virgin atlantic

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Dear Mr Grimwade

Qantas/British Airways Restated Joint Services Agreement

Thank you for the opportunity to respond to Qantas/British Airways' submission dated 7 August 2003, in which they comment on issues raised in our submission dated 10 June 2003. Our response is attached.

Please do not hesitate to contact me if you would like to discuss further.

Kind regards

BARRY HUMPHREYS

Director, External Affairs and Route Development

Qantas/British Airways Restated Joint Services Agreement

Response to Qantas/British Airways' submission dated 7 August 2003

Heathrow is a distinct market

In their submission dated 7 August 2003, Qantas and British Airways (BA) assert that Virgin Atlantic is wrong to argue that Heathrow is an economically distinct market for time-sensitive passengers. This is because, Qantas and BA argue, the relevant market for analysis of the RJSA is the (regional) market between Europe and Australia, given the large variety of routeings used by passengers travelling between Australia and Europe, the significant proportion of passengers from Australia who visit multiple destinations within Europe, and the dense network of connecting flights that exists within Europe. It is also because, Qantas and BA argue, of the extreme long-haul nature of flights between Europe and Australia, the European Commission's finding in the case of bmi british midland (bmi)/Lufthansa/SAS, and the fact that connections to Continental Europe are available from other airports apart from Heathrow.

As stated in our submission dated 10 June 2003[1], Virgin Atlantic believes that the relevant markets are city pair markets. This is because travellers generally want to travel to a specific destination and are not prepared to substitute another destination when faced with an increase in price. This concurs with previous findings of the European Commission.

The fact that passengers travelling between Europe and Australia have available to them different routeings does not mean that the cities via which they travelled are in the same market as the origin or destination city. For example, a passenger wanting to travel from London to Adelaide may fly BA and Qantas via Sydney, but their ultimate

[1] At page 5.

destination is Adelaide, and hence Sydney cannot be said to be in the same market as Adelaide. Indeed, a ticket

only as far as Sydney holds little interest for this passenger. Similarly, the fact that a significant proportion of passengers originating their journey in Australia visit multiple destinations within Europe does not mean that these destinations are in the same market: a passenger wanting to travel from Australia to London and Brussels will not be interested in a ticket to London only or Brussels only. The fact that there are a number of flights between London and Brussels does not alter this conclusion.

Nor does the fact that rates offered on services to other European destinations from London may be the same or similar. This is because carriers offering such connections are not competing in Australia-Europe city-pair markets, and hence will not set the terms and conditions of any pro-rate agreement entered into according to demand in these markets. For example, if bmi has a pro-rate agreement with Qantas pertaining to the services it offers from Heathrow, the terms and conditions of this agreement will not depend on demand in Australia-Europe city-pair markets, as bmi does not operate to Australia. Rather, the terms and conditions will depend on demand in London-rest of Europe city-pair markets, in which bmi competes. Indeed, bmi can be expected only to make seats on its flights available to Qantas where it cannot sell them itself at a higher price.

As stated at our meeting with the ACCC on 29 September 2003, the fact that the relevant markets are city-pairs means that the ACCC's previous analysis of the costs and benefits associated with the RJSA and its predecessor were conducted relative to the wrong markets. It is necessary, therefore, for the ACCC to examine the impacts of the RJSA on each city-pair market.

Our submission dated 10 June also argues that Heathrow is a separate market, not only for time-sensitive passengers, but also for many non-time-sensitive passengers, given the large number of services provided to many destinations by many competing carriers. Support for such an argument is provided by the fact that <u>average</u> yields (across all cabins) on flights operated from Heathrow are greater than on flights operated to the same

destinations from any other London airport. In the case of long-haul flights, the difference in average yields between flights operated from Heathrow and Gatwick is 15% - 20% on average. This is why Heathrow has been held in the past to constitute a distinct market, for example in various statements made by competition authorities in their investigations of the two applications of BA and American Airlines for an exemption from competition laws for their proposed alliance, why BA continues to switch services from Gatwick to Heathrow, and why the various attempts made by UK airlines over the years to compete from Gatwick with services operated from Heathrow have been unsuccessful[2].

The behaviour of carriers providing services between London and Australia suggests that the fact that these flights are extremely long-haul does not alter this conclusion. Neither Qantas nor BA operates services to Australia from Gatwick, despite the availability of slots at Gatwick. Indeed, of all the carriers providing services between London and Australia, only Emirates provides services from Gatwick, but <u>in addition</u> to the services it operates from Heathrow.

The European Commission's findings in the case of bmi/Lufthansa/SAS have no relevance to Qantas and BA's application. London City, Stansted and Luton's runways are not capable of accommodating the types of aircraft used to operate services between London and South East Asia and Australia.

The fact that connections are available to other European cities from other airports apart from Heathrow has no relevance to London-Australia city-pair markets. As stated in our submission dated 10 June[3], Virgin Atlantic does not have access to information on passengers travelling between other European cities and Australia, and other European cities and South East Asia, except where these passengers travel via London, and hence cannot comment meaningfully on these markets. However, we

[2] See pages 7 to 10 for more detail.
[3] At page 11.

would expect that Qantas and BA would have a sizeable market share in these markets, given

that they provide by far the greatest flight frequency in them. For example, according to Singapore Airlines' website[4], it provides 14 services per week between Singapore and Frankfurt, and according to Table 13 of our submission[5], it provides 21 services per week between Singapore and Sydney. Singapore Airlines therefore provides 14 services per week between Sydney and Frankfurt. Table 13 of our submission shows that Qantas and BA provide 68 flights per week between Sydney and London, and BA's website[6] shows that it provides 51 non-stop services per week between Heathrow and Frankfurt.

Barriers to entry

Qantas and BA assert that Virgin Atlantic is wrong to argue that there are barriers to entry to the relevant markets. This is primarily because, Qantas and BA argue, other carriers, particularly Emirates, have entered these markets and expanded their operations over the period the RJSA and its predecessor have been in effect, and because of certain recent comments made by Virgin Atlantic Chairman Sir Richard Branson. Qantas and BA then argue that if barriers to entry do exist, then they apply just as much to Qantas and BA as to Virgin Atlantic, and, in the case of Europe – Australia markets, they apply more to carriers based at the ends of these routes than carriers based at midpoints.

Tables 5 and 6 of Virgin Atlantic's submission dated 10 June[7] show that despite the existence of competitors in the relevant markets and their expansion over time, it is still the case that Qantas and BA not only carry by far the most passengers travelling for business purposes between London and Australia, but also provide services in all of the biggest business markets between the two countries and are the largest carrier

[4] http://www.singaporeair.com
[5] At page 24.
[6] http://www.britishairways.com
[7] At pages 14 and 15 respectively.

of passengers in all business markets except the London – Perth market (in which they were the

second largest carrier of business passengers). Qantas and BA also carry the most passengers travelling for leisure purposes between London and Australia, provide services in all of the biggest leisure markets between London and Australia, and are the largest carrier of passengers in the two biggest leisure markets, London – Sydney and London – Melbourne. (Other carriers are the largest carriers of passengers in at most one of the other smaller markets).

These results clearly show that the RJSA and its predecessor have had a profound effect on the entry into and expansion within the relevant markets of Qantas and BA's competitors and hence on competition. Indeed, it is interesting to note that the majority of airlines listed in Tables 5 and 6 of our submission are substantially state-owned and hence have soft budget constraints. Our submission dated 10 June[8] also states that the RJSA and its predecessor certainly have affected the entry of Virgin Atlantic.

The recent statements of Sir Richard Branson which Qantas and BA quote actually refer to the possibility of the Hong Kong Government allowing (for the first time) UK carriers to fly passengers between Australia and Hong Kong. Sir Richard believes (as does Virgin Atlantic) that operating to Australia via Hong Kong will put Virgin Atlantic in a stronger position to compete against Qantas and BA, given that Virgin Atlantic is an established competitor in London – Hong Kong markets. However, having the rights to fly via Hong Kong and a track record of competing vigorously on price and service quality is not a guarantee of success in London – Australia markets given that the playing field is not even approximately level, due substantially to the RJSA and its predecessor. This is why we state in our submission dated 10 June that if we are granted the rights to fly via Hong Kong, our chances of success would be greatly improved if either the RJSA is not re-authorised, or if terms and conditions are

[8] At page 4.

attached to its re-authorisation which re-establish effective competition in the relevant markets.

Even if this were to occur, it would still not be the case that a level playing field exists in the relevant markets between carriers based at the ends of these routes. For example, BA enjoys by far the greatest presence at Heathrow, which allows it to better induce the loyalty of loyalty programme participants than its competitors, given the non-linear pay-off schedules inherent in these schemes, as discussed in Virgin Atlantic's submission dated 10 June[9].

It would also not be the case that barriers to entry apply more to carriers based at the ends of routes than carriers based at midpoints. Even if a carrier has the rights to provide services in the relevant markets, their entry into and expansion within these markets will depend on their slot portfolio at Heathrow: as far as Virgin Atlantic is aware, commercially viable slots are still available at all East and South East Asia airports with the exception of Tokyo's Narita Airport. BA enjoys by far the greatest holding of slots at Heathrow.

Market share

Qantas and BA appear to suggest that they do not believe there is a positive relationship between relative market share and barriers to entry, and state that UK CAA *Passenger Survey* data are not reliable enough to analyse outcomes in the relevant markets.

The relationships between relative market share and market power and between relative market power and barriers to entry are well understood and hence no explanation is provided here. Indeed, the European Commission has issued statements about the general relationship between market share and dominance:

[9] See pages 28-36.

"a dominant position can generally be said to exist once a market share of 40-45% is reached".[10]

This has been confirmed in numerous decisions of the European Court of Justice. In its judgement in *United Brands*[11], for example, the Court confirmed the Commission's decision that a firm with a market share in the 40-45% range was dominant where other factors supporting a preponderant position were also present, such as the relationship between the dominant undertaking's market share and shares of its closest competitors.

The CAA's *Passenger Survey* is useful because it permits analysis of the relevant markets. It provides data on what passengers do, rather than the services airlines provide. It therefore permits analysis of where passengers fly, how many passengers fly to each destination, how many passengers travel for business and leisure purposes respectively, how many passengers fly direct and indirect respectively, which airlines passengers fly, and how many passengers fly on each airline. Other data sources typically show only how many passengers fly on the services airlines provide, permitting little analysis of the relevant markets, as no information is given on how many passengers on each service are connecting to other services or otherwise.

MIDT does not contain information on tickets not transacted via Global Distribution Systems (GDSs) (such as Amadeus, Galileo, Sabre and Worldspan). It therefore does not contain information on tickets transacted by travel agents or airlines through BA's former booking system[12] (BABS) or current system (hosted by Amadeus) or through the booking system Virgin Atlantic uses (SHARES). It also does not include any tickets purchased over the phone through BA's, Virgin Atlantic's and other airlines' reservation departments, or over airlines' Internet sites.

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[10] *Xth Report on Competition Policy (1980)*, Point 150.
[11] Case 27/76.
[12] BA switched to Amadeus on 23 February 2002 (British Airways News Release, "British Airways simplifies its business systems to improve customer service and cut costs", 28 February 2002).

This is why the European Commission, in its draft decision dated 8 July 1998 on the first application of BA and American Airlines for an exemption from competition laws for their proposed alliance, used CAA *Passenger Survey* data (as well as other data sources) to examine the impact of the alliance on the relevant markets[13]. The European Commission has not, of course, used this data in cases where the relevant markets do not include services provided to, from or via at least one of Heathrow, Gatwick and Manchester airports (given that these are the only services on which data is provided in the CAA *Passenger Survey*). We also note that BA uses this data in the paper it sent to the Canadian authorities in connection with the acquisition of Canadian Airlines by Air Canada, a copy of which is attached (as Attachment B) to Virgin Atlantic's submission dated 10 June[14].

ASA restrictions

The reasons why Virgin Atlantic believes that the barriers to entry to the relevant markets resulting from ASA restrictions apply more to other carriers based at the ends of these routes and to carriers based at midpoints than to Qantas and BA are discussed above and hence are not repeated here.

Qantas and BA also state that Virgin Atlantic is not prevented by ASA restrictions from serving London – Australia markets, given that, based on statements made in our submission dated 10 June and by Sir Richard Branson, Virgin Atlantic will soon be able to fly to Australia via Hong Kong, and can already operate via Thailand, Malaysia, Singapore or Shanghai. They also state that Virgin Atlantic could provide services between London and Australia with Virgin Blue.

What Virgin Atlantic actually said in its submission dated 10 June with regards to flying via Hong Kong was:

[13] See in particular Annex 1 at page 74.
[14] See for example page 3 of Attachment B.

> "Virgin Atlantic will continue to lobby for the UK – Hong Kong ASA to be amended accordingly, including at the UK – Hong Kong air service negotiations expected to be held in the near future."[15]

Since this time, the air service negotiations between the UK and Hong Kong scheduled to take place at the end of September have been postponed at least until the end of November, for the reasons discussed at our meeting with the ACCC of 29 September. Virgin Atlantic of course hopes that the Hong Kong Government will grant UK carriers the rights to operate to Australia via Hong Kong at these talks, but it is in no way 'guaranteed' that they will do so.

(Redacted) The UK – People's Republic of China (PRC) ASA prevents UK carriers from carrying passengers between the PRC and Australia, as stated in Virgin Atlantic's submission dated 10 June[16].

Despite having a common Chairman and both being part of The Virgin Group (and hence using the Virgin brand name), Virgin Atlantic and Virgin Blue are entirely separate companies. Virgin Atlantic therefore has no control over Virgin Blue's actions. We also understand that any international services operated by Virgin Blue will not use the Virgin brand name.

Airport capacity constraints

Qantas and BA state that the fact that there are no unutilised slots at Heathrow Airport does not constitute a barrier to entry to the relevant markets because slots are available at other airports, carriers apart from Qantas and BA hold significant portfolios of slots at Heathrow which could be easily re-deployed to London – Australia markets, a market for slots exists at Heathrow, costs associated with

[15] At page 4.
[16] At page 20.

acquiring slots at Heathrow are faced by all carriers, the extreme long-haul nature of London – Australia

services means that a low frequency service will be competitive, and Gatwick is also situated close to London.

The reasons why the relevant markets are city-pair markets and Heathrow constitutes a separate market were discussed above. The fact that slots are available at other airports is therefore irrelevant to London – Australia markets.

As shown in Table 4 of Virgin Atlantic's submission dated 10 June[17], Qantas and BA hold by far the largest number of slots at Heathrow. In August 2001, Qantas and BA held 38.4% of slots, more than two-and-a-half times the slots of the next largest slot holder, bmi british midland (14.1%), and over ten times the number of slots held by the third largest holders of slots, Aer Lingus and Lufthansa. Virgin Atlantic held just over 2% of slots. Redeploying slots is therefore likely to be much easier for Qantas and BA than for any other carrier serving Heathrow. Slots for services to Australia also need to be at specific times, given time zones and airport operating restrictions. Providing services to Australia via slot redeployment will also reduce competition in the market the slots were formally used to serve.

Despite the existence of a "grey" market for slots at Heathrow, since 1996 Virgin Atlantic has been able to acquire just a handful of new slots. This is because the vast majority of slots are simply 'not for sale' and those that are for sale are frequently denied to a carrier such as Virgin Atlantic because of "non-price" arrangements. The recent sale of slots to BA by United and Swiss International would appear to fall into this category. Virgin Atlantic expends considerable effort to purchase Heathrow slots, and is prepared to pay the market price for viable slots, but still only has just over 2% of total slots at the airport.

[17] At page 28.

Under the system used to allocate slots at most airports (including Heathrow), historical users of slots are afforded priority. This means that incumbents such as Qantas and BA will have obtained the vast majority of their slot holdings for free. Newcomers such as Virgin Atlantic, on the other hand, have had to pay for many of their slots. BA's large slot holding, by far the largest at Heathrow, will also enable it to acquire slots necessary to operate additional services more easily and at lower cost than carriers such as Virgin Atlantic. This is because it will be able to combine less commercially attractive slots (with a lower price tag) with its existing slot portfolio to produce more attractive slot combinations. This is not an option available to a carrier such as Virgin Atlantic with a relatively small slot portfolio.

It is interesting to note that, despite claiming that re-authorisation of their RJSA would allow them to provide more frequent service and therefore compete more effectively in the relevant markets, Qantas and BA state that new entrants to London – Australia markets can compete effectively providing "one frequency per day or even less".

Loyalty programmes

Qantas and BA assert that loyalty programmes do not create barriers to entry in general and to the relevant markets in particular. They also state that other carriers provide services in the relevant markets despite Qantas and BA offering such schemes.

Virgin Atlantic notes that Qantas and BA's comments here differ markedly from BA's submission to the Canadian authorities in connection with the acquisition of Canadian Airlines by Air Canada, a copy of which is attached (as Attachment B) to Virgin Atlantic's submission dated 10 June, such as:

> "(Air Canada)'s near-monopoly on domestic routes affords it an opportunity to leverage that position to reduce competition in international air travel markets through the use of incentive programmes. Although British Airways believes that, as a generality, it is entirely proper for an airline to offer incentives that are linked to the amount of travel which is booked on that airline, it does not believe that this extends to a situation where an incentive is offered to a customer on a route or bundle of routes on which the airline is in a monopoly position conditional upon the customer's also acquiring a significant part of its requirements in another, competitive market. Air Canada has instituted programs which offer discounts on domestic travel within Canada in exchange for a higher share of international business. As a result, (Air Canada)'s near monopoly in the domestic Canadian market is being leveraged against international competitors to permit Air Canada to secure a further share of the international market."[18]

Indeed, so concerned was BA about the ability of Air Canada to use its loyalty programmes to influence outcomes in London – Canada markets (among others), it stated that:

> "... legislation to ensure that Air Canada's near monopoly does not extract a heavy price to consumers is essential...
>
> We believe that the correct approach to ensuring competition within Canadian markets consists of two main components: legislation that would ensure that competing carriers are able to gain access to the services and facilities controlled by Air Canada that they need to compete with the merged entity;

[18] See page 9 of Attachment B to Virgin Atlantic's submission dated 10 June.

and, legislation to prevent Air Canada from engaging in anti-competitive acts."[19]

BA suggested draft language for regulatory provisions in an Appendix, in which it defined anti-competitive conduct in air transportation markets as:

> "...ii) offers a discount, commission or other concession to a person or persons in respect of, or in connection with, domestic or international travel on the condition that such person or persons commit to purchase, acquire or book air transportation services for either domestic or international travel primarily from that carrier.
>
> iii) uses a frequent flyer program, loyalty program or any non-price incentive for the purpose of or with the effect of discipling or eliminating a competitor or otherwise substantially lessening competition in a market."

It also defined essential services and facilities in air transportation markets as:

> "... an essential "service" or "facility", without restricting the generality of these terms, includes: frequent flyer programs, interline services, maintenance services, baggage handling, loading and other ground services."[20]

As stated in Virgin Atlantic's submission dated 10 June, loyalty programmes induce participant loyalty to the largest provider of services at the airport closest to the participant with the required degree of choice, because they invoke non-linear pay-off schedules. That is, greater frequent flyer points, commissions or discounts are offered the more business transacted with a particular carrier. Such benefits are not related to airline costs (there are no significant economies of scale in the provision of air

[19] See pages 2 and 3 of Attachment B.
[20] See page 19 of Attachment B.

transport services[21]), but rather to the extent to which a participant directs all, or substantially all, of its business to the airline.

Where airlines are dominant they will be able to use these schemes to exclude competitors in markets where they face effective competition, to the detriment of competition and hence consumers. For example, say the business of a company based in Sydney is such that its employees need to travel (for business purposes) frequently to all the capital cities of Australia and to London. Say employee travel within Australia constitutes approximately 80% of the company's total annual travel expenditure and travel to London approximately 20%. The company could choose to fly Qantas domestically and Virgin Atlantic to London. However, in order to prevent the company choosing Virgin Atlantic for travel to London, Qantas could make any discount it offers on the company's domestic travel (by far the largest proportion of its total annual travel expenditure) conditional on obtaining all, or substantially all, of the company's business to London. In order to obtain any of the company's business to London, Virgin Atlantic will need to offer it, on its London business only, the equivalent of the (overall) discount offered by Qantas on the company's domestic and London business. This would make it extremely difficult for Virgin Atlantic to compete for this company's business and the business of other companies like it, making it difficult for Virgin Atlantic to compete in Sydney – London markets. If, as a result of Qantas's behaviour, competition is reduced or even eliminated, Qantas will be able to withdraw the discounts it offers entirely.

As stated in our submission dated 10 June, Virgin Atlantic has first-hand experience of BA engaging in this sort of behaviour. In a decision dated 14 July 1999, the European Commission found that BA had acted in this manner in its dealings with travel agents, fined BA 6.8 million Euros and ordered BA to bring its infringements to an end[22].

[21] See page 37 for further explanation.
[22] See page 35 for further information.

Feed traffic

Qantas and BA state that Virgin Atlantic does not need Australian domestic feed from Qantas because Virgin Blue exists and because both Virgin Blue and Sir Richard Branson have stated that they are keen for Virgin Blue to provide feed for international services, including any operated by Virgin Atlantic.

As far as Virgin Atlantic is aware, Virgin Blue currently has an interlining agreement with just one carrier, United Airlines. Moreover, in practice, interlining between United Airlines and Virgin Blue occurs manually, as there is no interface between the two carriers' computer systems.

Virgin Atlantic also notes that in the Virgin Blue statement quoted by Qantas and BA, it is clear that Virgin Blue will accept feed only where doing so does not adversely affect its existing operations:

> "A value based airline will not operate an unprofitable service simply to obtain feed from that service… It will arrange its schedules so as to maximise feed between *its* services…" (emphasis added)

This is because the business model underpinning Virgin Blue's operations relies crucially on low costs, and there are significant costs associated with interlining.

Hence, despite the fact that Virgin Blue is keen to cooperate with Virgin Atlantic, it is not able at present to provide the sort of interlining options required by passengers arriving or departing on international services, particularly those required by time-sensitive passengers.

Other comments

Returns from scale and density

Qantas and BA state that the RJSA gives rise to substantial cost-savings and hence allows them to provide more services to more cities than would otherwise be possible as, by allowing the two carriers to pool traffic at mid-points such as Singapore, it allows them to capture economies of traffic density. Qantas and BA state that this accounts for a substantial proportion of the benefit associated with the RJSA.

As stated in Virgin Atlantic's submission dated 10 June, there are no substantial economies of scale in the provision of air transport services[23]. Cost-savings associated with economies of traffic density will only be passed on to consumers (in the form of lower air fares, improved service quality, etc) rather than absorbed by factors of production if Qantas and BA face effective competition in the relevant markets. The substantial cost-cutting programmes announced by Qantas in recent months suggest that any cost-savings have been absorbed throughout the existence of the RJSA and its predecessor. Virgin Atlantic also notes that one of the first things that happened after the RJSA was authorised in May 2000, was that BA withdrew its services to Perth and Brisbane (in July 2000 and November 2000 respectively). These occurred despite the existence of mid-point carriers supposedly similarly capturing economies of traffic density at mid-points.

Reductions in overheads

Qantas and BA state that there are significant reductions in overheads resulting from the RJSA, due to the two carriers operating joint facilities and jointly developing IT applications. They state aircraft utilisation is also improved through improved yield and traffic management.

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[23] See page 37 for further explanation.

In its submission dated 10 June, Virgin Atlantic stated that it is difficult to see how the RJSA has reduced overhead costs given that both Qantas and BA's managements have been maintained and presumably some sort of management team is needed to oversee the RJSA[24]. It is also the case that, as stated above, cost-savings (if any) will only be passed on to consumers if Qantas and BA face effective competition in the relevant markets. The substantial cost-cutting programmes announced by Qantas in recent months suggests that any cost-savings resulting from the RJSA and its predecessor have in fact been absorbed by factors of production.

Virgin Atlantic also notes that jointly developing IT applications (and rolling these out within Qantas and BA) is not costless. Indeed, in a press release issued just prior to the oneworld alliance being implemented, BA stated:

> "Hundreds more man years have been spent planning the introduction of the services and benefits, developing and linking IT systems and preparing the millions (of) items of airport signage and stationery to support the brand."[25]

BA also stated, at the time of switching from BABS to being hosted by Amadeus:

> "The change to Amadeus has been a fantastic demonstration of the skills and commitment of everyone in British Airways. More than 11,000 members of staff have been trained and more than 500 experts from the IT, Sales, Customer Service and other departments managed the 'Migration' over Saturday night."[26]

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[24] See page 38.
[25] BA *News Release,* 25 January 1999.
[26] BA *News Release,* 28 February 2002.

Yield management is undertaken by airlines primarily to improve average yields. Airlines use information available to them to better 'price-discriminate'. This presents no competition concerns provided that airlines face effective competition in the markets in which they operate.

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