# Chapter 7

## Market Definition and Competitive Effects

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www.necg.com.au contactus@necg.com.au
Canberra ○ Sydney ○ Brisbane
NETWORK ECONOMICS CONSULTING GROUP PTY LTD
ACN 006 819 969 ABN 72 006 819 969

## Contents

# 1 Air Passenger Service Markets

## 1.1 Market Definition

1 In the NECG Report, we stated that the precise delineation of the relevant markets did not impact on our overall analysis of competitive effects. However, there are two aspects of the Commission's market definition analysis that are worth further consideration because they do in fact appear to influence Commission's views on the competitive effects of the Alliance, and more generally, its assessment of the way airline markets work:

- First, the Commission's analysis of customer markets, perhaps most importantly, its characterisation of business customers; and
- Second, the Commission's approach to evaluating geographic markets.

### 1.1.1 Customer markets

2 The Commission concludes that there is a single customer market.[1] We agree with the Commission's conclusion. However, we believe the Commission errs in its underlying analysis, particularly in relation to the following: (1) the relevant economic test for substitution, (2) the characterisation of business travellers with respect to their sensitivities to price and frequency, and (3) the scope for supply side substitution.

3 Turning to the first issue, the Commission does not believe that demand side substitution brings all customers into a single customer market, basing its view on a number of differences between business and VFR/leisure passengers (paragraphs 162 to 164). To define a single customer market, it is not necessary for each and every business passenger to switch to leisure/VFR 'products' in response to a SSNIP. Rather, all that is

[1] The Commission concludes that, despite differentiation between business and VFR/leisure passengers, 'it is appropriate to consider them as belonging to one market for the purposes of considering the Applications' (paragraph 169).

required is a sufficient quantum of substitution to defeat the SSNIP.[2] In this respect, the Commission does not appear to dispute NECG's critical loss analysis:

> The NECG analysis demonstrated that, even if there are some customers who are not willing to substitute fare types, the cross-section of customers who are willing to substitute is significant enough to prevent a price increase by a hypothetical monopolist. (Paragraph 150)

4 If the Commission does not dispute NECG's critical loss analysis, then the Commission should have concluded that demand side substitution alone brings all customers into a single product/customer market.

5 With respect to the second issue, which is the Commission's characterisation of business travellers, we believe the evidence indicates that business travellers are sensitive to price and place considerable importance on frequency and schedules:

- *Price sensitivity*. As noted below, a significant fraction of Virgin Blue's revenues are from business travellers, indicating significant switching by business travellers in response to lower fares. This is consistent with the Commission's observation that 'markets have changed, with business travel having become more fare … elastic' (paragraph 142). It is also consistent with a further observation that '… business travellers appear to becoming more price sensitive, particularly on short hauls as in New Zealand' (paragraph 375).

- *Importance of frequency and schedules*. The Commission asserts that frequency is becoming less important for business travellers (paragraph 142). However, the evidence is that business travellers are sensitive to frequency and schedules. Virgin Blue has constantly emphasised frequency in discussing its targeting of and marketing to business travellers.[3] The Commission's assertion is also inconsistent

2 This seems consistent with the Commission's discussion in its own merger guidelines (p. 16).

3 See, for instance, Virgin Blue News Releases, 2000, Virgin Blue Offers More Flights For Growing Business Market, 30 November, http://www.virginblue.com.au/news/nov2000.html; Virgin Blue News Room, 2002, Virgin Blue Launches Non Stop Sydney-Perth Flights $199, 15 May,

with other statements it makes. For instance, the Commission notes that 'frequency is the main consideration for an entrant wishing to appeal to business travellers' (paragraph 369). Recent studies in the academic literature also highlight the importance of frequency.[4]

6 Turning to the third issue, the Commission lists several factors outlined in the NECG Report that were used to demonstrate the scope for supply side substitution between customer types (see paragraph 166). The Commission does not appear to object to most of these factors, which makes it questionable as to why it does not consider supply side substitution to bring all customers into a single market. However, it then relies on ACCC Determination A30202 to assert that, 'The high proportion of business passengers travelling under corporate contracts and within loyalty programmes also tends to operate against supply-side substitutability' (paragraph 168).

7 It is open to question as to whether this is more an issue relevant to demand side substitution rather than supply side substitution. Regardless, the evidence demonstrates that the Commission need not be concerned over the impact of corporate contracts, since this has not been a problem for the most likely entrant on the routes in question. In particular, Virgin Blue's ability to accumulate corporate customers is noted in a recent article:[5]

> About 40 per cent of Virgin's revenues stem from the corporate market. In 2002, Virgin had 167 corporate clients, but Mr Godfrey said the number "was substantially" more than that now.

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http://www.virginblue.com.au/news/may2002.html; and Virgin Blue, 2001, Kick A Goal Between Melbourne and Adelaide, March, http://www.virginblue.com.au/news/mar2001.html.

4 See for example Y. Suzuki et al "Airline Market Share and Customer Service Quality" Transportation Research Part A 35 (2001) 773.

5 *The Sydney Morning Herald*, 2003, Air NZ unwilling to forsake its Freedom to Qantas, Mark Todd, 14 April, p. 35, http://www.smh.com.au/articles/2003/04/13/1050172475933.html.

8 Another recent article reports:[6]

> "Generally, there are three groups of travellers," says Virgin head of communications David Huttner. "There are tourists, people travelling for a specific social purpose such as to visit relatives, and people travelling for business. For us, business travellers make up the largest category. When we started, it was mainly people from smaller firms, but now we have people from every type and size of company."

9 Indeed, a recent report in the Australian Financial Review cites Virgin Blue as claiming that with 27 per cent or so of the total market, it is flying some 26 per cent of trips generated by Australia's top 500 customers. This would hardly be the case if corporate contracts and loyalty points were material obstacles to securing the custom of business travellers.

10 To summarise our discussion on customer markets, we believe a consideration of the appropriate economic tests for defining customer markets, as well as the relevant evidence, indicates the existence of a single customer market.

### 1.1.2 Geographic markets

11 The NECG Report presented evidence that we believe indicated the relevant market is the Australia-New Zealand market, since this best captures commercial reality and the ease with which airlines can expand once they have established themselves in the region. The Commission does not agree that there is a single market. In response, we merely note that the Commission itself observes:

> The Commission notes that possible entrants would see New Zealand and Australia as one market and would be unlikely to enter New Zealand without first also entering Australia and the Tasman. (Paragraph 374)

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6 *The Australian*, 2003, Business trades style for value, Derek Parker, February 28, http://www.theaustralian.news.com.au/common/story_page/0,5744,6013601%255E25579,00.html. See also *The Australian*, 2003, Cheaper tickets sideline options, Tracey Grayson, 13 June.

12 The overlooking of the evidence underpinning our view that the relevant market is the broader Australia-New Zealand market pervades the Commission’s entry barrier analysis, in particular, the failure to distinguish *ex novo* entry barriers from what are effectively barriers to adjacent market entry and / or barriers to expansion.

## 1.2 Competitive effects

13 Turning to the competitive effects of the Alliance in air passenger service markets, the Commission believes that the Alliance would likely lead to a substantial lessening of competition in each of the air passenger service markets it defines, except for the market it defines as the ‘International Market’ – that is, it concludes a likely substantial lessening of competition in the main trunk market, the provincial market, the Tasman market, the NZ-Asia market, the NZ-Pacific market, and the NZ-US market (paragraph 597).

14 Though varying from market to market, the Commission’s conclusions are typically based on the Alliance’s high market share, insufficient constraint from existing competitors or any likely competitor, and an increase in entry / expansion barriers when considered collectively.[7]

15 The objectives of the following sections are as follows:

- First, to elaborate on the concept of what constitutes an entry / expansion barrier from an economic point of view; and

- Second, to then consider several factors that underpin the Commission’s view regarding the structure of air service markets, and hence, its conclusions as to the significance of entry and expansion barriers for the relevant markets.

[7] Paragraphs 439, 460, 502, 514, 532 and 541.

### 1.2.1 Entry barriers

16 An entry[8] barrier is a cost borne by an entrant that is not incurred by an incumbent. It may be a cost borne on entry or reflect some ongoing cost disadvantage. Thus, an entry barrier reflects a cost *asymmetry* between an entrant and incumbent, such that an incumbent can earn monopoly profits without constraint from potential competition. Bearing in mind this definition, in the matter at hand, our evaluation of the Commission's analysis of entry barriers are underpinned by the following propositions:

- *For the purposes of analysing a merger, an analysis of entry barriers in the abstract should be viewed in terms of the cost asymmetries faced by the most likely entrant*. We believe that this is a valid proposition, particularly when the identity and cost structure of the most likely entrant is known. In this case, it is clear that the most likely entrant on Tasman and New Zealand domestic routes is Virgin Blue, and its low cost structure is widely recognised (see below). Hence, entry barriers for these routes should be viewed in terms of the cost asymmetries faced by Virgin Blue, with the key issue being whether those asymmetries are so marked that the Applicants could, in the Factual, increase prices and profits without inducing competing entry.

- *The costs of adjacent market entry and/or market expansion are typically lower than the costs of ex novo entry*. Virgin Blue is an established airline in the Australia-New Zealand region, which we believe to be the relevant geographic market. Thus, we believe that any commencement of services on Tasman and New Zealand domestic routes by Virgin Blue should be viewed as adjacent market entry and/or market expansion, which generally entails lower costs than pure, ex novo, entry. We believe this proposition is demonstrated in the NECG Report, and hence, requires no further elaboration.

- *An entrant that has a lower cost structure relative to incumbents is unlikely to face significant entry barriers*. We believe this proposition is a correct as a matter of basic

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8 We use the term entry barrier (as opposed to referring to both entry and expansion barriers) for ease of exposition and to align our analysis with the Commission's relevant markets. It is also for these reasons alone that, in some instances, we refer to the relevant markets as the Commission has defined them.

economics. Virgin Blue, the most likely entrant on these routes, has a low cost base. For instance, the following newspaper article notes the following comments of Brett Godfrey, CEO of Virgin Blue:[9]

> "We've got low costs and that's a huge competitive advantage for us," he said. "That hasn't come from luck – it's come from negotiations and some good hard work." Mr Godfrey said he was particularly pleased that global benchmarking against other low-cost carriers showed Virgin Blue had the world's youngest fleet. He said it ranked second after Irish carrier Ryanair in terms of operating profit margin.

More importantly, Virgin Blue has a demonstrably lower cost base than Qantas and Air New Zealand, the incumbent airlines on these routes.[10] In economic terms, Virgin Blue operates on a lower cost curve compared with Qantas and Air New Zealand. This is for two reasons:

- First, it operates using a vertically differentiated business model, in particular, a no-frills type model that avoids many of the costs inherent in the full service model (e.g. catering, full scale interlining, etc.); and
- Second, as suggested in the comments of Mr Godfrey above, Virgin Blue is able to avoid legacy costs, most relevantly, those relating to labour and aircraft.

17 Drawing on these propositions, the following sections consider in greater detail those substantive factors that the Commission believes give rise to entry barriers in air service markets in general, and more specifically, in markets relevant to evaluating the Alliance.

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9 *The Australian*, 2003, QC to rule on Virgin float, Michael McGuire and Steve Creedy, May 16.

10 While Air New Zealand has moved to ANZ Express in New Zealand, putting aside the fact that it no longer operates a business cabin, it otherwise has FSA characteristics. In particular, it still carries those legacy costs that a newer airline operating a pure VBA model would avoid.

### 1.2.2 The Commission's views on entry barriers

18 For the Alliance to result in a substantial lessening of competition in a market, it generally must have one of the following two effects:

- First, the effect of significantly increasing market concentration in a market, where (1) there are material entry/expansion barriers and (2) entry on a timely and sufficient scale is unlikely;[11] and

- Second, where there is no significant direct aggregation in market share, the effect of significantly increasing the materiality of entry/expansion barriers or reducing the competitive constraints imposed by (and ultimately, market shares of) existing players.

19 Thus, in considering the Commission's evaluation of entry and expansion barriers on routes such as New Zealand provincial and routes between New Zealand and Asia, where there is no significant aggregation in market shares, the ability for the Commission to demonstrate an *increase* in entry barriers is paramount to any conclusion that competition would likely be substantially lessened.[12]

20 The Commission begins its analysis by considering the main trunk market. It lists fourteen factors as being relevant to an assessment of the materiality of entry barriers for

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11 With respect to this second condition, where entry/expansion is *certain*, the materiality of entry/expansion barriers might still be potentially relevant in evaluating the *extent* and *timeliness* of entry/expansion. Where there is entrenched and vigorous competition in a market, there may well be no substantial lessening of competition even with an increase in market concentration in the presence of material entry barriers and where there is no likely entry.

12 Additionally, to find an substantial lessening of competition, the Commission would need to be convinced that competition between incumbents would not be so vigorous in any event as to make consideration of further entry unnecessary.

main trunk routes.[13] The Commission accepts that many of these do not give rise to entry barriers.[14]

21 Those remaining substantive factors that the Commission perceives as giving rise to entry barriers are as follows:[15] capital requirements, sunk cost requirements, incumbent response to entry, scale and scope of entry, market size, GDS / CRS related factors, access to travel distribution services, access to feeder services, and loyalty schemes.

22 These factors, which underpin the Commission's view as to the materiality of entry barriers on main trunk routes, are also the factors that invariably underpin its view on the materiality of entry barriers for the other air passenger service markets it considers.

23 For markets where the Commission believes the Alliance will *increase* entry barriers, this appears to be premised on the following factors increasing in significance: incumbent response to entry (especially), access to travel distribution services and access to feeder traffic. If the factor relating to incumbent response to entry were to increase in significance, then this would also increase capital and sunk cost requirements.

13 They are as follows: capital requirements; regulatory requirements; incumbent response to entry; scale and scope of entry; access to facilities; access to travel distribution services; access to feeder services; access to CRS; access to catering services; loyalty schemes; brand awareness; size of market; availability of pilots; and availability of aircraft (paragraph 331).

14 The Commission accepts that access to CRS, access to catering services, availability of pilots, and availability of aircraft do not give rise to entry or expansion barriers, and accepts that brand awareness does not give rise to entry or expansion barriers for an established player such as Virgin Blue or for fifth freedom operators (paragraph 412).

15 The Commission considers access to facilities to give rise to entry barriers. We note that the Applicants are willing to enter into undertakings, including for line maintenance, which should alleviate concerns that facilities access might deter or hinder effective entry. The Commission also suggests that an entrant would face regulatory hurdles arising from the 'substantial cost in writing the necessary manuals' (paragraph 350). To the extent that there are some costs involved, this surely could not be seen as being determinative of the materiality of entry barriers for the routes in question.

24 For reasons elaborated on in the following sub-sections, we believe the Commission overstates the significance of each of these factors, and where relevant, the likelihood of these factors increasing in significance with the Alliance.

### *Capital requirements and capital costs*

25 The Commission believes that upfront and ongoing capital requirements associated with entry have the effect of deterring entry into air passenger service markets, including for the main trunk route market (paragraph 341) and Tasman routes (paragraph 477). It also believes that raising capital is difficult in the current climate.

26 Turning first to the size of upfront capital requirements, in analysing main trunk routes, the Commission seems to recognise the distinction between market expansion, which is an incremental cost, as compared with 'fresh' entry, which might require much greater initial outlays (paragraph 333). It also seems to recognise this in its analysis of Tasman routes, where it seems to accept that capital requirements and sunk costs 'may be less for an existing participant expanding into this market' (paragraph 477).

27 However, the Commission does not seem to recognise this distinction as a matter of practice. In particular, the most likely entrant Virgin Blue is an established operator in the Australia-New Zealand region. Therefore, we believe that, for Virgin Blue, commencing services on Tasman and New Zealand domestic routes should be viewed as adjacent market entry or market expansion. It follows that the only capital requirements that are relevant in evaluating expansion barriers are route specific capital outlays.

28 In turn, these route specific outlays must be considered in conjunction with potential market revenues associated with these outlays. The two important points in this respect are that (1) several main trunk and Tasman routes comprise the bulk of all New Zealand domestic and Tasman revenues, as noted in the NECG Report, and (2) Virgin Blue's superior cost advantage suggests it would be capable of obtaining a sizeable share of these market revenues. For these reasons, we believe that the route specific outlays required for commencing services on Tasman and main trunk routes should not be viewed as imposing significant adjacent market entry barriers for Virgin Blue.

29 Turning to the issue of raising capital in the current aviation climate, the evidence suggests that it is in fact the incumbent airlines that face a substantial cost disadvantage

in this regard. VBAs generally have ratios of market to book value that are far greater than those of FSA's, including the Applicants, implying that their cost of capital is lower.

30 Virgin Blue is financially strong due its position on Australian domestic routes. Its financial strength is reflected in its operating profits and Patrick Corporation's 50 percent stake, which would provide significant financial security. Virgin Blue's ample ability to raise capital is also evidenced by the fact that it is considering a partial float despite the current aviation climate.[16] Virgin Blue has publicly stated that the Alliance will not impact on any partial float, suggesting that the Alliance would not impact on the ability for it to raise capital.[17]

### *Sunk costs*

31 The Commission believes that sunk costs act as an entry barrier by increasing the 'downside risks of entry', which is likely to delay entry and affect an entrant's ability to raise funds (paragraph 345).

32 As noted immediately above, Virgin Blue has publicly stated that the Alliance will have no impact on its decision to float, implying that the Alliance would not affect the risk of Virgin Blue's operations, and therefore its ability to raise funds. This is consistent with our view that lenders of capital would take account of Virgin Blue's cost advantage relative to incumbents, which significantly reduces its risk of failure.

33 Moreover, as with the analysis of capital requirements, there is a difference between the sunk costs that an *ex novo* entrant would face, and those that an adjacent market entrant or expanding airline would face. The Commission does seem to correctly recognise that a cost such as branding has already been largely incurred by an established airline,

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16 *The Age*, 2002, Virgin Blue to consider partial float next year, Alex Tilbury, November 19, http://www.theage.com.au/articles/2002/11/18/1037599360424.html.

17 *The Sydney Morning Herald*, 2002, Air pact won't scuttle Virgin Blue's float plans, Mark Todd, November 27, http://www.smh.com.au/articles/2002/11/26/1038274302717.html.

particularly an airline operating in an adjacent market such as Virgin Blue.[18] We believe that if the Commission were to apply a similar process to analysing other potential sunk costs, it would conclude that sunk costs should not materially affect Virgin Blue's decision to enter.

### *Incumbent response to entry*

34 We evaluate the Commission's analysis of strategic behaviour as an entry barrier for the main trunk route market, and then consider separately issues specific to evaluating strategic entry barriers for other markets.

35 The Commission believes that the incumbents would respond vigorously and immediately to entry/expansion, and that this response and the threat of this response would amount to significant entry barriers (paragraph 367). The Commission believes that such a response could be implemented through a range of mechanisms, including fare discounts, increasing capacity, ramping up advertising for loyalty programs, as well as free add-ons (paragraph 353). The competitive response might focus on a few routes, 'gaining strength from operations across a number of routes' (paragraph 353).

36 Moreover, the Commission believes the Alliance would increase the entry barrier that arises from the threat of and actual strategic behaviour because (1) the Alliance would be more profitable than the airlines acting independently, thus enabling it to devote more profits to "subsidising" price reductions and/or capacity dumping on routes where entry occurs, (2) the greater strength of the Alliance's route coverage, which would make it easier to shift capacity onto Tasman and New Zealand domestic routes, (3) the enhanced ability for Air New Zealand and Qantas to coordinate responses, and (4) the

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18 Paragraph 343. The Commission refers to the Applicants' claim that sunk costs are not a material expansion barrier for an incumbent Australasian air services provider, since it would not face cost asymmetries or disadvantages relating to (1) brand recognition, (2) operating manuals, (3) access to computerised information and reservation systems, while (4) it also may have potentially underutilised aircraft that might be diverted to the new routes. The Commission disputes this fourth factor, though does not dispute the other contentions, including that regarding brand recognition. Brand recognition is discussed further below.

mere perception of the size and strength of the Alliance, as compared to Air New Zealand and Qantas acting independently.

37 The increased threat and likelihood of strategic and/or predatory behaviour (and associated impacts on capital requirements and sunk costs) would appear to be a crucial factor underpinning the Commission's view as to why entry and expansion barriers will *increase*, including for main trunk and Tasman routes. This is because, for most other factors noted by the Commission as contributing to entry and expansion barriers, the Commission suggests that these constitute barriers, though it does not say they will *increase* as a result of the Alliance.

*38* As a first and general point, we note that Virgin Blue has said that it will enter Tasman and New Zealand domestic routes with or without the Alliance. This would tend to suggest that it has evaluated these routes, and concluded that they are viable. We believe that any analysis underlying such a conclusion would have factored in potential entry barriers, including the likelihood of strategic conduct on the part of Air New Zealand and Qantas, acting either collectively or individually. Hence, Virgin Blue's public statements imply that any entry barriers that exist are not sufficient to deter entry.

39 Regardless, from an economic perspective, it is unlikely that the conditions exist for Air New Zealand or Qantas, acting in unison or independently, to credibly deter the extent and timeliness of Virgin Blue's entry, or to successfully engage in a predatory strategy in the event that it enters.[19]

40 To begin with, we note that the essence of a successful predatory strategy is that, though it involves initial losses, it is profitable in the long run. The profitability of such a strategy depends on the costs incurred in engaging in the strategy and the payoff in the event that the strategy is successful. The ability for the Alliance to engage in strategic behaviour has been discussed in the NECG response to economic submissions. In that response, NECG noted that Virgin Blue would not be susceptible to conduct aimed at hindering its market expansion for several reasons. We place this discussion into a more formal approach to analysing the likelihood of strategic behaviour.

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19 We note that the Applicants have submitted undertakings in relation to Freedom's operations in the event the Alliance proceeds.

41 In particular, from a theoretical perspective, we believe that key conditions for certain types of predation, those being *information incompleteness* and *information asymmetry*, do not exist in the situation at hand.

42 Information incompleteness is a condition that may be required for "signal-jamming" theories and sunk-cost commitment predation. In the context of airline markets, an entrant could be faced with incomplete information if incumbents operate on a much broader set of routes than the potential entrant for the following reasons:

- First, the firm might not realise the extent of cost shifting by the incumbent between the routes subject to entry and other routes operated by the incumbent, which would distort perceived market cost conditions; and

- Second, on the demand side, the firm might not know the extent to which revenues derived on the routes in question rely upon traffic interlining from other routes served by the incumbent.

43 In the situation at hand, Virgin Blue, were it to enter Tasman and main trunk routes, would have a presence across the whole Australia-New Zealand region. These routes cover a significant portion of the Qantas and Air New Zealand route structure, and the majority of those (at least for Air New Zealand) that generate any sort of profit. Many of the other international routes operated by Qantas and Air New Zealand that Virgin Blue would not operate are only marginally profitable at best. Thus, the scope for the Alliance to shift costs and distort market cost conditions would seem limited. Moreover, as discussed below, interlining is likely to weigh less on the entry decision of a VBA such as Virgin Blue. Based on these market observations, we believe it is unlikely Virgin Blue would be deterred from entry by strategic behaviour that relies on the condition of incomplete information.

44 Information asymmetries form the basis of reputational and signalling models of predation. The essence of these models is that incumbents deter entry by developing a 'reputation' for aggressive pricing faced with the credible threat of or actual entry. In particular, the incumbent uses an informational advantage to deter entry or induce exit by convincing the entrant that it has a cost advantage. The fact of the matter, however, is that Virgin Blue has a low cost structure relative to Air New Zealand and Qantas, and each of these airlines knows this. Hence, Virgin Blue would realise that low pricing by either of these airlines prior to its entry or immediately following its entry could not be

credibly sustained. Thus, the condition required for models of reputation and signalling to be of relevance would not hold in the current circumstances.

45 Turning to the question of whether strategic behaviour is more likely under the Factual than the Counterfactual, we note that (1) the Commission believes that Air New Zealand has deep pockets because of government ownership,[20] and (2) under the Counterfactual, the Commission holds the view that there would be three airlines competing on Tasman routes. These two factors combined suggest that, given its smaller size and higher costs, the incentives for Air New Zealand to engage in predatory conduct would be greater under the Counterfactual than the incentives it would face under the Factual. This is all the more the case as Air New Zealand would be 'fighting for its life' in key parts of the market which had never supported two players, much less three.

46 There is extensive empirical evidence on airline fare wars. This literature shows that sharp reductions in fares do not arise as a strategic response to entry; rather, price wars are most common, and typically prolonged, when there is a weak player in the market seeking to hang on to market share. As a result, it seems far more reasonable to suppose that the price risk faced by Virgin Blue (or any other entrant) would be materially greater in the counterfactual than in the factual.

47 Additionally, it is a fact that entry is common in aviation markets and that there has been substantial and on-going entry by VBAs in "monopoly" markets, as discussed in Chapter 5. This includes Virgin Blue's strong expansion throughout the Australian route structure. Were incumbent carriers far more able to create or exploit strategic entry barriers in such markets, the entry that has occurred world-wide would surely not have been observed.

48 Furthermore, it is worth noting that the Applicants have submitted proposed conditions to the Commission that are intended to facilitate entry and provide additional comfort in relation to potential strategic behaviour, which will only be applicable under the Factual.

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[20] See paragraph 288, where the Commission asserts, 'As a cornerstone shareholder with potentially large resources to call upon, the Government would be in a position credibly to support the company.'

49 As a final and unrelated point, it is worth commenting on an argument the Commission makes regarding the impact of the marginal passenger. The Commission says that an incumbent airline can engage in loss-making price reductions, with the result of drawing passengers away from a VBA. The Commission suggests that it is the last few passengers that can determine a VBA's profitability, and hence, an FSA can affect the profitability of the new VBA, by drawing away these marginal passengers. Thus, the implication is that the marginal passenger is more important than infra-marginal passengers. The Commission makes a similar argument with respect to the importance of interlining traffic (see below).

50 In both these instances, the Commission misconstrues the impact of the marginal customer. Given that the majority of flight costs are fixed, all customers make the *same* contribution to cost coverage. The greater the number of customers an airline is able to secure, the greater is the contribution to fixed costs, and hence, the likelihood of covering fixed costs. However, it is not the marginal customers who are "the last few passengers who generate the profit for the VBA" (paragraph 353) any more or less than they do for the FSA.

### *Tasman routes*

51 With specific respect to the Tasman market, the Commission points to the example of Kiwi International as evidence that these factors are significant when evaluating entry barriers. The Commission suggests that Freedom played a role in the demise of Kiwi International. This is a view also expressed by a number of other industry participants. Expansion by Virgin Blue clearly differs from the Kiwi International example in that it is not an *ex novo* entrant, has a substantial home base built around services on Australian domestic routes, as well as having ample capital resources and capital raising ability, as discussed above.

52 Additionally, it is in the nature of markets that some entrants fail (including due to poor management) while others succeed. Aviation markets are certainly no exception to this fact of life. It is no more sensible to conclude from Kiwi International's failure that entry barriers are high than it would be to infer from Virgin Blue's continuing and prospective success that entry is inherently riskless.

### Provincial routes

53 We believe that one cannot plausibly argue that the conditions required for strategic conduct exist for provincial routes because of several attributes of provincial routes.

54 First, the incentives for strategic conduct do not appear to exist. Many of the routes in question are not especially profitable. Thus, the costs incurred by incumbents in engaging in predatory conduct would not seem to be justified by the revenues and profits at stake.

55 Second, and more importantly, the market structure required for successful strategic conduct do not appear to exist. Entry barriers would not appear to be high for these routes. In this respect, we note that the Commission says that strategic behaviour constitutes an entry barrier for these routes, though does not explicitly list capital requirements and sunk costs as being significant factors that give rise to entry barriers. We do not believe that capital requirements and sunk costs could be argued to be pervasively high for provincial routes. Rather, there seem to be scope diseconomies for FSAs to operate as regional carriers, including difficulty in managing the level of flexibility required, difficulty in maintaining a consistent image in terms of service quality, and difficulty in managing on-site costs. Hence, the conditions of entry would appear more onerous for FSAs attempting to expand from main trunk routes, rather than for pure regional airlines.

56 What is likely to be more determinative of entry is route size. Many of the routes in question are thin and, as noted above, are not likely to be especially profitable. The Commission's observation that Air New Zealand acquired Nelson Air and Eagle when they both expanded could suggest that the volume of traffic on some routes might not be sufficient to sustain more than one operator.

### ***Scale and scope of entry***

57 Consistent with Virgin Blue's expansion in Australia, we believe the VBA would initially offset somewhat lower frequency with lower fares, which it can do due to its lower cost structure, but would then scale up capacity. As we have previously noted, because any rational entry strategy would require frequency and capacity on a scale sufficient to attract all customer types, any entry would necessarily be substantial.

58 That said, the issue of whether entry is sufficient in the context of a 'LET' test cannot be assessed in terms of physical indicators such as ASKs, flights or frequencies. Rather,

whether entry is sufficient depends on the extent of the constraining impact it has on incumbents. That constraining impact will reflect not merely the current scale of an entrant's activity but also the ease with which an entrant can expand. As we have noted, the evidence internationally highlights the ease with which VBAs can ramp up supply, and it is this that underpins the very strong impact VBAs have on prices and outputs.

### *Size of market*

59 The Commission believes that an entrant would have to be a certain size to compete. It holds the view that for a VBA entrant to compete on main trunk and Tasman routes, it would have to grow the market significantly, particularly for a small market such as that for main trunk routes. It believes that ANZ Express has captured much of the potential growth on main trunk routes, with the effect that it "would not relax" barriers relating to scale economies (paragraph 416). Similarly, the Commission suggests that Freedom would limit the scope for a VBA to grow the market on Tasman routes (paragraph 494).

60 We believe that, in the situation at hand, scale economies should not be viewed as giving rise to entry barriers. Such barriers are most relevant when competitors have similar cost curves, so competitiveness depends on where each firm is on that cost curve. As a result, an entrant, to be competitive, must enter on a scale that risks increasing capacity to a point where entry is no longer viable. However, where a firm has lower costs then the scale of entry is less important. Such a firm could and would reach the same cost level supplying a lower volume of output compared to its higher cost rivals. As noted above, the most likely entrant, Virgin Blue, operates on a lower cost curve than Air New Zealand or Qantas. For this reason, we believe that the Commission's concerns over scale economy barriers are overstated. It would, in other words, be able to cover its costs at lower levels of residual demand than would be required by the higher cost incumbents.

61 As noted above, the most likely entrant, Virgin Blue, operates on a lower cost curve than Air New Zealand or Qantas. For this reason, we believe that the Commission's concerns over scale economy barriers are overstated.

62 Moreover, to the extent that these barriers exist, they are more likely to exist under the Counterfactual where an entrant would face Air New Zealand and Qantas competing individually, rather than acting in unison, where there would be a degree of capacity rationalisation. The residual demand curve facing the entrant will be significantly

further to the right in the factual than in the counterfactual. This is consistent with our view that entry is more likely under the Factual as compared with the Counterfactual.

### GDS related factors

63 The Commission considers the potential for GDS to distort competition in its discussion on strategic entry barriers (paragraph 352). We believe that it is best dealt with as a separate issue. The Commission believes the Alliance would benefit from being displayed more prominently and more times on GDS. While there might be some advantages accruing to the Alliance, we do not believe that this would have any significant effects in terms of foreclosing airline entry, for the following reasons:

- First, as the Commission observes, neither Qantas nor Air New Zealand has an equity stake in a GDS (paragraph 215), and hence, neither is in a position to manipulate GDS displays.
- Second, most JAO routes only have a few operating airlines. Thus, the airline options for consumers booking flights through travel agents would be readily apparent.
- Third, the Commission's own observation is that there has been significant growth in the use of direct sales (i.e. call centres and the Internet) as a distribution channel (see section 2.1), and more specifically, the disproportionate reliance on these channels by VBAs (NECG Report, section 2.1.4).

### Access to Feeder Traffic

64 The Commission believes that access to feeder traffic is a factor that gives rise to entry barriers in airline markets, including the main trunk market (paragraph 399). As discussed above, we believe the Commission misconstrues the concept of the marginal passenger, and the extent to which this passenger contributes to profitability as compared with infra-marginal passengers. For this reason, we believe the Commission's suggestion that 'the last handful of interconnecting passengers often make the difference between a flight operating profitably and it making a loss' (paragraph 394) is incorrect.

65 Regardless, we believe the Commission's analysis is incomplete for the following reasons.

66 First, even if the Commission's interpretation of the marginal passenger were correct, while it is certainly plausible that "the last handful" of passengers would be comprised mainly of full fare business paying passengers and some last minute discount fare travellers, there is no reason why one would expect that these would be any more likely to be interlining passengers as compared to other passengers.

67 Second, the Commission overlooks the costs of interlining. Thus, the fact that interlining passengers may generate revenues says little without reference to the underlying costs of serving these passengers.

68 Third, and perhaps most importantly, in order to compete on Tasman and main trunk routes, the ability to access feeder traffic would unlikely be determinative of the entry decision for the most likely entrant, Virgin Blue. As the Commission notes, feed is not generally an issue for a VBA, which operates on a point-to-point basis (paragraph 396). The Commission also notes that industry participants did not raise feed as an issue. Even if Virgin Blue were reliant on feed for main trunk and Tasman services to be viable, it could rely on its own Australian domestic traffic, as well as any traffic it could secure from entry on main trunk and Tasman routes. It could also seek to expand the extent to which it currently interlines with United Airlines on international routes. Its ability to enter into such agreements is evidenced by its recent agreement to interline with Rex on regional Australian routes.[21]

69 With respect to the importance of accessing feeder traffic in order to compete on other routes:

- For provincial routes, the Commission notes that 20 per cent of all traffic on provincial routes is derived from feeder traffic (paragraph 447). However, there would be nothing to stop a regional airline competing for point-to-point traffic. Moreover, there is no reason why a regional airline could not secure feed from airlines competing with the Alliance on main trunk, Tasman and other international routes, including Emirates, which will commence Tasman services in August of this year, and Virgin Blue, should it enter.

21 *Virgin Blue News Releases*, 2003, Regional Flyers To Benefit From Virgin Blue & REX Deal, 10th June.

- For international routes, to the extent that Air New Zealand and Qantas obtain advantages from domestic and Tasman services when competing on other international routes, these should not be viewed in isolation to the far greater advantages that their competitors on international routes have in terms of securing feed. A notable example is an airline such as Singapore Airlines, which can access feeder traffic from throughout Asia and Europe.

70 Beyond revenues, including those from inter-lining, are important for all carriers, but are mainly of significance to airlines operating extensive long haul networks. For point to point operators, their significance is far more marginal, all the more so when only a low share of traffic utilises multiple segments on any single trip that spans that point to point link. This is very much the case in the routes here at issue.

### *Loyalty programs and brand reputation*

71 The Commission concludes that loyalty programs give rise to entry barriers for entrants on main trunk routes, particularly in terms of capturing business traffic, since they prevent customers switching to a new entrant (paragraph 409). The Commission believes they ‘could be an issue’ on Tasman routes (paragraph 488). The Commission suggests that 50 percent of main trunk passengers and 35 percent of Tasman passengers are business travellers. The Commission also suggests that leisure passengers increasingly belong to frequent flyer programs.

72 We believe the Commission greatly overstates the importance of loyalty programs, particularly when considering the most likely entrant on Tasman and main trunk routes.

73 First, as noted above, business travellers comprise a significant portion of Virgin Blue revenues. The fact that Virgin Blue has achieved this without any loyalty program suggests that low fares and service frequency play a far more important role in attracting business passengers than do loyalty programs.

74 Second, as noted in the NECG Report, the evidence demonstrates that loyalty programs are less significant for passengers travelling on Tasman routes than the Commission seems to believe.[22] Further information has been obtained indicating that loyalty

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[22] NECG Report, section 2.3.2.

programs are not that much more important for passengers travelling on New Zealand domestic routes compared with those travelling on Tasman routes.[23]

75 Third, the Commission overlooks that the benefits obtained from loyalty programs, lounges, etc. provide are not costless. Hence, in choosing not to operate loyalty programs and lounges, VBAs are making an investment trade off – that is, forgoing investments in loyalty programs, lounges, etc., and instead, investing in low fares. Thus, as a matter of observation, VBAs around the world have grown successfully by making this trade-off.[24] Additionally, when VBAs have offered loyalty programs, which is typically as they mature, they have found that they can do so effectively offering much simpler programs than FSAs typically offer. Southwest is a case in point. Virgin Blue appears to be moving in this direction. In short, while loyalty programs introduce some short term switching cost they do so in ways that are quite open to being negated, most obviously by simply setting lower fares.

76 It is worth bearing in mind that Ansett Australia lost very substantial passenger numbers to entrants in a remarkably short span of time despite having a large, long established and highly popular loyalty program.

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23 There are four levels of frequent flyer status for members of Air New Zealand's frequent flyer program, with the lowest level being Jade status, a level that requires no flights at all for qualification. For the year ended May 2003, around **[ ]** of passengers travelling domestically within New Zealand belonged to Air New Zealand's frequent flyer program. **[**

**]** Of these, less than **[ ]** had achieved anything other than Jade status. Hence, nearly **[ ]** of all passengers travelling on New Zealand domestic routes are either not members of Air New Zealand's frequent flyer program or are on the lowest frequent flyer status.

24 This trade-off is evidenced in Singapore Airlines' current promotion, where it is seeking to sell cheap fares, for which consumers cannot earn frequent flyer points. See *The New Zealand Herald*, 2003, Asian carriers slash prices to fill planes, Chris Daniels, 10 June.

### *Access to Travel Distribution Services*

77 The Commission believes that access to travel distribution services amounts to a barrier to entry (paragraph 393). The conclusion appears to be based on the views of industry participants that Qantas Holidays could obtain dominance in this market, and that the Alliance could place pressure on travel businesses not to deal with an entrant.

78 We believe the Commission greatly overstates the likelihood of either Qantas Holidays obtaining a position of dominance and/or acquiring the capacity to foreclose a competing airline through the distribution function. The incentives for the Alliance to engage in a foreclosure strategy, and the conditions required for a successful foreclosure strategy, are relevant to evaluating the Commission's analysis of competitive effects in its defined wholesale travel distribution market. For reasons outlined in section 2.2, we believe the incentives for the Alliance to engage in a foreclosure strategy, and the conditions required for such a strategy to be successful, do not exist. And hence, the ability for an entrant to access travel distribution services should not be viewed as a factor likely to constrain entry.

### *Summary*

79 To summarise, we believe the Commission's view as to the nature of airline markets is distorted, in that it overstates the significance of a number of factors in terms of their ability to insulate incumbent airlines from competitive discipline. This overstatement is particular significant in the matter at hand, where the routes central to the transaction are short haul, point to point routes, and hence, particularly conducive to entry by the most likely entrant, Virgin Blue, a well capitalised VBA that has a demonstrably lower cost base than the incumbents serving these routes.

80 In the following sections, we elaborate on aspects of the Commission's analysis that are not captured in the preceding sub-sections.

### 1.2.3 Tasman market

81 The Commission believes that the competitive constraints imposed by fifth freedom operators on Tasman routes are overstated, citing the views of other market participants (paragraph 470 to 472). This is despite the fact that the Commission does not appear to dispute the evidence of the impact that fifth freedom operators have had on the AKL-SYD and AKL-BNE routes, nor does it appear to dispute the view of the ACCC

presented by the Applicants in their original submission. The Commission agrees with Virgin Blue's assertion that 'fifth freedom carriers do not determine their schedules and their operations by reference to, and therefore do not competitively respond to, price and capacity signals on the Tasman routes' (paragraph 495).

82 While these operators only operate out of Auckland, and (until Emirates' entry) there are no services to Melbourne, the relevant point is that if market opportunities existed, fifth freedom operators could enter using otherwise idle capacity. The imminent entry of Emirates in August of this year is consistent with this assessment.

83 As to Virgin Blue's assertion, to suggest that these operators are, in some sense, not making capacity decisions on the Tasman based on actual price and capacity signals is simply incorrect. Rather, current observed entry only on Auckland routes is likely to reflect the competitiveness of Tasman routes, and the fact that the density of routes to and from Auckland provides fifth freedom operators the greatest opportunity to earn revenues relative to the low opportunity cost of their idle capacity.

84 Additionally, what matters is not the current pattern of entry but the extent to which capacity patterns would change if prices were to rise. There is nothing in the history of fifth freedom operations to date to suggest that fifth freedom operators would not respond on a rational commercial basis to incentives to increase output.

### 1.2.4 New Zealand-Asia market

85 The Commission concludes that the Alliance would substantially lessen competition on New Zealand-Asia routes, because comparing the Factual and Counterfactual, there would, amongst other things, be insufficient constraint from existing competition on some routes and there would be no likely entry or expansion (paragraph 514).

86 As noted above, for markets where there is no significant aggregation in market power, one could only conclude a substantial lessening of competition if incumbent competition were likely to be inadequate and entry barriers were to rise. There will be no aggregation of market shares on these routes with the Alliance. Thus, it is not necessary to determine whether a competing airline would likely enter or expand on these routes to conclude whether there would be a substantial lessening of competition.

87 Instead, it is relevant to consider the materiality of expansion and entry barriers and / or the existing constraints Air New Zealand faces on these routes.

88 Though the Commission asserts that the barriers identified with respect to the Tasman apply to the New Zealand-Asia market and that an entrant, presumably *ex novo*, would require substantial financial backing (paragraph 509), it holds the view that airlines would be capable of expanding to constrain the Alliance if it attempted to exercise market power (paragraph 511).

89 However, the Commission believes that they would choose not to expand for commercial reasons – that is, the routes in question are low yielding and the fact that more lucrative options for airlines exist elsewhere – rather than any increase in expansion constraints (paragraph 511). The Commission's comments that the routes in question are low yielding appear to relate to the market in general.[25] Put differently, the Commission does not highlight any exceptions to this rule – that is, routes where yields are high and / or monopoly rents are being earned.

90 The logical conclusion to draw from these observed low yields is that actual entrenched competition or the threat of expansion constrains Air New Zealand. If it did not, then Air New Zealand would act to increase its prices and earn economic rents, which clearly it has not done. If the Commission accepts that competition is strong – and the Commission in no way suggests that capacity currently constraining Air New Zealand will be removed as a result of the Alliance[26] – then future competition will also be strong with or without the Alliance.

91 The Commission's conclusion on New Zealand-Asia routes also appear at odds with its comments in subsequent sections. For instance, in discussing the International Market, the Commission states:

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25 Thus, while suggesting that the Alliance might not be constrained on a route such as New Zealand-Japan, the Commission does not appear to perceive Air New Zealand to be earning economic profits on this route.

26 Indeed, a recent article notes that Cathay Pacific will be increasing services to New Zealand from July of this year. See *The New Zealand Herald*, 2003, Asian carriers slash prices to fill planes, Chris Daniels, 10 June. The same articles notes that Singapore Airlines is mounting a global campaign, based on low air fares, to stimulate demand.

> The Commission is of the view that for the NZ-Asia sector of the west bound routes, the proposed Alliance will not be constrained by potential competition. The reasons are discussed above with respect to the NZ-Asia market. The Commission, however, considers that the proposed Alliance *would be constrained by potential competition on the NZ-Asia and Asia to Europe sectors of these routes, due to the large number of airlines that already fly those routes or that could commence flying on them*. (Paragraph 545, emphasis added)

92 Also, in its discussion on the International Belly Hold Freight Market, the Commission states:

> *Although the Commission found that the proposed Alliance would be constrained in the NZ-Asia and international markets*, it is of the view that the overall effect of the proposed Alliance on these markets is such that the Commission is of the view that existing competition will not provide a constraint on the proposed Alliance in the international belly hold market. (Paragraph 568, emphasis added)

### 1.2.5 New Zealand-Pacific market

93 The Commission concludes that the Alliance will substantially lessen competition on New Zealand-Pacific routes, despite the fact that there will be no significant aggregation in market shares on these routes (paragraph 532). Here, what is important to note is that demand is typically comprised of leisure travellers, whose demand is elastic, and VFR travellers, whose demand would be more elastic than typical business travellers. As a result, the prospects for extracting monopoly rents would appear to be poor, since leisure travellers would have a range of demand side substitutes to turn to in the event of an attempted price rise, both in terms of different destinations and other consumer products.

94 There are good reasons to argue that this should be reflected in the defining of a broader market than the New Zealand-Pacific market the Commission defines. Regardless, taking account of these substitution possibilities in an analysis of competitive effects, we believe it would be unlikely that Air New Zealand could exercise market power by increasing prices on New Zealand-Pacific routes with or without the Alliance.

# 2 Travel distribution services

## 2.1 Market definition

95 The Commission characterises the travel distribution services market as ‘the market for the retailing of passenger air travel both to and from New Zealand, and within New Zealand’ (paragraph 206). It concludes that there is a national wholesale travel distribution services market, because it believes the Alliance would affect the wholesale distribution of travel services much more than at the retail level (paragraph 211). Thus, the Commission’s market definition is based on the perceived incidence of the conduct. We believe it is incorrect to define a market based merely on the perceived incidence of the conduct, and that it is inconsistent with accepted principles for defining markets. In short, our view is that the evidence implies no distinct functional markets for ticket distribution, and the Commission does not demonstrate that there is a separate wholesale travel distribution service market.[27]

96 The Commission’s analysis goes to the functional market issue. In particular, the Commission lists the various stages at which airline tickets are sold.[28] Based on this analysis, it does not seem that the Commission believes that wholesalers sell directly to the public.[29] We note that this view differs from that of the ACCC.[30] If the structure is no

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27 As noted in the NECG Report, we see two competition issues potentially relevant to evaluating the Alliance involving travel agents. The first is the issue of market foreclosure – that is, whether an entering or expanding airline would be able to access ticket distribution services. The second issue relates to whether competition in a market for travel agency services (which the Commission refers to as travel distribution services) will be substantially lessened.

28 Paragraph 207. We assume that when the Commission refers to travel distributors, it is referring to retail travel agents. The approach seems to draw upon that adopted by the ACCC (paragraph 210).

29 The Commission says that tickets are sold, ‘By airlines to wholesalers who purchase tickets and package with other products, on-sell these to travel distributors, who then sell to the public’ (paragraph 207).

different in New Zealand than it is in Australia – that is, consumers can purchase from various stages in the functional chain, including from wholesalers – this ability to directly substitute between different layers in the functional chain would imply that there is not a separate functional market for wholesale ticket distribution.

97 Even putting this aside, the Commission's own evidence is consistent with a single functional market. The Commission itself observes the significance of and growth in direct sales by the vertically integrated Applicants through call centres and the Internet (paragraph 209). Thus, if a wholesaler attempted to increase prices to retail travel agents, and retail travel agents attempted to pass this price increase on to consumers, consumers would increase purchases of tickets from these direct airline channels. Thus, the attempted price rise by wholesalers would be defeated by substitution involving an upstream layer (the airlines) and the retail level, demonstrating a single functional market.

## 2.2 Competitive effects

98 Regardless of the precise delineation of the travel distribution market, we believe the Commission is incorrect in concluding that there would be a substantial lessening of competition in this market (paragraph 592).

99 Underlying the Commission's conclusion are the views of many industry participants that the Alliance would have market power upstream, and that to protect or enhance upstream economic rents, the Alliance would have some incentive to limit competition and/or accept inefficiencies in the downstream distribution function. More generally, there is the view that the more market power there is upstream, the greater is the incentive to distort competition and inefficiency downstream.[31]

100 Submissions made to the Commission in relation to the impact of upstream competition on the downstream distribution function and/or the incentive for the Alliance to limit competition and efficiency downstream include the following:

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30 ACCC Draft Determination, paragraphs 7.25 and 7.26.

31 Gullivers Pacific Further Submission.

- House of Travel claims that when Qantas and Ansett were in competition with each other, they had incentives to provide wholesalers with low fares to best ensure their own tickets were distributed (paragraph 577).

- House of Travel says that, in Australia, most wholesalers have exited the market, Qantas Holidays is one of two wholesalers that remain, and that this has arisen as the difference between the price at which Qantas Holidays sells directly to the public and the price at which it sells to other wholesale packagers has fallen (paragraph 578). House of Travel is concerned that the Alliance might lead to similar outcomes in New Zealand (paragraph 579). Gullivers Pacific shares a similar concern (paragraph 582).

- The Commission refers to a confidential submission made by Gary Toomey, and submissions from United Travel and Gullivers Pacific, the essence of which is that the Alliance would foreclose travel agents because the Alliance would pay deep discounts to corporate and Government consumers to secure their business, at the expense of travel distributors (paragraphs 580 and 581).

101 Generally speaking, upstream providers have incentives to ensure a competitive and efficient downstream distribution function, regardless of how much or how little competition they face upstream. If anything, the less competitive the upstream, the greater is the incentive to maintain a competitive distribution system so that any economic rents do not need to be shared. In our view, these are the incentives the Applicants face with or without the Alliance.

102 The only reason why they would have incentives to do so – that is, to engage in rent sharing with downstream distributors – is if the effect of reducing competition and efficiency in the downstream would be to foreclose airline entry. The conduct giving effect to the foreclosure strategy might involve the Alliance explicitly entering into exclusive distribution arrangements with a few travel agents, which would then become the sole suppliers of air tickets in addition to the airlines own vertically integrated downstream operations.

103 To begin with, such an arrangement, particularly if it involved the Alliance refusing to allow travel agents to sell Alliance tickets because they sold Virgin Blue tickets, would be closely scrutinised under the Commerce Act, and hence, would unlikely occur in reality. There are in other words highly effective remedies available for dealing with this

situation (which we in any event do not believe would arise) that do not require foregoing the substantial net benefits the Alliance would bring to New Zealand.

104 Regardless, the conditions required for the foreclosure strategy to be successfully implemented simply do not hold, and hence, the incentives to engage in the strategy to start with would not appear to exist.

105 *First, entry barriers for travel agents are low*. The Commission notes that it concluded that entry barriers were low in its Bodas Determination (paragraph 588). However, it concludes that the Alliance may discourage entry ‘particularly as Air NZ and Qantas make up between 70% and 80% of all airline sales for each travel distributor in New Zealand’ (paragraph 589). If this is predicated on the fact that the Alliance might facilitate the reduction in commissions, thereby making entry unattractive, then we disagree that the Alliance would discourage entry.[32] As noted in the NECG Report, the developments in the Australia-New Zealand region merely mimic those that have occurred in other jurisdictions. If anything, the driver of competitive pressures at the distribution layer has been the emergence of VBA airlines, which no authority has ever accused of having market power. Regardless, we have noted that any reductions in commissions could be offset by service charges at the distribution layer for providing value added services.

106 Gullivers Pacific says that there are significant economies of scale in travel distribution, and ‘this would make it harder for entrants to gain a toehold in the New Zealand market.’[33] Gullivers Pacific points to scale economies in developing and running a web site, and hence, direct distribution, which we agree with. However, it provides no evidence of scale economies in operating travel agencies. In fact, Gullivers Pacific’s own assertion is that there are currently around 800 independent retail and inbound travel agencies in New Zealand who are not owned or operated by either Air New Zealand or Qantas, and several firms operating at higher levels in the functional chain (Gullivers

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32 Indeed, if the Alliance tried to unduly depress commissions, say through the exercise of monopsony power, this would make entry upstream more, rather than less, profitable, as an entrant could also expand output in the related market for travel services.

33 Gullivers Pacific Further Submission.

Pacific Submission, p. 17 to 19). This suggests that economies of scale are not so significant as to prevent entry by relatively small travel agents. More generally, it suggests entry barriers for travel agents are low. We are unfamiliar with any study or investigation internationally that has found significant scale economies in or entry barriers to the provision of these services.

107 *Second, airlines have alternative distribution channels other than travel agents*. This is most notably the case with respect to domestic services, and for VBAs. The Commission says that 29 percent of ANZ Express tickets are sold over the Internet, while half of Australian domestic tickets are purchased through the Internet or airline call centres (paragraph 209). The most likely entering or expanding airline on New Zealand domestic main trunk and Tasman routes is Virgin Blue. Virgin Blue says that 90% of its sales are made through the Internet, a significant fraction of which are likely to be direct sales.[34] Thus, it seems that Virgin Blue does not rely to any significant extent on travel agents as a source of ticket distribution.[35]

108 *Third, even if Virgin Blue and other airlines were reliant on travel agents, there is no evidence that all travel agents that were not able to access Air New Zealand and Qantas tickets would face exit*. Instead, travel agents might operate, though perhaps less profitably, by distributing the tickets of airlines other than the Alliance that operated on other international routes, particularly long haul services. One suspects that such services would form the substantial part of travel agent revenues, since international flights tend to be more complex than short haul services such as New Zealand domestic and main trunk route services.[36] It is for these types of services that consumers will place value on the service of arranging travel, and general travel advice. Because we believe that other travel agents could maintain a presence in the market, Virgin Blue or any other airline

34 Virgin Blue Submission In Response To Applications For Authorisation Of The Proposed Qantas / Air New Zealand / Air Pacific Alliance, 12 February 2003, footnote 34.

35 We have previously noted that, given Virgin Blue's presence in the Australia-New Zealand region, it is likely to have existing relationships with ticket distributors in New Zealand.

36 As noted above, the evidence is that tickets on short haul point to point routes to be predominantly distributed through direct channels.

servicing international routes would be assured a source of ticket distribution through travel agents.

109 *Fourth, consumer search costs would not appear to increase the prospects of the foreclosure strategy being successful.* Gullivers Pacific argues that the Alliance could hinder airlines operating on international routes that the Alliance itself did not serve (e.g. Malaysia Airlines to Kuala Lumpur) because of the higher search costs for consumers in finding a distributor of these airlines' tickets. No international airline has submitted that the Alliance would engage in this strategy. If travel agents distributing the Alliance's tickets were still able to sell tickets of other airlines, search costs would not increase. If this were not the case, then if there were significant economies of scale in distribution, any competing travel agents would sell the full range of air tickets for all other airlines operating in and out of New Zealand. Such a distributor would have considerable profile, being the alternative distributor to distributors of the Alliance's air tickets, rendering search costs low.

110 In summary, there is no reason to believe a strategy directed at foreclosing airline entry, involving the elimination of travel agents, could be successful. And hence, there is no reason why airlines would attempt to engage in such a strategy to begin with. Absent these incentives to limit competition and efficiency in downstream distribution, we believe the Alliance would not lead to any lessening of competition amongst travel distributors.