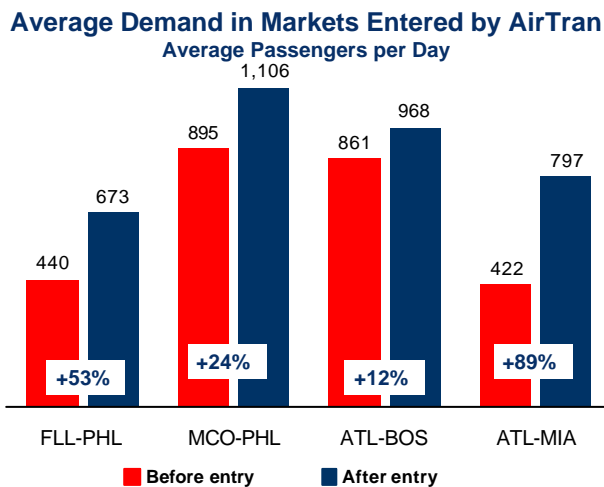
Percent Change in Average Fare and Demand Following VBA entry



Source: OAG, US DOT, sample of all 44 routes entered by B6, FL, and WN in 2001, APG analysis based on 2Q 2002 vs 2Q 2000; metro areas combined

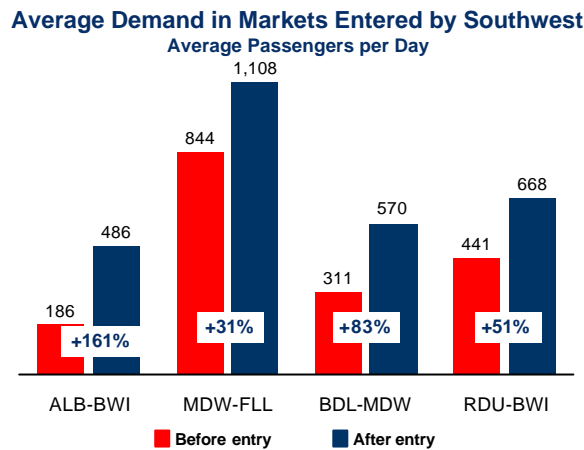
3.150 The following figures provide a more detailed illustration of demand stimulation resulting from the low fares that occurred upon entry by AirTran and Southwest. In each case, the resulting fare reductions stimulated additional demand. (A discussion of the stimulation possible on routes already experiencing low fares is provided from paragraph 3.151 below.)

Figure 16



Source: OAG, APG analysis based on 4 quarters prior as compared to 4 quarters after VBA entry

Figure 17



Source: OAG, APG analysis based on 4 quarters prior as compared to 4 quarters after VBA entry; metro areas combined

Conclusion:

- **Where a VBA enters a market, average fares decrease and demand is stimulated.**

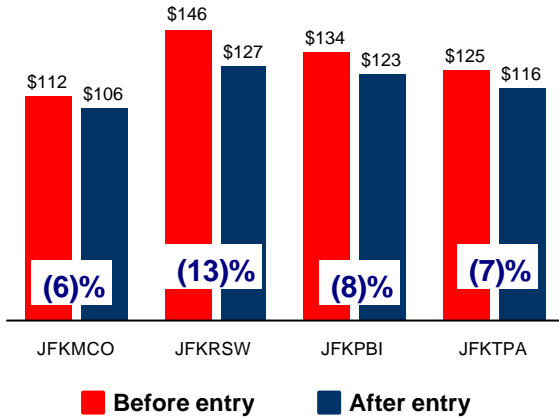
VBA entry specifically relevant to the VBA Routes

Entry onto routes with existing downward pressure on fares – analysis of jetBlue entry

- 3.151 In addition to the increased scope for demand stimulation that would occur if fares on the VBA Routes increased as predicted by the Commission, the entry of jetBlue onto certain low-fare U.S. routes illustrates that VBA entry on routes already experiencing reduced fares can nevertheless lead to even lower fares and additional demand stimulation.
- 3.152 Prior to jetBlue’s entry, New York to Florida routes had already experienced a decrease in fares due to the arrival of US Airways’ VBA subsidiary MetroJet, and the presence of Southwest at Long Island, New York. In order to assess the impacts of jetBlue’s entry onto routes with similar characteristics to the VBA Routes, APG analysed New York - Florida routes for the 2000-2002 period.
- 3.153 Despite existing downward pressure on fares, the fares post jetBlue’s entry were significantly lower than prior to its entry (Figure 18). These routes are very similar in stage length to the Tasman VBA routes.

Figure 18

Average Fare on Florida Routes Entered by jetBlue

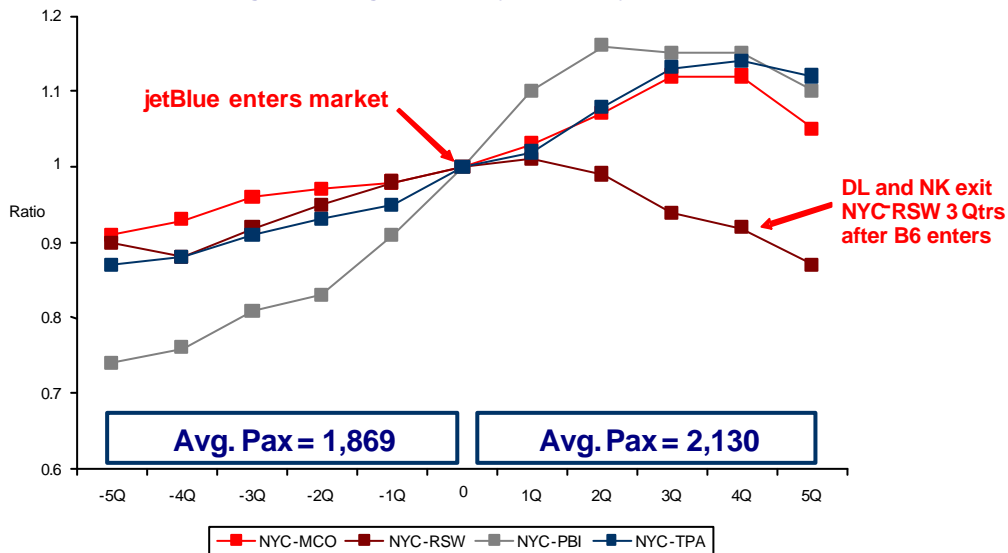


Source: OAG, US DOT, APG analysis based on 4 quarters prior as compared to 4 quarters after VBA entry; metro areas combined

3.154 The fare reductions stimulated significant additional demand of, on average, 14%. (Demand at the time of jetBlue’s entry is indexed to 1.)

Figure 19

Demand stimulation from jetBlue entry
(Average Passengers per Day Each Way NYC to Florida)



Source: US DOT, APG analysis based on ratio of passengers before and after VBA entry to the passengers at time of entry, assuming ratio of passengers at time of entry is 1

Virgin Blue's entry and expansion in domestic Australia

- 3.155 The Commission accepts that the most likely entrant is Virgin Blue.⁵⁵ Accordingly, it is relevant to assess the impact of Virgin Blue's entry and subsequent expansion in domestic Australia.
- 3.156 The growth of Virgin Blue's route coverage and capacity are graphically set out in Figure 11 and Figure 12 above as part of the discussion of the likely scale of VBA entry.
- 3.157 The fare and demand impacts resulting from Virgin Blue's entry into domestic Australia are consistent with the wider impacts of VBA entry evidenced above. As Figure 20 below illustrates, based on the January-June period pre and post Virgin Blue entry, a significant reduction in fares and stimulation of traffic has occurred.

Figure 20

[

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]

- 3.158 The graph on the left hand side indexes the pre-entry average fare to 100. It shows that, for example, fares fell to **[CONFIDENTIAL]** % of their pre-entry level on the Adelaide-Melbourne route, to **[CONFIDENTIAL]** % on the Adelaide-Sydney route etc. The graph on the right hand side illustrates demand stimulation (by reference to PDEW volumes) following Virgin Blue's entry. Given the similarity of the VBA Routes to other routes entered by VBAs, Virgin Blue's entry on Tasman and domestic New Zealand routes is forecast to have a significant impact on fares. This outcome is not surprising: it is entirely consistent with the impact of VBA entry elsewhere.

⁵⁵ Draft Determination, paragraph 300.

CONCLUSION

- 3.159 This Chapter has provided evidence that constraining VBA entry will occur on the VBA Routes in a timely fashion. The assertions are supported by evidence that is applicable to the Tasman and domestic New Zealand routes.
- 3.160 The VBA model is now well established. The Applicants have shown that the VBA model has successfully been applied to routes with similar characteristics to the Tasman and domestic New Zealand routes.
- 3.161 Virgin Blue is one of the most profitable airlines in the world. It has committed to significant numbers of additional aircraft. Its largest class of customers are what it terms “business” passengers. It is well capitalised and, for a long period of time, has expressed an intention to enter the Tasman and domestic New Zealand with or without the Alliance. Its recent application to the IASC for the right to add “unlimited capacity” on routes to New Zealand from October 2003 is consistent with this stated intention. In that application, Virgin Blue declared that “[t]he international operations form a very important part of Virgin Blue expansion and as such has the full support of Board and Management to make it a success.”
- 3.162 Further, the Applicants have offered to restrict the operations of Freedom in the event Virgin Blue, or any other entrant, commences operations. The Applicants have offered capacity ceilings for 18 months following an announcement by an entrant of an intention to enter. In response to the submission from Virgin Blue and the Commission’s concerns regarding access to facilities at peak times the Applicants have proffered enforceable conditions that will guarantee access to facilities. All of these conditions are simple and easy to police.
- 3.163 The evidence supports the Applicants’ submission that VBA entry will occur within a 12 month period and that the Applicants will be constrained by that entry, and by the ability of a VBA entrant such as Virgin Blue to expand even further.

Schedule A: Virgin Blue Media Statements

Source/Date	Key Quotes/Major Events
<p>David Huttner, Virgin Blue <i>National Business Review</i></p> <p>20 June 2003</p>	<p>“We have started negotiations with Auckland and Christchurch airports, which lease gates to carriers, and they have been very open with us. And we are prepared to build our own terminals although that may take two years”.</p> <p>Mr Huttner said Virgin could start flying here relatively soon – “without planning our life around what Air New Zealand and Qantas do.”</p>
<p>Brett Godfrey, Virgin Blue <i>Dominion Post</i></p> <p>13 February 2003</p>	<p>The only matter that we have not resolved is determining when to enter and, more importantly, whether we should simply "cherry pick" a few safe routes or offer the entire region access to the same sustainable low fares and great service that we have built our reputation on throughout Australia. If, on the other hand, this merger is simply a strategy to barricade the New Zealand travelling public from getting access to a sustainable low-fare option that exists in Australia and much of the rest of industrialised world, then Air New Zealand and Qantas will be unlikely to concede these two points. If that is the case, the regulators have no choice but to reject their application.</p>
<p>Virgin Blue Submission to the Commission</p> <p>12 February 2003</p>	<p>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.</p>
<p>David Huttner, Virgin Blue <i>The Dominion Post</i></p> <p>12 November 2002</p>	<p>Mr Huttner said that Virgin Blue was more likely to fly to another Pacific destination first if negotiations were not completed soon, and there was no clear indication from consumer watchdogs on how competition would be preserved. “In the present environment we are reluctant to go to New Zealand till we get a little more clarity. That doesn’t mean that we don’t think that we will eventually fly to New Zealand, it just means that we are going to wait and see how the deal is structured and how it works.</p> <p>You don’t want to get into a market where the whole environment may change two or three months after you enter”.</p>

Source/Date	Key Quotes/Major Events
<p>David Huttner, Virgin Blue <i>The New Zealand Herald</i> 9 August 2002</p>	<p>Virgin Blue still vows to fly in the New Zealand market although it says travellers will be stung by Qantas/Air New Zealand share tie up. Huttner said his airline had never taken its eye off this side of the Tasman and fully intends to fly here within a year, whether or not Qantas gains an Air New Zealand shareholding. He stated that Virgin would be unable to service more than a handful of destinations at first however, and in the meantime, passengers flying elsewhere would be 'belted' by Qantas and Air New Zealand with high fares to bankroll all attempts to shut out Virgin Blue, in the future.</p>
<p>David Huttner <i>The Dominion Post</i> 23 July 2002</p>	<p>Virgin Blue's head of commercial operations said he could not see how consumers would benefit if Qantas was allowed to buy part of Air New Zealand. He stated that Air New Zealand was by no means a failing firm, and that the deal would reduce competition and could result in higher prices. He can see that if the Qantas Air New Zealand deal was allowed it would make it easier for Virgin Blue to enter the market, but the reality was that it was not good for competition. "Allowing the financial might of Qantas to drive Air New Zealand against Virgin was not in anyone's best interests".</p>
<p>David Huttner www.xtramsn.com/business IRN Limited 22 July 2002</p>	<ul style="list-style-type: none"> • David Huttner states that "he is not convinced there will be any consumer benefits from an arrangement between the two trans-Tasman operators..." • Mr Huttner felt that there would be "a certain amount of collaboration between Qantas and Air New Zealand, that Virgin Airlines would not be able to compete with, if the deal goes through". • He also states that Virgin Blue is definitely planning to set up in New Zealand for domestic and trans-Tasman flights.
<p>Virgin Blue Chief Executive Brett Godfrey <i>News articles from Sophie Rigby</i> 1 June 2002</p>	<p>Virgin Blue CEO said that the discount carrier remained committed to expanding to New Zealand, but competition would get tougher if Qantas bought a minority stake in Air New Zealand. "It is going to make it tough from our point of view competing ... but we will still be getting into New Zealand."</p>
<p>David Huttner, Virgin Blue <i>1ZB News Report</i> 31 May 2002</p>	<p>Commercial head of Virgin Blue David Huttner, says Virgin won't shy away if an alliance is formed between Air New Zealand and Qantas. "Monopolies, if they are formed are almost a source of encouragement for Virgin Blue to challenge them. It is part of the nature of Virgin not to let monopolies price in a way that is detrimental to the public".</p>

Appendix I: Centre for Asia Pacific Aviation Article

“Virgin Blue – The Luckiest Little Airlines Alive? Where to next?”

Appendix II: VBA Routes/Hubs

The following analysis confirms that none of the VBA Routes are “fortress hubs” for the purposes of interpreting the evidence of the incumbent response to VBA entry elsewhere.

There are two key components to “Fortress hubs”:

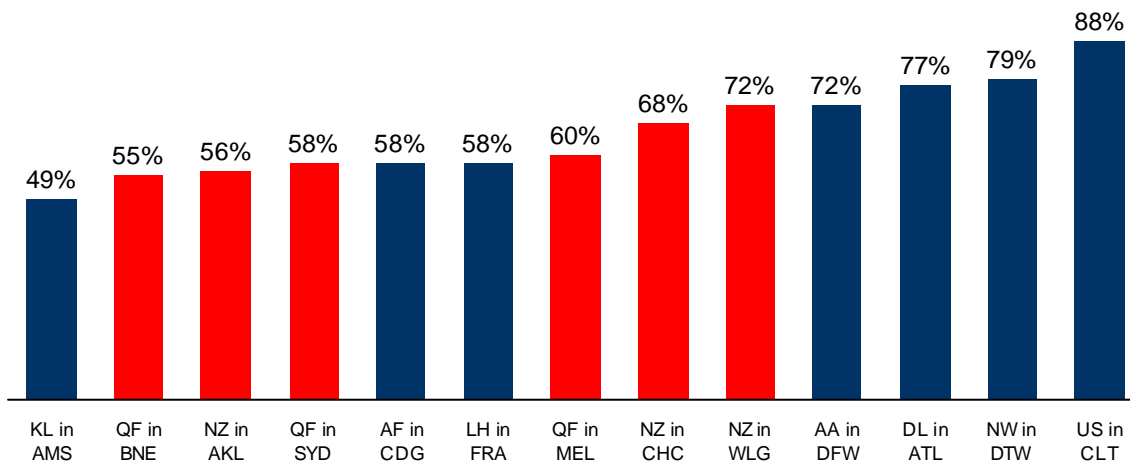
- % of total capacity controlled at Hub City; and
- the level of connections at connecting hub.

Although Qantas and Air New Zealand have a large share of total capacity in their main cities (Figure 21), they do not provide the requisite connecting opportunities to qualify as and fortress hubs“ (Figure 22).

Figure 21

Capacity Controlled by Incumbent in Hub Cities (%)

Seats per Week for May 2003

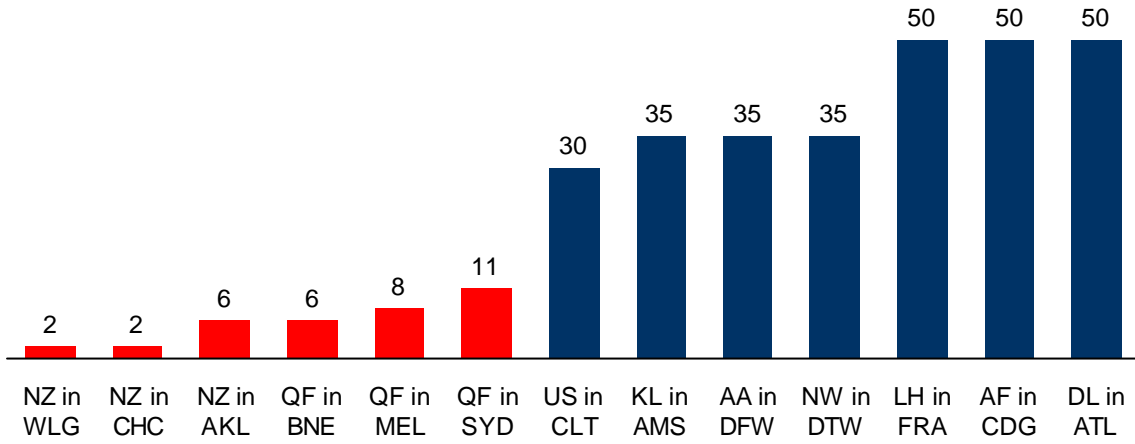


Source: OAG

Figure 22

Number of Average Jet Departures Connecting to Arrival

Average Flights per Bank for May 2003; Aircraft with Seats > 90



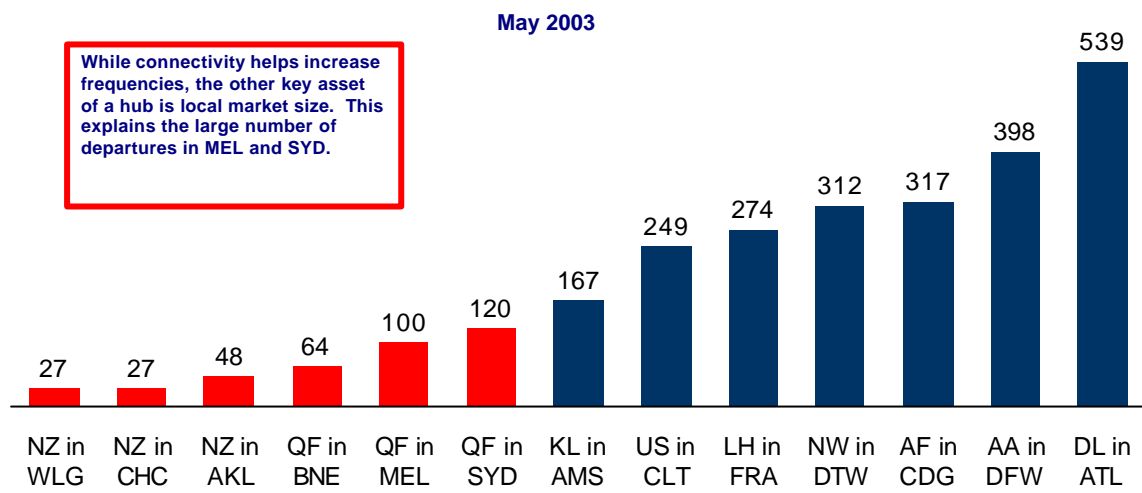
Source: OAG, assumes in hubs with rolling banks that flights in a given hour will connect in the next hour
Connection assumed within 90 minutes

This lack of connecting opportunities leads to a high reliance on local traffic (Figure 23) and the inability to offer a large number of frequencies (Figure 24).

Figure 23 [CONFIDENTIAL]

Figure 24

Number of Daily Departures

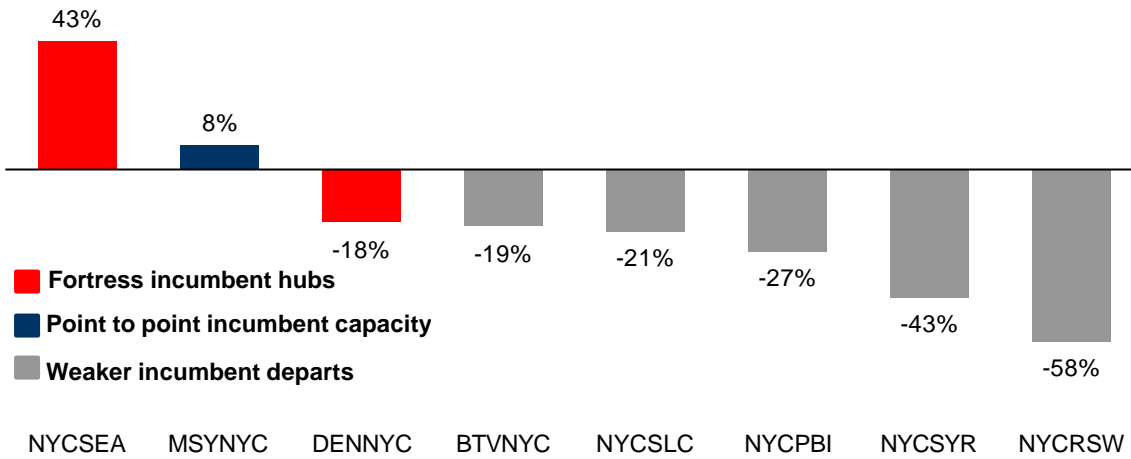


Source: OAG

Appendix III: Change in Incumbent Capacity

Figure 25

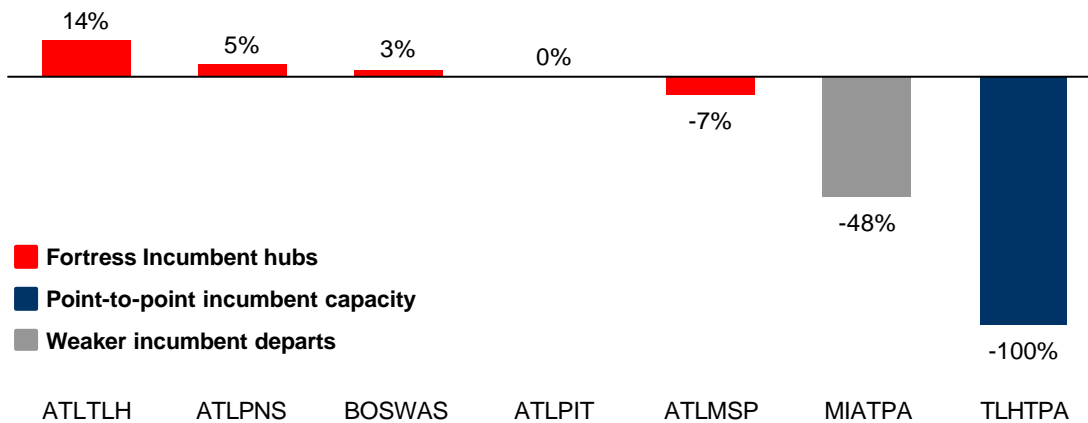
Incumbent Change in Total Seats Three Years Following jetBlue (B6) Entry
All Markets B6 entered in 2001



Source: OAG

Figure 26

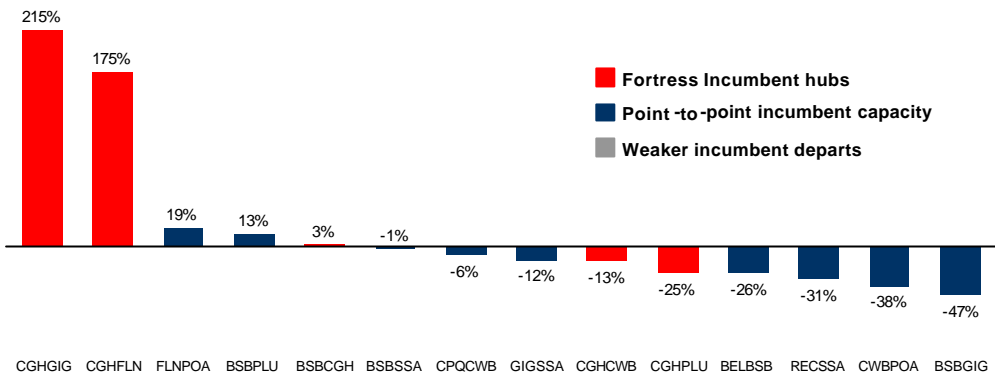
Incumbent Change in Total Seats Three Years Following Air Trans (FL) Entry
All Markets FL entered in 2001



Source: OAG

Figure 27

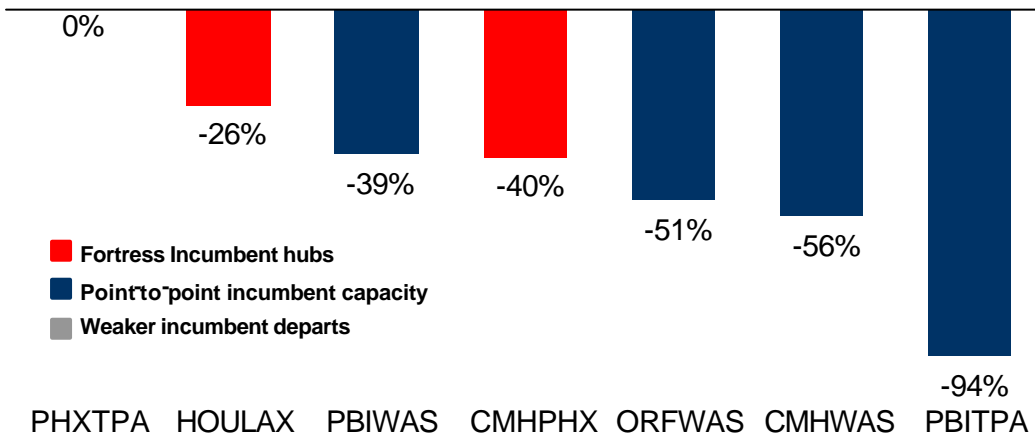
Incumbent Change in Total Seats Three Years Following GoI (G3) Entry
 All Routes G3 entered in 2001



Source: OAG

Figure 28

Incumbent Change in Total Seats Three Years Following Southwest Entry
 All Routes WN entered in 2001



Source: OAG