General Counsel
Brett Johnson

7 August 2003

Mr Scott Gregson
Director
Adjudication Branch
Australian Competition and Consumer Commission
470 Northbourne Avenue
DICKSON ACT 2602

Dear Mr Gregson

Qantas Airways Limited and British Airways PLC
Applications for Reauthorisation of Restated Joint Services Agreement (JSA)

I refer to your letter of 30 June 2003 inviting Qantas and British Airways (the **Applicants**) to respond to submissions made by interested parties and requesting certain additional information. This response is provided on behalf of both Qantas and British Airways.

The Applicants are pleased to note that all submissions received by the Commission other than those from Virgin Atlantic and Virgin Blue support the reauthorisation of the JSA. The Applicants note in particular the support expressed by the Department of Industry, Tourism and Resources, the Australian Tourist Commission, the Australian Business Travel Association and the State Governments of New South Wales, Queensland, Tasmania and Western Australia.

The issues raised by Virgin Atlantic and Virgin Blue are addressed in Attachments 1 and 2 to this letter respectively.

The Australian Federation of Travel Agents has provided the Commission with a submission supporting the reauthorisation of the JSA subject to some reservations set out in their submission. The Applicants have commented on these reservations in Attachment 3 to this letter.

The Applicants' responses to questions 1 to 3 and 5 from the Commission's letter of 30 June 2003 are set out in Attachment 4. The Applicants have not yet completed the response to question 4 but expect to be able to provide this to the Commission shortly.

NECG has prepared a supplementary report providing responses to questions 6 to 10 from the Commission's letter of 30 June. A copy of this supplementary report is attached as Attachment 5. Whilst NECG has provided the Commission with additional information relating to IT cost savings attributed to the JSA in the yield management and Triton New Gen program areas, additional information on the IT cost savings related to shared facilities has not been able to be provided as the employee who prepared the original data is on long service leave. We expect to be able to provide the Commission with some additional information on these cost savings within the next two weeks.

Attachments 2, 4 and 5 to this letter include certain commercially confidential information. Disclosure of that information could result in material financial loss and prejudice the competitive position of the Applicants. Pursuant to section 89(5) of the Trade Practices Act, the Applicants apply for this information to be kept confidential by the Commission and excluded from the register kept by the Commission in accordance with section 89(3) of the Act. For convenience, the confidential information is indicated by the use of bold red square parentheses around confidential text or around the heading of a confidential table or graph. This information has been deleted and replaced with '[*CONFIDENTIAL INFORMATION DELETED*]' in non-confidential public versions of these Attachments, which are also attached to this letter.

The Applicants would appreciate the opportunity to meet with the Commission at its convenience to discuss any of the matters addressed in this response or to address any other concerns the Commission may have in relation to this application.

Yours sincerely

Brett Johnson
General Counsel

cc Roger Featherston
Mallesons Stephen Jaques

Attachment 1

Response to Issues Raised by Virgin Atlantic in its Submission to the Commission Dated 10 June 2003

Assertion by Virgin Atlantic that it is Appropriate to Consider Heathrow as an "Economically Distinct Market for Time Sensitive Passengers"

Virgin Atlantic suggests in its Submission to the Commission that flights between Australia and London Heathrow Airport may constitute a distinct product market for time sensitive passengers.

In the context of extreme long haul flights, such as flights to and from Australia, it is clear that there can be no separate product market for flights to and from London Heathrow Airport. Indeed, given the large variety of routings commonly used by passengers to travel between Australia and Europe, the significant proportion of passengers from Australia who visit multiple ports within Europe and the dense network of connecting flights that exists within Europe, the Applicants believe that the appropriate market for analysis of the JSA is the regional market for flights between Australia and Europe generally (see also section 4.2 of the report dated May 2003 prepared by Network Economics Consulting Group in relation to the JSA (**NECG Report**)).

Transfer Times to London

Virgin Atlantic's suggestion that flights to and from Heathrow Airport should be considered to constitute a separate product market appears to be based primarily on the fact that Heathrow Airport is the closest international airport to central London for passengers arriving in London[1]. Gatwick Airport, however, is also close to London and provides high quality facilities for international air services. Gatwick Airport is used by many international airlines including Emirates, Virgin Atlantic, British Airways, Garuda Indonesia, Delta Air Lines, USAir, Continential Airlines, American Airlines, Air France, Northwest Airlines, Lot, easyJet, Ryanair, Aeroflot, Air Sychelles and Olympic.

As pointed out by Virgin Atlantic, Heathrow Airport is served by the Heathrow Express rail service which runs four times an hour and carries passengers from Heathrow to Paddington station in either 15 or 20 minutes (depending on the terminal at Heathrow from which the passenger is travelling). Gatwick Airport is served by two express rail services to London. The Gatwick Express runs four times per hour and takes 30 minutes to reach Victoria Street station. In addition, Thameslink provides half hour services to the centre of London between two and four times per hour. The difference in transfer time between travelling to London from Gatwick compared to travelling to London from Heathrow is therefore likely to be in the order of only 10 to 15 minutes.

In the context of flights from Australia which are of at least 22 hours duration, such a time difference is of no significance. For example, the total travel times for the Applicants' own through services between London and Sydney currently vary in duration by almost two hours between services. The Applicants' experience, however, is that this variation does not materially affect the yield or mix of fare classes achieved on each service.

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1 For passengers originating in London the orbital and radial links are such that there is very significant overlap in the catchment areas and all London airports can and do compete with each other for both longhaul and shorthaul traffic.

The European Commission has held that, even for time sensitive passengers and even in the context of short haul flights, flights to and from a range of airports within the London region all form part of the one product market.[2]

Availability of Connecting Services

Virgin Atlantic has stated in its Submission that flights to Heathrow may be preferred to flights to other London airports by some passengers because a larger number of connecting services may be available from Heathrow than from Gatwick Airport.

The number of connections available from an airport in London is only relevant to passengers who want to connect in London to a flight to somewhere in Europe other than London. Such passengers, when flying from Australia, are likely to have at least the following alternatives to flying via Heathrow:

1. Travel with a carrier that has its hub at a mid-point on the Kangaroo Route, such as Singapore Airlines, Thai Airways, Emirates, Cathay Pacific or Malaysia Airlines. Each of these carriers is likely to be able to transfer passengers at its mid-point hub on to a direct flight to the passengers' ultimate destination in Europe. By doing so, these carriers are likely to be able to offer passengers a one-stop service to their ultimate destination, compared with the two stop service which would be required if passengers were to travel via Heathrow.

2. Travel to a hub in Europe other than Heathrow, such as Paris or Frankfurt, and transfer there to a flight to their ultimate destination. For example, a passenger may fly with Singapore Airlines to Frankfurt and connect there to a flight within Europe with Lufthansa. Lufthansa is part of the Star Alliance with Singapore Airlines and operates a comprehensive network of flights within Europe from its hub in Frankfurt.

The Applicants believe that either of these alternatives would be highly substitutable with an itinerary that involves flying via Heathrow[3].

The Barriers to Entry Alleged by Virgin Atlantic

Virgin Atlantic has alleged that a number of barriers to entry exist in the market for air services between Australia and Europe.

Before addressing Virgin Atlantic's specific comments, it is appropriate to make the following preliminary comments:

1. The JSA Routes have witnessed entry and expansion by players other than British Airways and Qantas. The Applicants believe that barriers to entry and expansion between Europe and Australia are not significant is demonstrated by the history of successful entry and expansion on the Kangaroo Route:

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2 For example, in its BMI-Lufthansa decision (Case COMP/38.712 British Midland Ltd/Deutsche Lufthansa AG/Scandinavian Airlines System), services out of all five London airports were considered as substitutable for non-time sensitive passengers. For time-sensitive passengers, services out of Gatwick Airport, London City Airport and Heathrow Airport were all considered to be substitutable for short haul flights.

3 In addition, for many passengers there will be likely to be a range of other alternatives that will be highly substitutable, such as one-stop itineraries via such mid-points as Los Angeles, Japan or even Africa.

- the combined market share of mid-point carriers has nearly doubled since 1995, whilst the Applicants' market share has fallen;
- Emirates has successfully entered the market and continues to expand rapidly; and
- other carriers have signalled that they intend to enter the market including, most recently, Virgin Atlantic.

2. Virgin Atlantic has confirmed through its public statements that it does not believe it faces high barriers to entry to this market. Indeed, so confident is Virgin Atlantic of this that on 24 July 2003, Richard Branson issued a public challenge to Geoff Dixon, stating that *"If Virgin Atlantic fails to fly to Australia (within 18 months, say) I'd be prepared to suffer the indignity of donning one of your stewardesses brand new designer outfits and will work your flight from London to Australia serving your customers throughout"*.[4]

3. The issues discussed by Virgin Atlantic in its Submission are challenges faced by any carrier that seeks to operate services between Europe and Australia from one or other end of these extremely long routes rather than from a mid-point. As such, they generally apply as much to the Applicants as to Virgin Atlantic.

4. Barriers to entry are of secondary significance in markets where there are already many effective competitors in the market. On JSA Routes the Applicants already face intense competition from more than a dozen other airlines operating services between Australia and Europe. New entry is not required to ensure effective competition.

5. To the extent that Virgin Atlantic has identified challenges to competing in this market from one or other end of these routes (such as the fact that it can be more difficult to obtain fifth freedom rights required by end-point carriers than the third and fourth freedom rights relied on by mid-point carriers) this does not establish barriers to entry to the market as a whole. Rather, it merely underlines the significant advantages that mid-point carriers enjoy in competing with end-point carriers. This highlights the need the Applicants have to cooperate through the JSA if they are to continue to compete effectively and offer the full range of services and benefits to consumers that they offer in this market.

The Applicants comment in more detail below on the alleged barriers to entry discussed by Virgin Atlantic.

<u>Market Share</u>

Virgin Atlantic notes that the Applicants are the leading carrier between Australia and Europe in terms of passengers carried and market share. Virgin Atlantic appears to suggest that this, of itself, represents a barrier to entry.

It is difficult to comment on this, as Virgin Atlantic presents no explanation of how or why they believe this to be the case. It clearly was no barrier to entry or expansion on the route by Emirates.

The Applicants note, however, that Virgin has relied for market share data in its Submission on United Kingdom Civil Aviation Authority survey data. The parties do not believe this data is reliable to use in analysing what are by any standard complex traffic flows between Europe and

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4 Open letter from Richard Branson to Geoff Dixon dated 24 July 2003. Reported in "Virgin addresses Kangaroo Route", *The Age*, 25 July 2003; and "Branson skirts landing rights detail", *Sydney Morning Herald*, 25 July 2003.

Australia. The average sample size on this survey is very small: less than 0.11%, or just 1 in 1,250.

As an example of the inherent difficulties in accurately measuring traffic flows, we note that in the CAA survey data relied on by Virgin Atlantic, the total number of passengers carried on British Airways services between London and Sydney according to CAA data is more than double the number reported by MiDT.

Further attempting, as Virgin Atlantic has done, to subdivide this very small number of passengers surveyed into subcategories, such as business and leisure, further reduces the relevant sample size to well below the level at which any statistically significant conclusions could be drawn. This is particularly so when one considers that, according to ABS data, only 12.8% of travellers on these routes are travelling on business (even the CAA data chosen by Virgin Atlantic suggests that only in the order of 16% of passengers on these routes are travelling on business).

The Applicants believe that the most reliable data to use in analysing traffic between Australia and Europe are the ABS and MiDT data that the Applicants have presented in their submissions. The Applicants note that ABS data is the data source on which the Commission has relied in all previous Australian aviation authorisations and MiDT is the principle data source relied on by the European and US regulators in the analysis of aviation markets and is used by the Applicants in making their own network planning decisions.

The Applicants therefore believe that wherever the CAA data quoted by Virgin Atlantic conflicts in any way with the ABS and MiDT data presented by the Applicants, ABS and MiDT data should be preferred.

Air Services Agreement (**ASA**) Restrictions

The Virgin Atlantic Submission recognises that any carrier seeking to compete on the Kangaroo Route must be able to 'refill' its aircraft by picking up passengers at the mid-point of its operations.

Restrictions on obtaining fifth freedom rights at some mid-points on the Kangaroo Route, such as Hong Kong, are an issue that affects only carriers operating from one or other end of the route (because only end-point carriers need to rely on fifth freedom rights to pick up passengers at the mid-point). As such, the difficulty affects British Airways and Qantas just as much as Virgin Atlantic.

Mid-point carriers operating between Australia and Europe, however, are not affected by restrictions in fifth freedom rights as they operate using third and fourth freedom rights between their home ports and each end of the route they are flying. As described in section 5.2.2 of the NECG Report, the Applicants believe that availability of third and fourth freedom rights does not present any material barrier to entry or expansion by mid-point carriers.

Virgin Atlantic states that its preferred mid-point for Kangaroo Route operations is Hong Kong and that it is currently negotiating with the Hong Kong Government for rights to be able to pick up passengers in Hong Kong. As noted above, Virgin Atlantic is clearly confident that it can obtain these rights and that they will not represent a barrier to Virgin Atlantic's entry to this market.[5]

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5 See comments in Richard Branson's open letter to Geoff Dixon cited above. In addition, Sir Richard Branson stated on 17 July 2003 that "*Maybe by Christmas or early in the New Year we'll see Virgin Atlantic flying either to Sydney, Brisbane or Melbourne, or even two or three of those cities*" (Quoted in the *Sydney Morning Herald*, 17 July 2003).

Even if Virgin Atlantic does not obtain these rights from the Hong Kong Government, however, the fact that one particular end-point carrier is not able to fly via its most preferred mid-point does not establish a general market barrier to entry.

Virgin Atlantic acknowledges in its Submission that it faces no regulatory restriction to operating between Australia and Europe via either Thailand or Malaysia. In his open letter to Geoff Dixon, in contradiction to Virgin Atlantic's Submission to the Commission, Richard Branson states that *"...in case you were wondering, we're not hung up on flying through Hong Kong"*. Mr Branson goes on to say that Virgin Atlantic is likely to operate *"... through Singapore, Thailand or Malaysia instead"*. Virgin Atlantic could also fly to Australia via Shanghai, a city to which Virgin Atlantic already flies.

In addition to these options, Virgin Atlantic could also operate a 'Virgin' branded service between London and Australia via Hong Kong using existing rights by operating in partnership with Virgin Blue. Under this option, Virgin Blue would operate the sector between Australia and Hong Kong utilising rights under the Australia-Hong Kong ASA to pick up both passengers originating in Hong Kong and passengers connecting from Virgin Atlantic flights from London.

<u>Airport Capacity Constraints</u>

Virgin Atlantic notes that there are currently no unutilised slots at Heathrow Airport. This does not constitute a barrier to entry to the market for air services between Australia and Europe for the following reasons:

- Slots are available in the London airport system and at a range of other hub airports in Europe.
- Many carriers such as Virgin Atlantic already hold significant portfolios of slots at Heathrow. Virgin Atlantic could easily redeploy existing slots held at Heathrow to launch services to Australia if it chose to do so. For example, Virgin Atlantic has recently commenced other long haul services from Heathrow Airport.
- There are some 9,000 slots at Heathrow Airport shared among over 90 airlines. An active market exists for trade in these slots. It is therefore possible for airlines that prefer to launch new services from Heathrow at a particular time to do so. For example, Cathay Pacific recently increased its operations to Heathrow to triple daily and Virgin Atlantic has obtained sufficient slots at Heathrow over the past five years to be able at the same time to increase its trans-Atlantic frequencies from Heathrow by over two thirds as well as being able to launch new services from Heathrow to both Shanghai and Johannesburg. It is therefore likely that Virgin Atlantic could acquire or redeploy slots to operate Kangaroo Route services from Heathrow Airport, if it wished to do so.
- Although there may be a cost associated with acquiring slots at Heathrow, this is a cost that is faced equally by the Applicants or any other competitor choosing to fly into Heathrow as by Virgin Atlantic. For this reason, at section 5.2.3 of the NECG Report, NECG concludes that slot constraints are best viewed as a factor that increases all airlines' costs rather than as a barrier to entry.
- The extreme long haul nature of the Kangaroo Route means that a competitive service to Australia can be established with low frequency (one frequency per day or even less). This means that launching a competitive service to Australia from Heathrow requires relatively few slots (ie, 14 slots or less - seven landings and seven take-offs).
- As discussed above, in the context of flights from Australia that have a duration of 22 hours or more, the extra 10 to 15 minutes that it may take to transfer from Gatwick to London compared with from Heathrow to London is not competitively significant. On such extreme

long haul flights as the Kangaroo Route, on-board service and product quality are more important in passenger choice than small differences in total travel time. Airlines are therefore able to compete on the Kangaroo Route equally effectively from Gatwick as they are from Heathrow, as demonstrated by Emirates which competes successfully offering services to and from both airports. We note that Virgin Atlantic has significant operations at both Gatwick and Heathrow and is therefore well placed to commence services from either airport.

Loyalty Programs

Virgin Atlantic states that loyalty programs create barriers to entry in markets for air travel. The Applicants do not accept Virgin Atlantic's assertions or their applicability to the markets relevant to the JSA. We nevertheless comment on each of the programs discussed by Virgin Atlantic below.

Frequent Flyer Programs

Most full service international airlines in the world operate frequent flyer programs under which passengers earn credit towards award flights whenever they fly on a normal commercial flight with a carrier. For example, Virgin Atlantic operates a frequent flyer program on all of its flights. The fact that it has chosen not to join the frequent flyer programs of other carriers has not prevented it from competing successfully against a plethora of carriers. The Applicants note also that there are many examples of value based airlines having entered and prospered in markets around the world without having a frequent flyer program. The Applicants therefore do not consider that frequent flyer programs constitute barriers to entry[6].

The mutual recognition of frequent flyer programs between British Airways and Qantas is also a function of British Airways' and Qantas' mutual **one**world membership, not just of the JSA. The reciprocal operation of these programs and the benefits they offer to consumers will therefore not be affected by whether or not the JSA is reauthorised. They are therefore not relevant to a consideration of the likely effects of reauthorisation of the JSA.

Travel Agent Commission Schemes

Qantas and British Airways do not operate joint travel agent schemes for either base or override commissions. Even if the Applicants were to implement a joint commission program, British Airways only accounts for approximately 3.3% of international traffic to and from Australia. The addition of British Airways sales would therefore be unlikely to materially affect the operation of Qantas commission schemes in any way.

Corporate Discount Programs

Qantas and British Airways do not believe that offering businesses the benefit of discounts and rebates on British Airways flights in addition to Qantas flights lessens competition in any market.

Qantas' corporate discount program is discussed in more detail in Attachment 2.

*Computer Reservation Systems (**CRS**)*

Virgin Atlantic appears to suggest in its Submission that Qantas and British Airways may manipulate the CRS displays used by travel agents to in some way give greater prominence to their own flights.

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6 See also the recent report by the OFT into "Switching Costs" which supports this conclusion.

Neither Qantas nor British Airways owns any interest in any CRS used by any travel agent in Australia and neither airline is able to bias the displays of these systems.

Unless travel agents search specifically for Qantas or British Airways flights, CRSs in Australia will display available flights for any requested route based on objective algorithms such as departure times, elapsed flight time or number of stopovers.

The most commonly used search function used by travel agents on CRS systems is an availability search. Such a search will display flights found in order of the time of departure of each flight. On JSA Routes, a number of mid-point carriers generally have earlier first departure times than Qantas and British Airways. As a result, CRS displays will show the Australia-Europe flights of these carriers ahead of the Applicants' flights.

Further, travel agents often do not use CRSs at all in responding to initial consumer enquires. Instead, travel agents use their own fare sheets or software such as the 'Fare Finder' software supplied by Concorde Travel to provide consumers with information about available fares. These sheets or software packages normally display available fares in simple price order.

<u>Feed Traffic</u>

Virgin Atlantic states that to commence operations to Australia it would need a source of domestic feed. At page 32 of its Submission it then says that "*given that Virgin Blue essentially does not interline, Qantas is the only potential provider of domestic feed in Australia*". This is disingenuous.

Virgin Blue now accounts for almost a third of all Australian domestic traffic. As such, the Applicants believe that it would be more than capable of providing feed to Virgin Atlantic and any other new entrant to the market for air services between Australia and Europe.

In confirmation of this, we note that Virgin Blue's Submission to the Commission in relation to the JSA states at paragraph 19 that:

> *"It is simply incorrect to say that VBAs or a low cost airline do not value feeder traffic. A value based airline will not operate an unprofitable service simply to obtain feed from that service, however, it does value feeder traffic. It will arrange its schedules so as to maximise feed between its services and a VBA will enter into feeder arrangements with other airlines."*

We note also that in November last year, when discussing Virgin Atlantic's intention to fly to Australia, Sir Richard Branson stated that by the time this happens the Virgin Blue fleet will have increased to around 40 aircraft thereby providing "*...a tremendous feeder service at this end for our passengers*".[7]

The likely effect of the JSA on feed arrangements and the Australian domestic market for air services is discussed further in Attachment 2.

<u>Other Comments Arising out of the Virgin Atlantic Submissions</u>

Virgin Atlantic makes a number of comments in relation to the public benefits that are likely to flow from continuation of the JSA.

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7 'Branson seeks rights to fly Australia-HK', *Australian Financial Review*, 6 November 2002, page 13.

Returns From Scale and Density

Virgin Atlantic suggests that there are no returns from scale in the provision of air transport services. The Applicants note that there are significant benefits to be obtained, however, in achieving increases in density of traffic through network hubs and on thinly trafficked routes.

Much of the benefit associated with the JSA flows from the ability the JSA provides for the Applicants to pool and coordinate traffic to achieve the density of traffic at the mid-point of their JSA Services necessary to support a viable hubbing operation in Singapore.

This ability to pool traffic and support a mid-point hub allows the Applicants to provide consumers with more services to more cities than would otherwise be viable because it allows each of the Applicants' services to obtain feed at the mid-point from the Applicants' other JSA Services. The increased connectivity the hub creates also allows consumers to combine flights in a variety of ways that would not otherwise be possible, providing a choice of 'one-stop' services between Australia and Europe.

Put simply, neither British Airways nor Qantas would have sufficient traffic through their mid-points to sustain such a hubbing operation on its own. In this way, it is clear that the ability of the Applicants to achieve greater density of traffic at their mid-points through pooling their traffic provides very substantial consumer benefits.

Mid-point carriers are able to achieve effective scale and density at their mid-points because the mid-point for such carriers on Australia-Europe services is their home hub through which all of their traffic flows.

Reductions in Overheads

Virgin Atlantic questions in its Submission whether the JSA generates reductions in overheads for the Applicants.

The very significant reductions in overheads and the ways in which they are achieved are described in detail in section 11.1 of the NECG Report. These include savings though operation of joint facilities, joint development of IT applications and improved aircraft utilisation through improved yield and traffic management.

Other Comments

The Applicants would be happy to respond to any other queries the Commission has arising out of the Virgin Atlantic Submission.

Attachment 2

Response to Issues Raised by Virgin Blue in its Submission to the Commission dated 20 June 2003

Virgin Blue's Submission that the Applicants have Failed to Properly Analyse the Anti-competitive Effects of the JSA in Australian Domestic Trunk and Regional Markets.

Virgin Blue states in its Submission that the JSA contributes about 40-45% of all international feed to Australian domestic air services. This is not correct, since the total share of traffic to and from Australia carried by the Applicants is materially less than this.

In any event, the distribution of Qantas' own feed is unlikely to change materially whether the JSA is reauthorised or not. The feed contributed to the Australian domestic market by Qantas' own international services is therefore not relevant to an assessment of the likely effects of the JSA.

To assess the likely effects of the JSA on patterns of feed to Australian domestic air services it is relevant to consider:

(a) the amount of feed contributed to the Australian domestic network by British Airways, as Qantas' partner in the JSA; and

(b) whether the pattern of distribution of this feed is likely to be affected by whether the JSA is reauthorised.

In addition, we note that Virgin Blue states at paragraph 20 of its Submission that it only seeks feed relationships with, at most, a few international airlines.

We comment on each of these points below.

Feed Contributed to the Australian Domestic Network by British Airways

Virgin Blue recommends at paragraph 18 of its Submission that feed should be measured by the number of international passengers travelling on Qantas' domestic services who purchased their domestic tickets with their international ticket.

Adopting this methodology, Qantas records show that during the period 1 February 2002 to 31 January 2003, just [*Confidential Information Deleted*] of the passenger sectors flown on its domestic network were accounted for by passengers who purchased their domestic tickets (whether in Australia or overseas) in conjunction with an international flight to or from Australia operated by British Airways.[8]

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8 The Qantas systems used to obtain this data are unfortunately unable to link Australian domestic flights to a British Airways flight if the passenger did not –

- start their domestic flights in the city they flew into on a British Airways flight; or
- end their domestic flights in the city from which they flew out on a British Airways flight.

Accordingly, domestic sectors associated with a British Airways flight will only fail to be included in these figures if a passenger has travelled by land from their arrival port to another city in Australia, then travelled by air somewhere else within Australia, and then travelled by land rather than air back

This figure represents British Airways related Australian domestic traffic as a proportion of Qantas domestic traffic, not the total Australian domestic air traffic.

In addition, Virgin Blue suggests that what is relevant is only that proportion of traffic accounted for by tickets purchased as part of a 'bundle' with international tickets. The Applicants have provided the Commission with data that shows all domestic flights related in any way to international travel on British Airways, whether purchased as part of an economic bundle or not, and therefore are likely to have overstated British Airways' feed contribution.

The Applicants believe it is clear from this data that on Virgin Blue's own methodology, the JSA does not affect a competitively significant proportion of Australian domestic air traffic.

<u>Will Distribution of British Airways Feed be Affected by Whether or Not the JSA is Reauthorised?</u>

Even if the level of feed contributed to the Australian domestic network were competitively significant, to assess the likely effects of the JSA it is necessary to consider whether or not the pattern of distribution of that feed is likely to be affected by reauthorisation of the JSA.

As described in section 3 of the Applicant's Submission, in addition to the JSA alliance between Qantas and British Airways:

(a) British Airways and Qantas are both members of the **one**world Alliance; and

(b) British Airways holds a substantial equity interest in Qantas.

These relationships mean that, even if the JSA is not reauthorised, the pattern of distribution of domestic Australia feed from British Airways is unlikely to be affected.

<u>Virgin Blue Does Not Seek Numerous Feed Arrangements</u>

Virgin Blue states at paragraph 20 of its Submission that "*it is not possible to enter into numerous minor code share arrangements with a diverse number of carriers as the arrangements will not be efficient due to difficulties in synchronising schedules.*"

In essence, Virgin Blue is saying that it seeks feed relationships with, at most, a few international airlines.

According to Department of Transport and Regional Services (**DoTaRS**) statistics, British Airways is only the 8th largest airline in terms of passengers carried to and from Australia, accounting in 2001/02 for 3.3% of international traffic.[9]

By contrast, Singapore Airlines accounted for 11.8% of international traffic to and from Australia, Malaysia Airlines for 5.4%, Thai Airways 4.2% and JAL 4.5%. United Airlines, with which Virgin Blue already has formal feed arrangements, also accounted for a similar number of passengers to British Airways, with 3% of international traffic.

It is therefore difficult to see how the JSA limits Virgin Blue's ability to negotiate several relationships with airlines that will be able to provide at least equal or greater amounts of international feed than British Airways.

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to their departure port. The Applicants believe that the level off error associated with this limitation in its systems is likely to be small.

9 DoTaRS *"Air Transport Statistics, International Airlines 2001-02"*, Chart III (2001-02 is the most recent full year report currently available from DoTaRS). DoTaRS is the department which compiles the air traffic data relied on by the ABS.

Virgin Blue's Submission that the Applicants have not had Regard to the Impact of "Bundling" Offers for Various Domestic and International Services

Virgin Blue alleges at paragraph 12 of its Submission that Qantas offers discounts to its customers where they purchase their international, domestic trunk and regional air service requirements from Qantas.

Virgin Blue's comments are not relevant to an assessment of the likely effects of the JSA because the structure of Qantas' business discounts will not be affected by whether or not the JSA is reauthorised. Qantas believes, however, that it is important to respond to these comments as they reflect either a misunderstanding or an intentional misrepresentation by Virgin Blue of Qantas' business discounts.

In Australia, Qantas offers businesses discounts or rebates based on the total value of their travel spend with Qantas. These offers are often referred to as Gross Financial Offers (**GFOs**).

The value of any individual customer to Qantas, and therefore its purchasing power and strength in negotiations with Qantas, is determined by the total value of travel likely to be purchased by that customer from Qantas. Negotiating discounts with a customer on the basis of the customer's total spend therefore reflects customer demands and is consistent with the way that volume discounts are negotiated in almost any industry.

Qantas does not require that a business place any proportion of its international or domestic travel with Qantas as a condition of negotiating any particular level of discount. The discount that a business will be able to negotiate based on any given level of annual expenditure will be broadly equivalent whether that represents all of the business's travel expenditure or only part. Qantas' negotiation of volume discounts is therefore neither anti-competitive nor creates a tie between its international and domestic services.

Nevertheless, Virgin Blue suggests that the Commission should seek an undertaking from Qantas that it will "*refrain form* (sic) *offering any discount or benefit to customers where they acquire their international, regional and domestic trunk requirements from Qantas*". Such an undertaking is unnecessary; its only effect would be to inhibit competition and reduce the discounts businesses can negotiate on their air travel by effectively preventing them from using their purchasing power in negotiations with Qantas.

Other Comments Arising out of the Virgin Blue Submission

Virgin Blue makes a number of comments in relation to the public benefits that are likely to flow from the continuation of the JSA that require response.

Tourism Benefits

Virgin Blue claims that little weight should be given to the tourism benefits of the JSA because some elements of the tourism benefits calculated by NECG in relation to the proposed alliance between Qantas and Air New Zealand have not to date been accepted by the Commission and the New Zealand Commerce Commission (**NZCC**).

We note that Federal Department of Industry, Tourism and Resources and the Australian Tourist Commission, the Federal Department of Transport and Regional Services, the Australian Federation of Travel Agents, the Western Australian State Government, the Queensland State Government and the Tasmanian State Government have all provided the Commission with submissions confirming that, in their view, the JSA provides substantial benefits to Australian tourism.

The Commission and the NZCC have challenged only the following aspects of NECG's analysis in relation to the proposed alliance between Qantas and Air New Zealand:

- the extent of the benefit that will flow from the promotion of New Zealand holidays and combined Australia and New Zealand holidays by Qantas Holidays; and

- whether the alliance would improve the effectiveness of existing promotional expenditure.

The analysis of the tourism benefits of the JSA does not rely on either of these elements. The queries raised by the Commission and the NZCC in relation to the alliance between Qantas and Air New Zealand therefore do not affect the analysis of the significant and continuing benefits to tourism that result from the JSA.

The Benefits of the JSA Flow to Consumers

Virgin Blue suggests that the majority of the benefits of the JSA are private benefits accruing to the Applicants. Clearly this is not correct.

The benefits of the improved breadth and quality of services made possible by the JSA are clearly benefits that flow to consumers. Similarly, the benefits of Australian job creation, greater net exports, higher levels of tourism and lower fares are all direct benefits to the Australian public.

To the extent that the JSA provides benefits to Qantas and British Airways through giving rise to cost savings, the very high level of competition on JSA Routes ensures that these efficiencies are passed on to consumers in the form of higher product standards and lower fares. This conclusion is confirmed by NECG at section 11.1 of its Report.

Other Comments

The Applicants would be happy to respond to any other queries the Commission has arising out of the Virgin Blue Submission.

Attachment 3

Response to Issues Raised by the Australian Federation of Travel Agents in its Submission to the Commission dated 6 June 2003

The Australian Federation of Travel Agents (**AFTA**) has provided the Commission with a Submission supporting the reauthorisation of the JSA. The Submission cites some reservations, however, and makes some statements that the Applicants believe require some clarification.

AFTA's Concern in Relation to Potential for Reduction of Agents' Commissions

AFTA states that it would be concerned if the Applicants jointly and under the guise of the reauthorisation attempted to reduce commissions payable to travel agents.

Many of the Applicants' promotions and market initiatives in the airline industry are implemented through travel agents and therefore require the Applicants to be able to coordinate their dealings with travel agents.

For example, the majority of the Applicants' discount fares are 'net' fares. To offer a net fare, the Applicants must be able to agree the amount that they will require travel agents to remit to them upon sale of such a fare (the 'net remit amount'). Similarly, many of the discounts offered to businesses by the Applicants are implemented through travel agents and require the Applicants to be able to coordinate their dealings with travel agents. It is important that British Airways and Qantas are able to coordinate their arrangements with travel agents in order to effectively implement such initiatives.

The AFTA Submission appears to assume that the ability to coordinate dealings with travel agents is something new that is being sought by the Applicants. In fact, Qantas and British Airways have had the right to coordinate conduct in relation to travel agents since authorisation of the Original Joint Services Agreement in 1995. The Applicants understand that AFTA has not had any concern with the way in which this ability has been used to date by the Applicants.

The Applicants have not implemented joint base or override commission programs. However, even if the Applicants were to implement a joint commission program, British Airways only accounts for approximately 3.3% of international traffic to and from Australia. Consequently, the additional sales volumes contributed by British Airways would be unlikely to afford any material degree of power to Qantas in its dealings with travel agents.

AFTA's Comments on Substitutability Between Economy and Premium Class Air Tickets

AFTA's Submission states that *"it is AFTA's experience that there is little or no substitutability between economy and premium class air tickets."*

The Applicants disagree with this statement. A large proportion of private travellers purchasing premium class tickets are price sensitive and will substitute between economy and business class or between business class and first class depending on the price differentials between each. Similarly, business travellers who work for smaller firms or who pay for their own travel are price sensitive.

As noted in the AFTA Submission, a considerable proportion of passengers in the premium cabins will be travelling on business on tickets paid for by large corporate employers. Whether such passengers are entitled to travel in economy class, business class or first class will depend on the travel policy of their employers. An employee who has been told by his or her employer that he or she is entitled to purchase a business class ticket will, of course, be reluctant to substitute an economy class ticket. We expect it is this fact on which AFTA is making its observation.

Although individual employees may not be price sensitive when their travel is being paid for by their employer, their employers will be. Corporate travel purchasing is increasingly controlled by professional travel managers whose performance is measured solely on their ability to reduce a corporation's overall travel costs. These travel managers constantly compare prices and discounts available from alternative carriers and ensure that corporate travel policies are strictly enforced.

The Applicants' experience is that corporations are becoming increasingly price sensitive in setting travel policies and selecting carriers. For example, Qantas has found that many Australian companies have recently changed travel policies to:

- introduce "best fare of the day" requirements which require employees to travel on the cheapest available fare from a range of carriers;
- restrict the number of people within each organisation who are entitled to purchase business or first class tickets;
- restrict the types of journey for which premium tickets may be purchased (for example, many companies now restrict premium class tickets to journeys of over a certain number of hours duration); and/or
- restrict the circumstances in which first or business class tickets may be purchased (for example, to restrict business class travel to circumstances where a manager has a business meeting on the day of their arrival and it is not feasible to travel a day earlier instead).

As noted elsewhere, Qantas is currently responding to these changes by reconfiguring many of its aircraft to reduce the number of premium class seats and replace these with increased economy class capacity.

AFTA's Statements in Relation to Increases in the Cost of Premium Class Tickets

AFTA claims that: *"The cost of premium class tickets has in fact risen considerably both in dollar and real terms."*

The Applicants will provide the Commission with data under cover of a separate letter to show that the cost of premium class tickets on JSA services has reduced in real terms whilst at the same time product standards have increased substantially.

Other Comments

The Applicants would be happy to respond to any other queries the Commission may have arising out of the AFTA Submission.

Attachment 4

Response to Questions 1 to 3 and 5 from the Commission's Letter to the Applicants Dated 30 June 2003

Q1 ***If available, the Applicants' market share data (both combined and individual) in terms of turnover of the Routes affected by the JSA.***

The Applicants have provided the Commission with details of their turnover on JSA Routes. These are set out in the NECG Report.

The Applicants do not have information on their competitors' turnover on the JSA Routes and are therefore unable to provide market share data on a turnover basis.

Q2 ***Do the Applicants intend to extend the operation of the JSA beyond the routes on which it is currently applied within the next five years?***

As part of their continuing alliance, Qantas and British Airways continually review their operations for opportunities where connections can be optimised, efficiencies can be realised or customer service can be improved by coordination of activities. To this extent, it is likely that the Applicants' coordination will continue to expand.

[*Confidential Information Deleted*]

Q3 ***Is the reduction in the "benchmark fare" of 25 per cent since May 1995 solely attributable to "intense and sustained price competition" (paragraph 5.25) or is it, in full or in part, attributable to other factors such as "significantly reduced demand for JSA services" (paragraph 1.18)? The Commission would also be grateful for a time series of movements in the benchmark fare over the past eight years and the comparison of this fare with similar fares offered by other carriers on JSA Routes.***

Reductions in the representative benchmark fare have occurred progressively since May 1995. These reductions are attributable to:

(a) the intense and sustained price competition faced by the Applicants on JSA Routes; and

(b) the efficiencies that the Applicants have realised through the JSA and through other measures which have allowed them to respond to competition and continue to decrease prices whilst also continuing to enhance the quality of their services.

The figure for reduction in real terms in the representative benchmark fare since the commencement of the JSA of over 25% which is cited in the Applicants' submission was calculated using the then most recent available data, which was to March 2002. The calculation therefore does not take into account the most recent reductions in average fares on JSA Routes resulting from the war in Iraq and the impact of the SARS virus.

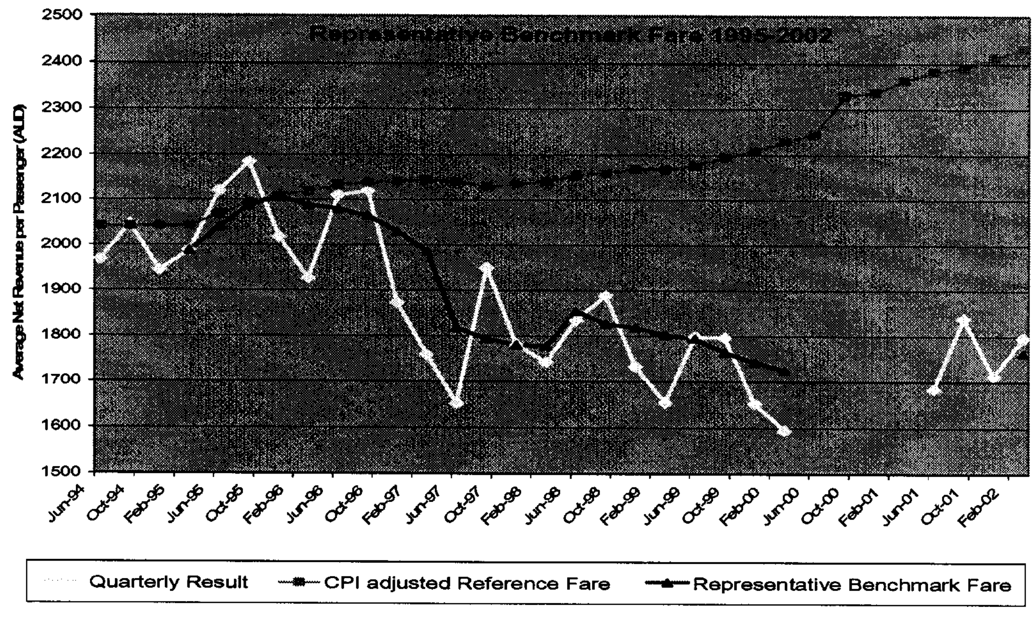
The representative benchmark fare is not a single fare or fare type. Rather, it is a blended fare calculated by averaging the yields realised by the Applicants across a 'basket' of discount economy fares. In addition, to adjust for seasonal fare variations, the representative benchmark fare is smoothed by averaging it over several sales seasons.

Over the course of the JSA, the Applicants have introduced new discounted fares that are not included in the original representative benchmark fare 'basket'. If sales of these newer types of discounted fares were included in the representative benchmark fare, the reduction in the fare in real terms over the course of the JSA would be significantly greater than the 25% cited in the Applicants' submissions.

Because the representative benchmark fare is a blended figure calculated from a basket of fare types, it is unfortunately not possible to provide the Commission with a comparison of the JSA representative benchmark fares with similar fares offered by other carriers on JSA Routes. Calculation of an equivalent blended fare for other carriers would require access to historic data on those carriers' yields in different fare classes and the mix of fare classes achieved by each carrier. This is highly confidential information to which the Applicants do not have access.

As requested by the Commission, we set out below a graph showing changes in the representative benchmark fare over time. The yellow line shows movements in the relevant basket of fares from quarter to quarter without smoothing The blue line shows the smoothed representative benchmark fare. The pink line shows the reference fare against which the representative benchmark fare was compared during the period of the first authorisation of the JSA adjusted for increases in the consumer price index (ie, the pink line approximates where the representative benchmark fare would be if Qantas and British Airways fares had risen in line with inflation).

Unfortunately, due to a change in Qantas accounting systems, there is a gap in available data between March 2000 and June 2001. Because the representative fare is calculated using a moving average, this affects calculation of the representative benchmark fare until March 2002. The Applicants have no reason, however, to believe that the trends in fares during this period for which data is unavailable would be different in any material way to the trend shown over the period for which data is available.



Q5 ***Please advise the Commission as to whether the "changes to improve the profitability of the JSA Routes" had been considered in the construction of the counterfactual scenario as well as the factual scenario. If these changes have not been considered, please advise the Commission as to why these changes cannot or will not be implemented by Qantas and/or British Airways individually in the absence of the JSA.***

In constructing their counterfactual scenarios, Qantas and British Airways have focused on identifying the likely revenue effects of the loss of the JSA on each carrier in order to identify which of their services would continue to be viable in the absence of the JSA.

Precise quantification of the increase in unit costs that would also accompany the loss of the JSA for both Applicants would be extremely difficult. The Applicants have therefore assumed for the purposes of the calculations provided to the Commission that current levels of unit costs would continue to achieved.

Therefore, to the extent that the changes described on pages 123 and 124 of the NECG Report are reflected in the Applicants' current costs of operations, the counterfactual calculations generally assume that the benefits of these changes will continue to be realised. As a result, the calculations set out in the NECG Report are likely to understate the impact of loss of the JSA on the viability of JSA Routes.

We have commented briefly below on the specific changes described on pages 123 and 124 of the NECG Report.

<u>Change in Paris and Rome Departure Times to Midday</u>

The cost benefits associated with the change in Paris and Rome departure times to midday have been assumed in both the factual and counterfactual calculations for Qantas' Paris and Rome services.

[*Confidential Information Deleted*]

<u>Brisbane-Singapore Services Changed From B767-300s to B747-300s</u>

The cost benefits associated with the change on Brisbane-Singapore services from B767-300 aircraft to B747-300 aircraft have been assumed in both the factual and counterfactual route profitability calculations for Qantas Brisbane-Singapore services.

[*Confidential Information Deleted*]

<u>British Airways London-Singapore-Melbourne services increased to 7 flights per week.</u>

The British Airways' counterfactual does not attempt to quantify the change in unit costs that it would suffer in the counterfactual. The unit costs assumed in the British Airways counterfactual are therefore the unit costs achieved with the current level of operations to Australia, which is two daily services to Sydney and five services a week to Melbourne.

British Airways has identified that, without the JSA, it would be likely over time to have to reduce capacity to Australia to just one service per day. It is inevitable that such a loss of scale would increase British Airways' unit costs.

Qantas' conversion of 747-400s from 3 class to 2 class

Qantas estimates of the improved revenue and cost performance that it expects to achieve from the move from three class to two class services to continental Europe have been taken into account in construction of both the Qantas factual and counterfactual scenarios.

Introduction of A330s in place of B767-300s on selected JSA Routes

[*Confidential Information Deleted*]

Introduction of A380s in place of B747-400s on selected JSA Routes

Both the Qantas factual and counterfactual assume that A380s will be introduced in place of B747-400s on selected JSA Services.

[*Confidential Information Deleted*]