virgin atlantic

Response to the
Australian Competition and Consumer Commission

Qantas/British Airways Restated Joint Services Agreement

10 June 2003

Introduction

Virgin Atlantic is extremely concerned by the application of Qantas and British Airways for re-authorisation of their "Restated Joint Services Agreement (RJSA)". Virgin Atlantic has, for a number of years, believed that this agreement – and its previous incarnation – affords the two carriers such market power in Europe – Australia, Europe – South East Asia and South East Asia – Australia markets that it effectively acts as a barrier to entry to these markets to carriers such as Virgin Atlantic.

These anti-competitive effects are not outweighed by public benefits arising from the RJSA. The costs and benefits associated with the RJSA are discussed in Virgin Atlantic's responses below to the questions contained in the ACCC's email message dated 12 May 2003.

Virgin Atlantic therefore maintains that the application should be rejected. If the ACCC nevertheless decides to re-authorise Qantas and British Airways' RJSA, it must impose severe conditions in order to re-establish effective competition in the relevant markets. In such circumstances, Virgin Atlantic would welcome the opportunity to comment further; however, general guidance on the conditions which might be applied is offered below.

Virgin Atlantic

Virgin Atlantic Airways Limited (Virgin Atlantic) was established in 1984, when it commenced scheduled air services between London's Gatwick Airport and Newark, New Jersey. Its principal offices are located in West Sussex in the UK.

Virgin Atlantic is currently the UK's second largest scheduled airline (in terms of, for example, Revenue Passenger Kilometres (RPKs) and revenue). Virgin Atlantic operates services from London's Heathrow and Gatwick Airports and Manchester Airport in the UK to 22 destinations in 11 countries (US: New York, Newark, Boston, Washington, Miami, Orlando, Las Vegas, Los Angeles and San Francisco; Caribbean: Barbados, Antigua, St Lucia, Grenada and Tobago; East and South Asia: Tokyo, Hong Kong, Shanghai and Delhi; Africa: Johannesburg, Cape Town, Lagos and Port Harcourt) with a fleet of 28 aircraft. In 2002, Virgin Atlantic operated 27,000 million RPKs, and for the financial year ending April 2002 recorded a pre-tax profit which has yet to be audited on a Virgin Atlantic group turnover of approximately £1.4 billion. Virgin Atlantic employed approximately 6,700 staff in December 2002.

Singapore Airlines purchased 49% of Virgin Atlantic in December 1999. Virgin Atlantic has a "free-sale" agreement with Singapore Airlines, under which it sells seats in Economy Class on Singapore Airlines' services between London and Singapore and Manchester and Singapore, and adds its designator code (VS) to these flights. Virgin Atlantic also has a "blocked-space" agreement with Malaysian Airlines. Under this agreement, Virgin Atlantic obtains a certain number of seats in Business and Economy Classes on Malaysian Airlines' flights between London and Kuala Lumpur, and between either Kuala Lumpur and Sydney or Kuala Lumpur and Melbourne and adds its designator code to these flights. This agreement between Virgin Atlantic and Malaysian Airlines terminates in 2005.

Virgin Atlantic has long held ambitions to fly to Australia in its own right. However, we have refrained from entering directly London – Australia markets to date because of the impacts of the RJSA and its predecessor on these markets. These impacts are discussed below.

We are currently re-considering our position in the light of the ACCC's review of the RJSA. We are considering flying to Sydney initially; however, over time it is our intention to fly also to other Australian destinations. Given that Heathrow is effectively full[1], we would need to operate services to Australia as extensions of our existing services, thereby utilising existing slots at Heathrow. Furthermore, since passengers prefer shorter travel times to longer ones, our choice would be to operate services to Australia as extensions of our Hong Kong services.

Under the UK – Australia ASA, any UK carrier currently has the ability to provide up to 7 services per week between the UK and Australia[2]. The UK – Hong Kong ASA currently prevents UK carriers from flying passengers to Australia via Hong Kong. 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.

However, even if the UK – Hong Kong ASA is amended accordingly, we believe that the only ways we would be able to mount a viable operation are if either the RJSA is not re-authorised, or if terms and conditions are attached to its re-authorisation which re-establish effective competition in the relevant markets, given the overwhelming dominance that the RJSA allows Qantas and British Airways to enjoy in the relevant markets.

[1] This is discussed further below.

[2] Under the UK – Australia ASA, UK carriers are allowed to operate up to 28 services per week between the UK and Australia with fifth freedom rights at all intermediate points except those in the US, Japan and the People's Republic of China (PRC). British Airways currently operates 21 services per week.

The relevant markets

The markets that are affected by the RJSA (and would continue to be affected if the RJSA is re-authorised) are Europe – Australia markets, Europe – South East Asia markets and South East Asia – Australia markets. Within each of these geographic areas, markets are differentiated according to origin and destination and purpose of travel.

From a traveller's point of view, every origin and destination pair (O&D Pair) constitutes an economically distinct product.[3] Travellers generally want to travel to a specific destination and are not prepared to substitute another destination when faced with an increase in price.

A distinction also has to be made between different types of passengers. For some passengers, all possible routeings between an O&D Pair may be substitutes and the O&D Pair market thus includes a bundle of routes comprising direct flights and indirect flights. However, for other passengers only services between specific airport pairs constitute substitutes. It is for this reason that competition authorities have in the past identified economically distinct groups of passengers.[4]

<u>Time-sensitive passengers are distinct</u>

There is a group of passengers on whose time corporations place a high valuation, and hence their employers are prepared to pay more for particular aspects of service quality, such as schedule convenience, superior food and entertainment options and business tools. Indeed, the International Air Transport Association (IATA)'s 1999 *Corporate Air Travel Survey* found that schedule (not price) was the most important determinant of airline choice on

[3] See Case C-66/86, Ahmed Saeed Flugreisen v Zentrale zur Bekämpfung unlauteren Wettbewerbs (1989) ECR 803.

[4] See, for example, the European Commission's *Eurotunnel* decision of 13 December 1994, IV/32.490.

long-haul routes for those travelling on business ('schedule' was cited by 40% of respondents)[5].

This is reflected in the fact that airlines provide several levels of service: Virgin Atlantic, for example, provides Premium Economy class for those passengers wanting schedule flexibility and more leg-room than Economy but who are not willing to pay Business Class prices, and Upper Class for those passengers who are prepared to pay more for additional service quality features. British Airways has recently invested heavily in its First and Business Class products, and developed its own version of Premium Economy.

In the case of London-Australia markets, the number of time-sensitive passengers is greater than otherwise would be expected based on population, given that London, partly by way of its international financial centre status, continues to contain large numbers of firms who place an extremely high value on their employees' time. Salaries in professions such as banking, management consultancy and law are often in excess of £100,000 (according to *The Economist,* 17 October 1998). Virgin Atlantic would expect that Sydney similarly contains a large number of firms who place an extremely high value on their employees' time.

Time-sensitive passengers prefer direct flights

Where there is a choice, time-sensitive travellers do not want to fly indirectly as this always involves additional time, inconvenience and a risk of missing one's connection or losing luggage.

[5] The study asked passengers which were the three most important factors determining their choice of airline for long-haul trips. The questionnaire listed 17 items, with room to specify 'other' factors.

In its Travel Agents decision[6], the European Commission stated (at paragraph 81) that:

> "... time-sensitive passengers who can complete their journey by taking a direct flight from their nearest airport will be in a different situation [from non-time-sensitive passengers]. These passengers will not be prepared to take the extra time required to make stops on their journeys and connect to other flights. Unless an alternative non-stop, speedy means of transport exists to their destination, such as for those passengers travelling from London to Paris or Brussels who may be able to substitute the Eurostar for a direct flight, these passengers will only consider direct flights from their nearest airport to their destination as being interchangeable."

The UK Director General of Fair Trading (DGFT) has also recently accepted that all things being equal, indirect flights are less attractive to most passengers than direct flights.[7] Whilst other factors such as airport or airline preference, schedule, price and seat availability are also relevant, it is clear that passengers, especially time-sensitive passengers, will always prefer a direct flight when given a choice.

Heathrow is a separate market

In London, Heathrow is of unique interest to time-sensitive passengers due to its close proximity to the centre of London (assisted by the new high speed rail link), its convenient schedules and its extensive range of flight connections. This is also evidenced by the greater average yields on flights operated from Heathrow than on flights operated to the same destinations from any other London airport, a difference of 15% - 20% on long-haul flights. It is for these reasons that Heathrow has been held in the past to constitute a distinct market for time-sensitive passengers, for example in various statements made by competition authorities in their investigations of the two applications of

[6] European Commission, 14 July 1999, IV/D-2/34.780.

[7] Notice of consultation issued pursuant to Rule 8(1)(a) of Schedule 1 of the EC Competition Law (Article 84 and 85) Enforcement Regulations 2001, dated 9 August 2002, Case CP/1535-01, at paragraph 65.

British Airways and American Airlines for an exemption from competition laws for their proposed alliance.

In his draft competition analysis of the 1996 British Airways/American Airlines Alliance proposal, the UK DGFT stated:

> "... price yields may indicate whether two airports serving the same catchment area are in the same markets, eg London Heathrow and London Gatwick. ... Both Gatwick and Heathrow are major hubs for BA. Although Gatwick serves more US cities, Heathrow is much more important both in terms of frequencies and passengers and it is much preferred by business passengers. The two airports produce markedly different yields, with Heathrow leading, despite broadly comparable (published) fares. Indeed several carriers wish to switch their services from Gatwick to Heathrow.[8]

The DGFT reinforced this view in his advice of 31 July 1998 by stating that the December 1996 advice

> "... had underestimated the impact of the strength of the alliance at Heathrow Airport on the ability of competitors to enter the UK/US passenger air services market"[9].

In its Public Comments of 17 December 2001 on the second application by British Airways and American Airlines for anti-trust immunity for their alliance, the US Department of Justice stated:

> "... the evidence shows that premium passengers overwhelmingly go to LHR and that most attempts to compete with LHR services from LGW have been unsuccessful."[10]

[8] At paragraphs 47 and 48 of *The proposed alliance between BA and American Airlines – the United Kingdom's draft competition analysis under EC competition law,* dated 13 December 1996 and confirmed in the DGFT's advice of 31 July 1998.

[9] At paragraph 3 of the DGFT's Statement.

[10] Comments of the Department of Justice dated 17 December 2001, page 20, OST-2001-11029-29.

This confirmed the Department of Justice's earlier findings in its investigation of the 1996 British Airways/American Airlines Alliance proposal, where it had also concluded that services provided from Heathrow are distinct markets as:

> "... the available evidence suggests that time-sensitive business travellers overwhelmingly prefer Heathrow to Gatwick and would not switch to Gatwick to avoid a price increase."[11]

The DGFT has also recently recognised that there is a preference among scheduled airlines to fly from Heathrow instead of, for example, Gatwick.[12] He stated that this was illustrated by the fact that peak hour slots are to a greater extent over-subscribed in every season at Heathrow than at Gatwick, by the fact that the average fare from Heathrow is significantly higher than the average fare from Gatwick which reflects the premium that primarily business passengers are prepared to pay to fly to and from Heathrow, and by the fact that airlines, in particular British Airways, have switched services from Gatwick to Heathrow in recent times.

In February 2002, British Airways announced that, as a result of its "Future Size and Shape" review:

> "... a further eight routes will transfer from Gatwick to Heathrow by summer 2002- four long haul (Mauritius, Buenos Aires, Lagos and Abuja) and four short haul (Bucharest, Kiev, Riga and Zagreb)...
> Since December 2000, the airline has been scaling back its operation at London Gatwick to transform it into a base for point-to-point short haul flights and a limited number of long haul routes. By summer 2003, long haul destinations will have reduced from 41 in summer 2001 to 15 destinations through the suspension of unprofitable routes and moving others to London Heathrow."[13]

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[11] Comments of the Department of Justice dated 21 May 1998, page 13, OST-97-2058-222.
[12] Notice of consultation issued pursuant to Rule 8(1)(a) of Schedule 1 of the EC Competition Law (Article 84 and 85) Enforcement Regulations 2001, dated 9 August 2002, Case CP/1535-01 at paragraph 61.
[13] British Airways News Release, *Future Size and Shape Unveiled*, 13 February 2002.

These actions by British Airways are yet another chapter in the long history of failed attempts by UK airlines to compete from Gatwick with services operated from Heathrow: Laker Airways, British Caledonian, Air Europe and Dan-Air all failed and eventually collapsed (British Caledonian was taken over by British Airways in 1987). This was in spite of frequently offering significantly lower published fares than competing services operated from Heathrow, including fares used by time-sensitive passengers.

In its recent investigation of the bmi/United alliance, the US Department of Transportation (DOT) in its Final Order also supported a market definition based on London's Heathrow Airport only and did not consider other London airports to be substitutes.[14]

Heathrow is therefore an economically distinct market for time-sensitive passengers. The relevant O&D Pair markets for time-sensitive passengers are thus direct services to and from Heathrow.

However, Heathrow is also preferred by many non-time-sensitive passengers, given the large number of services provided to many destinations by many competing carriers (as well as its close proximity to the centre of London, its convenient schedules and its extensive range of flight connections).

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[14] US DOT Final Order dated 4 April 2002, Docket OST-2001-11029-125, page 9.

Relative market shares

There are a number of ways passengers can (theoretically) travel between Europe and Australia, Europe and South East Asia, and South East Asia and Australia. The tables below show what passengers travelling between London and Australia, and London and South East Asia actually do in practice. 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, apart from those passengers travelling via London. We also do not have access to information on passengers travelling between South East Asia and Australia. Virgin Atlantic hopes that the ACCC will conduct analyses similar to that conducted below for these markets.

London – Australia markets

Table 1:

Passengers travelling between London and Australia, 2002

Source: UK CAA *Passenger Survey 2002*

	Number of passengers	Proportion of passengers
Originating at London - Terminating in Australia	1,236,591	68.4%
Connecting at London or Australia (or both)	572,351	31.6%
Total	1,808,942	100.0%

Table 2:

Passengers originating at London:

Purpose of travel

Source: UK CAA *Passenger Survey 2002*

	Number of passengers	Proportion of total
Business	206,445	16.7%
Leisure	1,030,146	83.3%
Total	1,236,591	100.0%

Table 1 shows that in 2002, approximately 1,808,942 passengers travelled between London and Australia[15]. Of these, approximately 1,236,591, or 68.4%, began their journeys in London (at Heathrow Airport or Gatwick Airport) and finished their journeys in Australia or vice versa. Table 2 shows that of the passengers beginning their journeys in London and finishing their journeys in Australia or vice versa, approximately 206,445, or 16.7%, were travelling on business; the remaining 1,030,146, or 83.3%, of passengers were travelling for leisure purposes.

Table 3:

Passengers originating at London:

Carrier choice, business passengers

Source: UK CAA *Passenger Survey 2002*

Airline	Number of passengers	Proportion of passengers
British Airways	58,488	28.3%
Qantas	60,771	29.4%
BA+Qantas	119,259	57.8%
Singapore Airlines	34,714	16.8%
Cathay Pacific	11,963	5.8%
Emirates	11,633	5.6%
Malaysian Airlines	9101	4.4%
Thai Airways	8994	4.4%
Japan Airlines3929		1.9%
Virgin Atlantic	3477	1.7%
United Airlines	3001	1.5%
Others	374	0.2%
Total	206,445	100.0%

Table 3 shows that, of those passengers travelling between London and Australia for business purposes, 119,259, or 57.8%, flew on Qantas or British Airways (or both). Qantas and British Airways carried almost three-and-a-half times the number of business passengers carried by the next largest carrier of business passengers, Singapore Airlines, almost ten times the number of business passengers carried by Cathay Pacific and Emirates, and more than thirteen times the number of business passengers carried by Malaysian Airlines and Thai Airways.

[15] UK CAA *Passenger Survey* data refers to return trips taken between two points, regardless of trip origin. For example, if the data states that 10 trips were taken between points A and B, this means that 10 A-B-A or B-A-B trips were made.

Table 4:

Passengers originating at London:

Carrier choice, leisure passengers

Source: UK CAA *Passenger Survey 2002*

Airline	Number of passengers	Proportion of passengers
British Airways	158,369	15.4%
Qantas	174,666	17.0%
BA+Qantas	333,035	32.4%
Singapore Airlines	220,972	21.5%
Malaysian Airlines	145,380	14.1%
Japan Airlines	96,732	9.4%
Emirates	54,956	5.3%
Royal Brunei Airlines	43,023	4.2%
Cathay Pacific	38,822	3.8%
Thai Airways	28,066	2.7%
United Airlines	15,479	1.5%
Garuda Indonesia	11,947	1.2%
Others*	41,734	3.9%
Total	1,030,146	100.0%

* Includes Virgin Atlantic

Table 4 shows that, of those passengers travelling between London and Australia for leisure purposes, 333,035, or 32.4%, flew on Qantas or British Airways (or both). Qantas and British Airways carried one-and-a-half times the number of passengers travelling for leisure purposes carried by the next largest carrier of such passengers, Singapore Airlines, more than twice the number of leisure passengers carried by Malaysian Airlines, almost three-and-a-half times the number of leisure passengers carried by JAL, more than six times the number carried by Emirates, and almost eight times the number carried by Royal Brunei Airlines.

Tables 5 and 6 show what passengers do in the relevant London-Australia markets. Table 5 shows that, in 2002, Melbourne and Sydney were by far the most popular destinations for business travellers. Melbourne attracted more than five times the number of business travellers travelling to Perth, almost six times the number of such travellers travelling to Brisbane, and over ten times the number of business travellers travelling to Adelaide.

Table 5:

London – Australia city-pair markets:

Carrier choice, business passengers

Source: UK CAA *Passenger Survey 2002*

			British Airways		Qantas		BA+Qantas		Singapore		Cathay Pacific		Emirates		Malaysian		Thai Airways		Others*	
Destination	No. pax	% pax	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Melbourne	80,107	38.8%	18,953	23.7%	28,699	35.8%	47,652	59.5%	16,292	20.3%	5840	7.3%	5941	7.4%	4382	5.5%	0	0.0%	0	0.0%
Sydney	72,913	35.3%	26,823	36.8%	13,659	18.7%	40,482	55.5%	8924	12.2%	4176	5.7%	2877	4.0%	4419	6.1%	8743	12.0%	3292	4.5%
Perth	15,945	7.7%	1017	6.4%	3794	23.8%	4811	30.2%	6908	43.3%	1160	7.3%	2815	17.7%	0	0.0%	251	1.6%	0	0.0%
Brisbane	13,897	6.7%	2798	20.1%	6161	44.3%	8959	64.5%	1405	10.1%	786	5.7%	0	0.0%	0	0.0%	0	0.0%	2748	19.8%
Adelaide	7,586	3.7%	1958	25.8%	2403	31.7%	4361	57.5%	1186	15.6%	0	0.0%	0	0.0%	300	4.0%	0	0.0%	1740	22.9%
Others	15,996	7.8%	6940		6055		12995		0		0		0		0		0		3001	
Total	206,445	100.0%																		

* Includes Virgin Atlantic

Table 6:

London – Australia city-pair markets:

Carrier choice, leisure passengers

Source: UK CAA *Passenger Survey 2002*

			British Airways		Qantas		BA+Qantas		Singapore		Malaysian		Japan Airlines		Emirates		Royal Brunei	
Destination	No. pax	% pax	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Sydney	380,155	36.9%	80,658	21.2%	61,769	16.2%	142,427	37.5%	61,705	16.2%	66,355	17.5%	46,001	12.1%	9447	2.5%	0	0.0%
Melbourne	233,982	22.7%	20,021	8.6%	58,753	25.1%	78,774	33.7%	58,817	25.1%	35,977	15.4%	3873	1.7%	31,723	13.6%	0	0.0%
Perth	166,067	16.1%	26,018	15.7%	13,966	8.4%	39,984	24.1%	56,428	34.0%	9307	5.6%	0	0.0%	13,025	7.8%	25,424	15.3%
Brisbane	143,821	14.0%	13,147	9.1%	18,233	12.7%	31,380	21.8%	33,619	23.4%	11,347	7.9%	36,561	25.4%	0	0.0%	10,655	7.4%
Adelaide	55,445	5.4%	4040	7.3%	8713	15.7%	12,753	23.0%	9744	17.6%	22,013	39.7%	5061	9.1%	0	0.0%	0	0.0%
Cairns	23,581	2.3%	6960	29.5%	7425	31.5%	14385	61.0%	0	0.0%	381	1.6%	4649	19.7%	0	0.0%	0	0.0%
Darwin	10.151	1.0%	1846	18.2%	1362	13.4%	3208	31.6%	0	0.0%	0	0.0%	0	0.0%	0	0.0%	6944	68.4%
Others	16,944	1.6%	5680		4446		10,126		659		0		586		761		0	
Total	1,030,146	100.0%																

	Cathay Pacific		Thai Airways		United		Garuda		Others*	
Destination	No.	%	No.	%	No.	%	No.	%	No.	%
Sydney	6393	1.7%	12,875	3.4%	14,074	3.7%	1580	0.4%	19,298	5.1%
Melbourne	8085	3.5%	6021	2.6%	1405	0.6%	2064	0.9%	7243	3.1%
Perth	11,830	7.1%	7792	4.7%	0	0.0%	500	0.3%	1776	1.1%
Brisbane	3441	2.4%	1079	0.8%	0	0.0%	6839	4.8%	8901	6.2%
Adelaide	3781	6.8%	0	0.0%	0	0.0%	963	1.7%	1131	2.0%
Cairns	4165	17.7%	0	0.0%	0	0.0%	0	0.0%	0	0.0%
Darwin	0	0.0%	0	0.0%	0	0.0%	0	0.0%	0	0.0%
Others	1126		300		0		0		3386	
Total										

* Includes Virgin Atlantic

Table 5 shows that Qantas and British Airways not only carried by far the most passengers travelling for business purposes between London and Australia, but also provided services in all of the biggest business markets between the two countries. They were also the largest carrier of passengers in all business markets except the London – Perth market, in which they were the second largest carrier of business passengers.

Table 6 shows that, in 2002, Sydney was the most popular destination for passengers travelling for leisure purposes, and Melbourne was the second most popular destination. The third and fourth most popular destinations for leisure travellers were Perth and Brisbane, respectively.

Table 6 shows that Qantas and British Airways not only carried the most passengers travelling for leisure purposes between London and Australia, but also provided services in all of the biggest leisure markets between London and Australia. They were also the largest carrier of passengers in the two biggest leisure markets, London – Sydney and London – Melbourne, as well as the London – Cairns market; other carriers were the largest carriers of passengers in at most one of the other (smaller) markets. Qantas and British Airways were also the second biggest carrier of leisure passengers in the London – Perth, London – Adelaide, and London – Darwin markets. They were the third biggest carrier of such passengers in the London – Brisbane market.

London – South East Asia markets

Table 7:

Passengers travelling between London and Singapore, 2002

Source: UK CAA *Passenger Survey 2002*

	Number of passengers	Proportion of passengers
Originating at London - Terminating at Singapore	477,330	34.1%
Originating at London - Connecting at Singapore	641,310	45.8%
Connecting at London - Terminating at Singapore	130,584	9.3%
Connecting at London - Connecting at Singapore	150,133	10.7%
Total	1,399,357	100.0%

Table 8:

Passengers originating at London:

Purpose of travel and routing

Source: UK CAA *Passenger Survey 2002*

	Number of passengers	Proportion of total	Direct	% direct	Indirect	% indirect
Business	119,593	25.1%	99,059	82.8%	20,534	17.2%
Leisure	357,737	74.9%	285,482	79.8%	72,255	20.2%
Total	477,330	100.0%	384,541		92,789	

Table 7 shows that in 2002, approximately 1,399,357 passengers travelled between London and Singapore. Of these, approximately 477,330 or 34.1% began their journey in London (at Heathrow Airport or Gatwick Airport) and finished their journey in Singapore or vice versa. Table 8 shows that of the passengers beginning their journey in London and finishing their journey in Singapore or vice versa, approximately 119,593 or 25.1% were travelling on business; the remaining 357,737 or 74.9% were travelling for leisure purposes. 99,059 or 82.8% of passengers travelling on business and 285,482 or 79.8% of passengers travelling for leisure purposes flew direct, respectively.

Table 9:

Passengers travelling between London and Bangkok, 2002

Source: UK CAA *Passenger Survey 2002*

	Number of passengers	Proportion of passengers
Originating at London - Terminating at Bangkok	537,411	55.8%
Originating at London - Connecting at Bangkok	201,204	20.9%
Connecting at London - Terminating at Bangkok	172,027	17.9%
Connecting at London - Connecting at Bangkok	52,298	5.4%
Total	962,940	100.0%

Table 10:

Passengers originating at London:

Purpose of travel and routing

Source: UK CAA *Passenger Survey 2002*

	Number of passengers	Proportion of total	Direct	% direct	Indirect	% indirect
Business	46,104	8.6%	43,869	95.2%	2,235	4.8%
Leisure	491,307	91.4%	324,950	66.1%	166,357	33.9%
Total	537,411	100.0%	368,819		168,592	

Table 9 shows that in 2002, approximately 962,940 passengers travelled between London and Bangkok. Of these, approximately 537,411 or 55.8% began their journey in London and finished their journey in Bangkok or vice versa. Table 10 shows that of the passengers beginning their journey in London and finishing their journey in Bangkok or vice versa, approximately 46,104 or 8.6% were travelling on business; the remaining 491,307 or 91.4% were travelling for leisure purposes. 43,869 or 95.2% of passengers travelling on business and 324,950 or 66.1% of passengers travelling for leisure purposes flew direct, respectively.

Tables 11 and 12 show that Qantas and British Airways were the largest carrier of passengers travelling for business purposes in the London – Bangkok market, the second largest carrier of business passengers in the London – Singapore market, and the second largest carrier of passengers travelling for leisure purposes in both the London – Singapore and London – Bangkok markets.

Of course, in the UK CAA *Passenger Survey,* information is given primarily in terms of passenger numbers or 'volumes': the only information given on the price at which passengers travelled or 'value' is whether passengers were travelling for business or leisure purposes. The European Commission has consistently found that value is a more accurate reflection of market power than volume. Virgin Atlantic agrees with this assessment and believes that share of total market turnover would be a good basis for assessing market power in each relevant market. Virgin Atlantic urges the ACCC to use the powers it has to obtain the data necessary for it to examine carrier shares of total market turnover.

Table 11:

London – Singapore, London – Bangkok markets:

Carrier choice, business passengers

Source: UK CAA *Passenger Survey 2002*

		British Airways		Qantas		BA+Qantas		Singapore		Cathay Pacific		Emirates		Malaysian		Thai Airways		Others*	
Destination	No. pax	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Singapore	119,593	27,942	23.4%	7,235	6.0%	35,177	29.4%	66,975	56.0%	2221	1.9%	5017	4.2%	2066	1.7%	0	0.0%	8139	6.8%
Bangkok	46,104	17,820	38.7%	5,677	12.3%	23,497	51.0%	0	0.0%	0	0.0%	0	0.0%	781	1.7%	14,177	30.8%	7649	16.6%

* Includes Virgin Atlantic

Table 12:

London – Singapore, London – Bangkok markets:

Carrier choice, leisure passengers

Source: UK CAA *Passenger Survey 2002*

		British Airways		Qantas		BA+Qantas		Singapore		Cathay Pacific		Emirates		Malaysian		Thai Airways		Others*	
Destination	No. pax	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Singapore	357,737	97,004	27.1%	52,424	14.7%	149,428	41.8%	154,348	43.1%	0	0.0%	17,886	5.0%	10,459	2.9%	2250	0.6%	23,366	6.5%
Bangkok	491,307	93,616	19.1%	44,069	9.0%	137,685	28.0%	8481	1.7%	7963	1.6%	33,984	6.9%	169	0.0%	147,003	29.9%	156,025	31.8%

* Includes Virgin Atlantic

Other barriers to entry

Market shares, even those based on value, however, underestimate the full extent of market power enjoyed by Qantas and British Airways in the relevant markets.

<u>ASA restrictions</u>

The restrictions on market entry inherent in the UK – Australia ASA and UK – Hong Kong ASA were discussed above. However, market entry is also restricted by a number of other ASAs.

The UK – Japan ASA and UK – PRC ASA prevent UK carriers from carrying passengers between Japan and Australia and the PRC and Australia, respectively. The UK – Singapore ASA restricts the number of passengers that UK carriers can pick-up in Singapore (passengers that they have not carried between the UK and Singapore) and fly to Australia, and British Airways is currently using almost all of the rights pertaining to the carriage of such passengers. Repeated attempts to liberalise the UK – Singapore ASA have been unsuccessful due to the unwillingness of the UK Government to grant Singapore Airlines the right to fly to the US from the UK (and pick-up passengers in the UK who have not originated their journey in Singapore).

The UK – Thailand ASA allows UK carriers to fly between Thailand and Australia and pick-up passengers in Thailand (passengers that they have not carried between the UK and Thailand), and British Airways is not currently using all of the rights pertaining to the carriage of such passengers. The UK – Malaysia ASA similarly allows UK carriers to fly between Malaysia and Australia and pick-up passengers in Malaysia (passengers that they have not carried between the UK and Malaysia). No UK airline is currently providing services between Malaysia and Australia (or indeed between the UK and Malaysia).

However, given that Virgin Atlantic currently does not operate to Bangkok or Kuala Lumpur, it would need to commence services to these destinations from London. In particular, these services would need to be provided from Heathrow, given that, as noted above, passengers, particularly time-sensitive passengers, overwhelmingly prefer services provided from Heathrow to services provided from Gatwick. However, Heathrow is effectively full.

Airport capacity constraints

Heathrow is effectively full due to the severe runway constraints that exist at almost all times of the day. This is confirmed by British Airways in its comments on the Institute of Directors' policy paper *Air Warfare*, a copy of which is attached:

> "Briefly stated, Heathrow as it currently stands is full."[16]

BAA, the owner of Heathrow, has reinforced this statement:

> "At Heathrow, the full utilisation of runway capacity at most times of the day would mean that any increase in the number of US services, would inevitably lead to a reduction of services to other destinations."[17]
>
> "It is not possible to increase Heathrow's runway capacity by more than a minimal amount without changing the operating protocols. And until Heathrow's Terminal 5 is approved, built and opened, there is relatively little that can be done to relieve the aircraft parking and terminal capacity constraints."[18]

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[16] British Airways, *Comments on the Institute of Directors Policy Paper "Air Warfare"*, February 2001.

[17] Memorandum of BAA Plc to the UK Transport Select Committee Inquiry into Air Services Agreements between the UK and the US, April 2000.

[18] Letter from Mike Toms, Group Strategy and Regulatory Affairs Director, BAA Plc, to Susan McDermott, Deputy Assistant Secretary for Aviation and International Affairs, US Department of Transportation, Docket No. OST-2001-10387-77, at paragraph 18.

As BAA's comments indicate, the runway capacity constraints mean that both incumbents and new entrants cannot significantly increase their provision of services to and from Heathrow by scheduling new services. Incumbent carriers can alter the destinations they fly to (fleet and terminal facilities permitting), but providing any additional services to one destination almost invariably involves reducing services to another. For example, British Airways has over the past few years substituted loss-making short-haul routes with profitable long-haul services. This option is not available to the likes of Virgin Atlantic.

<u>Contribution of time-sensitive passengers to route viability</u>

Attracting a substantial proportion of time-sensitive passengers is crucial to the commercial success of a carrier's operations in the type of markets in which Qantas/British Airways and Virgin Atlantic operate, as it ensures that the substantial fixed costs inherent in the provision of services are recovered over the course of economic cycles, given that these passengers are higher-yield.

Should a carrier's ability to attract a large number of time-sensitive passengers be reduced, the carrier will need to spread a greater proportion of fixed common costs across passengers with a lower willingness to pay, and hence charge these passengers higher fares. However, if it raises fares for these passengers, they will switch to its competitors. This will increase the extent to which it will need to raise its fares, causing more passengers to switch, and so on. Of course, other carriers in the market will only produce near-competitive prices, output levels and levels of service quality provided that they continue to face effective competition. If providing the service becomes non-commercially viable for competing carriers, the dominant carrier will be able to raise prices and make super-normal profits.

As stated above, Qantas and British Airways not only carried by far the most passengers travelling for business purposes between London and Australia, but were also the largest carrier of such passengers in all business markets except the London – Perth market, in which they were the second largest carrier of business passengers. Qantas and British Airways were also the largest carrier of passengers travelling for business purposes in the London – Bangkok market and the second largest carrier of business passengers in the London – Singapore market.

Flight frequency

The frequency of flights in a market provided by a carrier itself or via code-sharing on services operated by other carriers is important to time-sensitive passengers in particular when choosing a carrier as it guarantees flexibility should the need to change flights arise.

Tretheway and Oum (1992) [19] show that as the number of frequencies a carrier provides in a market increases (relative to those provided by competitors), that carrier will enjoy a more than proportionate increase in revenue from operating an additional frequency (this is commonly known as "the S-curve effect"). This is because the carrier operating the greater number of frequencies will be able to attract a greater proportion of time-sensitive passengers, as these passengers place a particularly high value on frequent service. Specifically, frequent service minimises time-sensitive passengers' "schedule-delay cost": the difference between actual departure times and desired departure time.

[19] Tretheway, M and T Oum (1992), *Airline Economics-Foundations for Strategy and Policy*, Centre for Transportation Studies, University of British Columbia, Vancouver, Canada.

Table 13: Weekly frequencies, London – Australia markets

Source: *OAG*, February 2003

Services from London									Mid point	Services to Australia									
BA	Qantas	BA+ Qantas	Singapore	Cathay Pacific	Emirates	Malaysian	Thai Airways	Japan Airlines		Destination	BA	Qantas	BA+ Qantas	Singapore	Cathay Pacific	Emirates	Malaysian	Thai Airways	Japan Airlines
12	14	26	21	0	0	0	0	0	Singapore	Melbourne	5	12	17	14	0	7	0	0	0
										Sydney	7	24	31	21	0	4	0	0	0
										Perth	0	14	14	18	0	0	0	0	0
										Brisbane	0	7	7	14	0	0	0	0	0
										Adelaide	0	3	3	3	0	0	0	0	0
										Others	0	3	3	0	0	0	0	0	0
7	7	14	0	0	0	0	11	0	Bangkok	Melbourne	0	7	7	0	0	0	0	12	0
										Sydney	7	7	14	0	0	0	0	14	0
										Perth	0	0	0	0	0	0	0	3	0
										Brisbane	0	0	0	0	0	0	0	3	0
										Adelaide	0	0	0	0	0	0	0	0	0
										Others	0	0	0	0	0	0	0	0	0
14	0	14	0	18	0	0	0	0	Hong Kong	Melbourne	0	7	7	0	11	0	0	0	0
										Sydney	0	14	14	0	14	0	0	0	0
										Perth	0	7	7	0	3	0	0	0	0
										Brisbane	0	5	5	0	5	0	0	0	0
										Adelaide	0	0	0	0	2	0	0	0	0
										Others	0	3	3	0	5	0	0	0	0
14	0	14	0	0	0	0	0	12	Tokyo	Melbourne	0	7	7	0	0	0	0	0	0
										Sydney	0	21	21	0	0	0	0	0	7
										Perth	0	3	3	0	0	0	0	0	0
										Brisbane	0	0	0	0	0	0	0	0	7
										Adelaide	0	0	0	0	0	0	0	0	0
										Others	0	14	14	0	0	0	0	0	0
0	0	0	0	0	0	18	0	0	Kuala Lumpur	Melbourne	0	0	0	0	0	0	14	0	0
										Sydney	0	0	0	0	0	0	14	0	0
										Perth	0	0	0	0	0	0	8	0	0
										Brisbane	0	0	0	0	0	0	5	0	0
										Adelaide	0	0	0	0	0	0	3	0	0
										Others	0	0	0	0	0	0	0	0	0
14	0	14	0	0	35	0	0	0	Dubai	Melbourne	0	0	0	0	0	7	0	0	0
										Sydney	0	0	0	0	0	4	0	0	0
										Perth	0	0	0	0	0	4	0	0	0
										Brisbane	0	0	0	0	0	0	0	0	0
										Adelaide	0	0	0	0	0	0	0	0	0
										Others	0	0	0	0	0	0	0	0	0
									All	Melbourne	5	33	38	14	11	7	14	11	0
										Sydney	14	66	68	21	14	4	14	11	7
										Perth	0	24	24	18	3	4	8	3	0
										Brisbane	0	12	12	14	5	0	5	3	7
										Adelaide	0	3	3	3	2	0	3	0	0
										Others	0	20	20	0	5	0	0	0	0

Table 13 shows, for the carriers travelled on by passengers travelling for business purposes in London – Australia city-pair markets (shown in Table 5 above), carrier routing and frequency of flights on routes. Given what carriers provide between London and Australian cities, it also shows (in the last row) what passengers perceive these carriers provide in terms of frequencies.

The last row shows that, according to passengers, Qantas and British Airways offer by far the most frequent service between London and Australia. Furthermore, Qantas and British Airways offer the most frequent service in all London – Australia city-pair markets except the London – Brisbane market, in which they offer the second most frequent service. In the London – Melbourne market, Qantas and British Airways offer well over twice the frequency of service per week offered by the second most frequent providers of services in this market, Singapore Airlines and Malaysian Airlines. In the London – Sydney market, Qantas and British Airways offer more than three times the frequency of service offered by the second most frequent provider of services, Singapore Airlines. In the London – Perth market, Qantas and British Airways offer a third more frequencies per week than Singapore Airlines.

Table 13 also shows that Qantas and British Airways offer the most frequent service between London and Singapore, and between London and Bangkok.

<u>Airport presence</u>

The larger a carrier's slot holding and hence airport presence, the greater the level of market power it enjoys in markets where this airport is an endpoint, for three reasons.

First, the larger the slot portfolio of a carrier, the greater operational flexibility it will have at the airport concerned to respond to the actions of competitors, and hence it will be able to 'target' markets where it faces strong competition by scheduling frequent services at convenient times, for example. This ability to 'credibly threaten' to respond to the actions of competitors will discourage competitors from vigorously competing upon entering any market or adding capacity in markets, and may even deter competitors from entering markets altogether.

Second, the more extensive a carrier's network, the greater the likelihood that it will face differing levels of competition across its network, and hence the greater financial flexibility it will have to respond to the actions of competitors. Specifically, it will be able to cross-subsidise across its route network: it will be able to offset any reduction in revenues in markets where entry occurs or competitors add capacity with economic rents earned in other markets.

Third, the greater the presence a carrier has at an airport, the more attractive the loyalty programmes it offers will be in the catchment area of that airport. This is because the non-linear pay-off schedules inherent in these schemes incentivise participants to direct substantially all of their business to the carrier with the largest presence at the airport located in their vicinity. These loyalty programmes are discussed further below.

A number of studies have attempted to estimate the magnitude of the additional market power enjoyed by carriers in city-pair markets where they have a substantial presence at one (or both) of the endpoint airports. Borenstein (1989)[20], using data on 3,591 domestic routes operated by the nine largest US airlines, found that a carrier with a 50% airport emplanement share at both ends of a route could charge high-end prices approximately 12% above those of a competitor with a 10% endpoint airport share. In a separate study, Borenstein (1991)[21], using data on 948 US domestic routes found that, on average, a one percentage point increase in airport originating traffic share is associated with a one-quarter percentage point increase in route traffic share, regardless of the difference in fares between competitors on each route. Borenstein also concluded in a 1992 study[22] based on the thirty largest US airports, that passengers on flights originating or terminating at the hub airport of a carrier paid a premium which increased by approximately 0.44%

20 Borenstein, S (1989), "Hubs and High Fares: Dominance and Market Power in the US Airline Industry", *Rand Journal of Economics,* 20(3), Autumn 1989; 344-365.

21 _____ (1991), "The Dominant-Firm Advantage in Multiproduct Industries: Evidence From the US Airlines", *Quarterly Journal of Economics,* 106, November 1991; 1237-1266.

22 _____ (1992), "The Evolution of US Airline Competition", *Journal of Economic Perspectives,* 6(2), Spring 1992; 45-73.

for every 1% increase in airport concentration. Berry (1990)[23] found that the premium carriers are able to charge is higher on hub-originating services (as opposed to hub-terminating services).

It was subsequently shown that studies such as these significantly underestimate the level of market power enjoyed by carriers with a substantial airport presence in airport-pair markets due to endogeneity in the estimated model. Evans, Froeb and Werden (1993)[24] found that when the model was properly adjusted, the (unbiased) estimate of the effect of concentration on price exceeded (biased) Ordinary Least Squares (OLS) estimates by approximately 250%.

Table 14 shows that in August 2001, British Airways held 38% of slots at Heathrow. Qantas held 0.4% of slots. British Airways held more than two-and-a-half times the slots of the next largest slot holder, bmi british midland, 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.

The oneworld alliance, of which Qantas and British Airways are members, held 47.4% of all slots, over one-and-a-half times the slot holdings of the next largest alliance at Heathrow, the Star Alliance (27.8%). British Airways had almost nine times the slots of the SkyTeam Alliance (5.3%).

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23 Berry, S (1990), "Airport Presence as Product Differentiation", *American Economics Association Papers and Proceedings*, 80(2), May 1990; 394-399.

24 Evans, W, L Froeb and G Werden (1993), "Endogeneity in the Concentration-Price Relationship: Causes, Consequences, and Cures", *Journal of Industrial Economics*, 41(4), December 1993; 431-438.

Table 14:

Slot holdings at Heathrow (August 2001)[25]

Carrier/alliance grouping	% share
British Airways (including franchisees)	38.0%
Qantas	0.4%
BA+Qantas	38.4%
Aer Lingus	3.5%
American Airlines	2.4%
Iberia	2.3%
Finnair	0.5%
Cathay Pacific	0.3%
oneworld Alliance	**47.4%**
bmi british midland	14.1%
Lufthansa	3.5%
SAS	3.3%
United Airlines	2.6%
Air Canada	2.0%
Austrian Airlines	0.5%
Singapore Airlines	0.5%
LOT Polish Airlines	0.5%
Thai Airways	0.2%
Varig	0.2%
All Nippon Airways	0.2%
Air New Zealand	0.2%
Star Alliance	**27.8%**
Air France	2.0%
Alitalia	2.0%
British European	0.9%
CSA Czech Airlines	0.3%
Korean Air	0.1%
SkyTeam Alliance	**5.3%**

25 Since this time, it has been reported that British Airways has acquired a number of additional slots. British Airways was reported by *The Observer* to have acquired (a total of) four daily slot pairs from Lithuanian Airlines, Balkan Airlines, Adria of Slovenia and Avianca of Colombia (*The Observer*, 21 April 2002, "BA buys up Heathrow slots") and by *The Financial Times* to have acquired an additional six weekly slot pairs from these four carriers and seven daily slot pairs from SN Brussels Airlines (*Financial Times*, 12 July 2002, "BA adds to capacity at Heathrow"). Virgin Atlantic has also acquired two daily slot pairs from SN Brussels Airlines. The slot holdings in the table, and hence the paragraphs referring to these, therefore do not take these purchases into account.

Carrier/alliance grouping	% share
KLM	1.9%
MAS Malaysian Airlines	0.3%
Kenya Airways	0.2%
Wings Alliance	**2.4%**
Virgin Atlantic	**2.18%**
Other Non-Aligned Carriers	16.68%

Loyalty programmes

"Full-service" carriers (as opposed to "low-" or "no-frills" carriers) generally operate three main loyalty programmes: frequent flyer programmes (FFPs), corporate deals, and travel agent commission override schemes (TACOs). All of these generally offer 'rewards' to participants once the value of their transactions reaches a certain threshold level and then increase the reward amount as higher threshold levels are reached. FFPs reward passengers with free flights, seat upgrades, car hire, etc; under corporate deals companies are offered discounts off the value of employee travel; under TACOs travel agents are rewarded with commissions, etc.

Such a (non-linear) pay-off schedule induces participant loyalty to a single, large carrier, for two reasons. First, the greater the extent to which a participant concentrates transactions on a single carrier, the higher the reward 'rate' it will be eligible for and hence the greater the reward it will earn. Second, the 'larger' this carrier is (the greater its presence at the airport in the vicinity of which the passenger, corporation or travel agent is based), the more likely it will provide most of the services demanded by passengers, firms or travel agents' customers, maximising the proportion of total transactions upon which a reward could be earned as well as the reward rate the participant is eligible for. In order to entice passengers, corporations or travel agents away from the largest carrier, smaller carriers need to offer larger rates of commission on smaller sales levels.

If corporations allow their employees to accumulate and redeem ("earn and burn") the frequent flyer miles associated with the travel they undertake for business purposes (for example, on leisure travel), frequent flyer programmes also encourage employee use of the largest provider of services for business travel. This is because this carrier will operate the largest number of services on which they can redeem accumulated frequent flyer miles. Hence frequent flyer programmes encourage employee use of the largest provider.

Several studies have empirically examined the link between FFPs and market power. Nako (1992)[26], using data on 497 business trips undertaken by the employees of three medium-size US firms during June 1990 and January 1991, found that membership of a carrier's FFP increased an employee's valuation of that carrier's services by approximately US$40, and a 10% increase in that carrier's airport presence increased the employee's valuation by $4.16 on average. He also found that the total effect of USAir's (now US Airways) FFP was greater on individuals residing in the Baltimore region, where US Airways has a hub, than on individuals residing in the Dallas-Fort Worth region, where US Airways does not have a hub.

Morrison and Winston (1995)[27] found that the marginal value of an additional frequent flyer mile in the second half of 1990 was 13.0 cents for those who had accumulated between 3501 and 15,000 miles and 21.5 cents for those who had accumulated between 15,001 and 80,000 miles. The authors also found that the marginal value of an extra mile to passengers whose tickets had been paid for by employers was approximately 16.8 cents. Morrison and Winston (1995) also simulated the effects of abolishing FFPs using 1990 data on twelve US carriers. They found that if all carriers had abolished their FFPs, larger airlines' fares would have fallen and they would have lost market share to smaller carriers.

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[26] Nako, S (1992), "Frequent Flyer Programs and Business Travellers: An Empirical Investigation", *Logistics and Transportation Review*, 28(4); 395-414.

[27] Morrison, S and C Winston (1995), *The Evolution of the Airline Industry*, The Brookings Institute, Washington DC.

Qantas operates Australia's largest FFP. Similarly, British Airways operates Europe's largest FFP. These FFPs encourage corporations to enter into corporate deals with Qantas and British Airways as such deals make corporate travel managers popular with employees who are usually allowed to accumulate the frequent flyer miles associated with the travel they undertake for business purposes and redeem these (on personal travel) on the wide range of services provided by Qantas and British Airways (and their oneworld alliance partners).

Being able to attract the business of corporations is crucial to the commercial success of a carrier's operations in the type of city-pair markets in which Qantas/British Airways and Virgin Atlantic operate, given that these firms purchase the majority of higher-yield tickets. Such purchases are made on behalf of employees whose time is valuable. Multi-national firms tend to purchase the largest proportion, since they have large numbers of employees whose time is particularly valuable and offices in several countries.

Carriers are also able to encourage loyalty via the computer reservation systems (CRSs) travel agents use to find out fare, route and departure time information and to make bookings. Studies of US booking behaviour have shown that, for any city-pair market, the majority of bookings are made on flights listed in the first screen of a CRS display and a substantial proportion of these are made on flights listed in the first few lines of the first screen[28]. Carriers therefore have the incentive to 'screen pad' to ensure that competing flights are 'pushed' further down the first screen or indeed onto subsequent screens. Listing code-shared flights as flights of each of the code-share partners, for example, will take up considerable screen space.

[28] American Airlines, for example, found that over 90% of all its Sabre system sales came from somewhere on the first screen of a CRS display, and 53.5% came from the first line of the first screen (Gillen, D, T Oum and M Tretheway (1988), "Entry Barriers and Anti-Competitive Behaviour in a Deregulated Airline Market: The Case of Canada", *International Journal of Transport Economics,* 15(1), February; 29-41.

Feed traffic

Where the volume of direct traffic alone will not make operations commercially viable, improved feed (relative to competitors) increases a carrier's market power, in two ways. First, having access to feed traffic at either or both ends of a route increases the commercial viability of a route by increasing loads and hence total revenue. Second, where greater loads permit more frequent service (relative to competitors), average yields earned on the route will increase due to the existence of the S-curve effect discussed above.

Whenever Virgin Atlantic commences a service, we always try to negotiate "Special Prorate Agreements" (SPAs) with carriers operating from endpoint airports. The extent to which we are successful, and hence the terms and conditions we are offered, depends on our bargaining power vis-à-vis these carriers, which in turn largely depends on their relative presence at the airports in question. Hence, even where we are successful, the margin charged on the connecting service gives the carrier with whom we have signed an agreement (and possibly their alliance partners) an advantage in one-stop markets via the airports in question. This will also reduce the viability of Virgin Atlantic's direct services. Carriers competing with our direct services or their alliance partners may be unwilling to enter into agreements with us at all. Alternatively, they may substantially increase the margin charged on connecting services.

Given that Virgin Blue essentially does not interline, Qantas is the only potential provider of domestic feed in Australia.

Abuse of a dominant position

Where a carrier is in a dominant position, it can use its operational and financial flexibility, loyalty programmes and interline agreements to compete unfairly.

A carrier in a dominant position can use its operational and financial flexibility to engage in predatory behaviour. For example, it can use its operational flexibility to "dump" capacity: it can add capacity in excess of that needed to compete fairly by using its slot portfolio to schedule additional flights in a market. Alternatively, it can use its financial flexibility to price below cost: it can offer fares in a market below those needed to compete fairly and subsidise its services in this market with the economic rents it earns in other markets where it faces little or no competition.

This sort of behaviour is recognised by British Airways in a paper it sent to the Canadian authorities in connection with the acquisition of Canadian Airlines by Air Canada[29], a copy of which is attached:

> "In markets where a merged entity acquires the ability to profit from anti-competitive behaviour, many practices which would otherwise be a pro-competitive response can be used for the objective of eliminating or disciplining remaining competition. For example, predatory pricing is not economically rational unless the entity engaging in the practice has a reasonable prospect of eliminating a competitor so that increased profits can be achieved following the exit of that competitor...".

Qantas and British Airways are similarly currently able to use their operational and financial flexibility to compete unfairly in Europe – Australia, Europe – South East Asia, and South East Asia – Australia (and other) markets.

By 'tying' the reward received for directing business to it in markets in which it faces little or no competition to the extent to which business is directed to it in markets in which it faces substantial competition, a carrier in a dominant position is able to compete unfairly in the latter markets. It can do this either by explicitly tying different geographic markets together, or by tying the reward received to total spend across its route network and raising the qualifying threshold levels beyond the level of business undertaken in the markets in which the carrier faces substantial competition. Under this type of behaviour,

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[29] British Airways, *Competition in the Canadian Airline Industry: Bill C-26,* Summer 2000.

passengers, corporations or travel agents transacting the same value of air travel will receive different rewards depending on the extent to which they direct substantially all of their business to the carrier in the dominant position. In order to compete, a competitor must offer on a much smaller volume of business the equivalent of the discount offered by the carrier in the dominant position across the tied geographically distinct markets or its entire route network.

British Airways expresses its concerns about Air Canada engaging in this sort of behaviour in London – Canada markets in the paper it sent to the Canadian authorities:

> "(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."[30]

[30] British Airways, *Competition in the Canadian Airline Industry: Bill C-26*, page 9.

In a decision dated 14 July 1999, the European Commission found that British Airways had acted in this manner in its dealings with travel agents. Specifically, the Commission found that British Airways was dominant in the UK market for air travel agency services, and that its "Marketing Agreements", "global incentive programmes" and "Performance Reward Scheme" constituted abuses of this dominant position as defined under Article 82 of the EC Treaty, as they had the object and effect of excluding British Airways' competitors from the markets for air transport originating in the United Kingdom, and discriminated between travel agents. British Airways was fined 6.8 million Euros and ordered to bring the infringements to an end. (This decision is subject to appeal by British Airways).

Qantas and British Airways are similarly currently able to use their loyalty programmes to compete unfairly in Europe – Australia, Europe – South East Asia, and South East Asia – Australia (and other) markets, by leveraging the dominant position they enjoy in many UK domestic, other European and Australian domestic markets.

The potential for carriers in a dominant position in the provision of connecting services to reduce the yields earned by competitors on the segment of the one-stop services they operate, and hence the viability of their direct services, is well understood by British Airways. In the paper it sent to the Canadian authorities, British Airways stated that:

> "(Feed traffic) permits (a carrier) to serve markets it otherwise could not competitively serve and allows for more frequent service... As a result of the merger, there is no alternative for feed traffic in Canada and Air Canada will have no incentive to enter into interline agreements at competitive prorates."[31]

The code share and competitive interline arrangements between Canadian Airlines and British Airways were in fact cancelled after the acquisition.[32]

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31 British Airways, *Competition in the Canadian Airline Industry: Bill C-26*, Summer 2000, page 7.

32 Ibid, page 6.

British Airways also stated that:

> "The absence of such interline and code share agreements is a major concern for consumers."[33]

British Airways therefore recommended that:

> "... Air Canada be required to provide access to its domestic network through competitive interline and prorate arrangements with international carriers under reasonable and competitive terms."[34]

Although Virgin Atlantic has traditionally focused on point-to-point markets, as our network has expanded we have become more reliant on feed traffic. The extent to which we can enter into SPAs on reasonable terms and conditions, therefore, will determine the extent to which we can enter markets in the future.

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[33] Ibid, page 7.
[34] Ibid.