

3. RESPONSE TO APPLICANTS CASE FOR AUTHORISATION

Markets

- 3.1 Virgin Blue does not support the market definition proposed by the Applicants.
- 3.2 For the reasons set out in section 3 of the Frontier Report Virgin Blue believes that the relevant markets in which to analyse the Proposed Alliance are:
- (a) a domestic New Zealand air services market. Virgin Blue has considered whether main trunk and provincial air services within New Zealand are separate markets, but on balance does not think that a separate market distinction is necessary to the analysis, provided that the different effects on main trunk as against provincial routes is taken into account in the competition analysis;²²
 - (b) a domestic Australian air services market;²³
 - (c) a trans Tasman air services market; and
 - (d) an Asia-Pacific air services market or markets and potentially a South Pacific air services market. This aspect of the Proposed Alliance is ignored in the Applicants' submission. However, the Proposed Alliance will have an anti-competitive effect, including the raising of strategic entry barriers, in these markets. The Commission needs to consider the impact of the Proposed Alliance on Asia-Pacific destinations. Virgin Blue has not reached a concluded position on market definition on these routes.
- 3.3 This approach to geographic market definition is broadly consistent with that previously adopted by both the New Zealand Commerce Commission (**Commerce Commission**) and the Commission.
- 3.4 The product market definition adopted by Virgin Blue differs from the Applicants' who separate passenger and freight air services. Virgin Blue endorses the Frontier Economics

²² This market is not a market in Australia and accordingly the Commission need not have regard to the detriment constituted by any substantial lessening of competition in these markets nor any benefits flowing to the public in these markets.

²³ This market is not a market in New Zealand and accordingly the Commerce Commission need not have regard to the detriment constituted by any substantial lessening of competition in these markets nor any benefits flowing to the public in these markets.

view that passenger and freight services are most usefully incorporated into one market definition. In adopting the separate product market definitions the Applicants have argued that there will be separate and contradictory competition effects in the relevant markets. The simplest way to avoid this error is to adopt a single product market definition of the air services market (which both a commercial and an economic approach would indicate is appropriate). However even if the Commission adopts separate product markets, it must recognise the linkage between passenger and freight services when analysing the effects of the Proposed Alliance. This issue is particularly relevant when properly considering the benefits and detriments as modelled in the NECG Report which is discussed in more detail in section 6 below.

Vale Based Airline and Full Service Airlines

- 3.5** A critical feature of the Applicants' position is the sharp distinction they draw between two stylised airline business models, namely the VBA and the FSA models. It is a critical feature because the Applicants' position is premised upon the relevant market not being able to support two FSAs but being able to support a VBA and an FSA. Without establishing this clear distinction, the viability of a VBA and the prospects that it may ultimately retire from the market would be the same as Air New Zealand exiting in the counterfactual.
- 3.6** The entire counterfactual scenario (discussed below) is dependent on this distinction, which is used conveniently. The distinctions are emphasised where it is critical to underpin the plausibility of the counterfactual, but are largely ignored where it becomes important to emphasise the competitive constraint of Virgin Blue under the Proposed Alliance scenario.
- 3.7** While there are differences between the operating structure of Virgin Blue and the Applicants, the overall differences have been overstated. The service offering of a full service airline on short to medium haul routes is not that different to a low fare airline or VBA. Increasingly the bulk of the travelling public is not prepared to pay a substantial premium for the limited service level differences, such that there is pressure on full service airlines to abandon their full service model and adopt a value based or low fare airline model. This in turn requires a careful review of the operational structure of the airline. This is the prevailing commercial pressure in New Zealand and Australia and it is clear that both Air New Zealand and Qantas believe that it is necessary to adopt a value based or low fare airline model, or at least elements of that model.²⁴

²⁴ Air New Zealand has moved to what has been described as a VBA+ model and also operates Freedom Air, a VBA that offers services on trans-Tasman routes. Further Qantas owns an aircraft operating company "Jet Connect" which is the vehicle through which Qantas supplies domestic services in New

3.8 The Applicants have sought to draw a distinction around the implicit value of the FSA model to customers, who in turn are implicitly critical for the successful operation of their overall network. Importantly, the distinctions that the Applicants seek to draw are either grossly overstated or cannot be sustained. For example, VBA's such as Virgin Blue can and do:

- (a) operate high frequency schedules;
- (b) target business customers;
- (c) seek interlining arrangements;
- (d) establish networked operations offering interconnectivity;²⁵ and
- (e) provide additional service features, such as lounges and loyalty programs²⁶ although this may be on a different revenue model (eg pay as you go or provided by a 3rd party).

3.9 This much seems to be acknowledged in the NECG Report where it says:

*VBAs come in many different shapes and sizes. They evolve as they grow, and the management models and route networks they adopt to handle greater traffic volumes and market share differ significantly. Even so, it is perhaps the most important feature of low cost carriers that they do not seek to provide full network interconnectivity.*²⁷

3.10 However, even the claimed difference in relation to interconnectivity is overstated. As discussed in paragraph 2.18(c), Virgin Blue currently offers 72 connecting services between cities that it does not fly directly. Further, Virgin Blue currently has interlining

Zealand. Virgin Blue understands Jet Connect has been established with a low cost structure similar to that of a VBA, but will remain branded as Qantas service. Qantas has also commenced a low cost airline, Australian Airlines to service international routes (mainly in Asia) which it has not found profitable to serve on a full service basis and has maintained Impulse as a separate operating company with its low cost structure under the Qantas brand. Qantas continues to operate Impulse aircraft through a separate operating company maintaining its low cost base.

²⁵ See Figure 1.

²⁶ Two prominent low fare airlines that offer loyalty programs are JetBlue (US) and Southwest (US). Southwest's is the more complex of the two. The points of difference with that of an FSA are that: - (a) all flights have the same earning value, but credits from partners make this somewhat more complicated; (b) the reward is a free round trip ticket to anywhere in the network; (c) availability is claimed to not be restricted. JetBlue's is very simple: - (a) earning points system (2, 4 or 6 points depending on distance); (b) no program partners; (c) points are redeemed for a round-trip ticket to anywhere in the network; and (d) availability is restricted.

²⁷ NECG Report at page 10.

arrangements in place with United Airlines, has had negotiations with a number of other airlines including members of the Star Alliance and is continuing to seek interlining opportunities.

- 3.11** Virgin Blue, like any other airline, is constantly seeking to increase the amount of traffic it services and is keenly interested in any arrangements that will facilitate an increase in its traffic. It would value any arrangements to obtain feeder traffic. Virgin Blue expects that as its network grows, particularly when it commences offering international services, that the opportunities to offer interconnecting services will increase and accordingly the amount of feeder traffic it receives from its network will increase.
- 3.12** Further, nowhere is there any attempt to substantiate the value to customers of this “interconnectivity”. If interconnectivity is, as it appears, relatively unimportant, then it does not provide a substantive basis upon which to sustain the FSA model.
- 3.13** In this regard, Virgin Blue notes that the desire to access feeder traffic from a particular route or market does not require that an airline has operations in all those places. Arrangements can be entered into with other airlines to obtain feeder traffic. Qantas flies to a number of international markets where it does not receive feeder traffic from its own flights within that market, for example, Europe, Japan, South Africa and the USA. In any event, in New Zealand international feeder traffic is unlikely to be significant.²⁸ As a general rule an FSA will only fly domestic routes within a country in its country of origin and in all other places receive its feeder traffic through other co-operative arrangements.
- 3.14** While it may be convenient to describe an airline as an FSA or as a VBA, ultimately this is an over simplification. Contrary to the NECG Report’s sharp distinction between FSA and VBA carriers, air transport services are characterised by a range of competitive strategies.
- 3.15** The principal distinction is that low fare airlines are much more focused on keeping costs low to maintain a low fare structure. This key distinction is reflected in the manner in which they seek to maximise profits. A low fare carrier will seek to stimulate demand through the wide availability of low fares whereas an incumbent seeks to maximise its returns through a strategy directed to price discrimination, such as offering different classes, fare conditions, ticket conditions and restrictions. All these activities impose costs on their operations. A low fare airline, in contrast, does not seek to constrain demand to maximise profits, but in response to demand will expand output.

²⁸ The Commerce Commission has previously found that international feed accounted for a relatively small amount of domestic traffic. *Bodas* at paragraph 272.

- 3.16 That is not to say that low fare airlines do not engage in yield management, they do, but from a completely different business model. A simplistic example of this difference is that where demand for seats on a route exceeds supply Virgin Blue would likely maintain its price structures and yield management practices but increase the capacity made available. However, an FSA would be more inclined to increase the average price paid through yield management rather than increase capacity.

Barriers to entry

- 3.17 As a preliminary point, Virgin Blue notes the Applicants have not addressed the issue of barriers to the market they have advanced. They chose to avoid the discussion as “...*there is scope for lengthy but inconclusive discussion on the extent and nature of barriers to entry*”.²⁹ Instead they focus on barriers to *expansion*, that is, the ability of an existing market participant to expand its services and offer an effective competitive restraint to a firm trying to use its market power.
- 3.18 The Applicants have submitted that the barriers to entry and expansion to the relevant markets are low. Virgin Blue considers that the Applicants have greatly understated the size and nature of barriers to entry and expansion.
- 3.19 When considering barriers to entry the Commission should not simply consider the barriers to commencing operations but the barriers to commencing operations on a successful and sustainable basis. The litany of failed airlines in Australia³⁰ and New Zealand³¹ is testimony to this distinction. Clearly the competition concerns raised by the Proposed Alliance will not be addressed if there was a new entrant, but that new entrant was to subsequently withdraw from the market.
- 3.20 There are two principal barriers to sustainable entry on the trans Tasman and New Zealand domestic routes:
- (a) access to facilities and commercial arrangements on reasonable and competitive terms; and
 - (b) the sunk costs of entry particularly losses incurred due to the strategic response of incumbent airlines.

²⁹ Air New Zealand and Qantas Limited Submission to the Australian Competition and Consumer Commission in Support of the Application for Authorisation dated 9 December 2002 (**Supporting Submission**) at paragraph 6.34.

³⁰ Impulse, Compass and Compass Mk II.

³¹ Kiwi Air and Tasman Pacific.

Access to Facilities and Commercial Arrangements

- 3.21** Virgin Blue notes that it has substantial commercial issues to resolve prior to the commencement of any operations in New Zealand.
- 3.22** It is not correct, as the Applicants have stated, that access to terminal and ground services is not an impediment to entry or expansion in the relevant market.³² In order for Virgin Blue to be able to provide a competitive service on trans Tasman and New Zealand domestic routes it will require significant terminal capacity at a variety of airports throughout New Zealand and Australia at peak times and on commercially reasonable terms. In many cases this will either require the construction of new facilities at the various airports, or the surrender by the Proposed Alliance of a proportion of capacity controlled by Qantas or Air New Zealand (unless other airports become available for use by Virgin Blue). The latter of these options is unlikely to occur through normal commercial negotiations and the former will be a difficult, expensive and long process, the cost of which would be borne by the new entrant.
- 3.23** Currently, there are significant space limitations at a number of key airports during peak times. For example, at Auckland Airport:
- (a) no gates are available to Virgin Blue during peak times. Auckland Airport has indicated that the only way in which passengers could be unloaded at Auckland Airport during peak times would be by passengers disembarking onto the tarmac and then catching buses back to the terminals; and
 - (b) there are limited check-in counters. United Airlines has recently relinquished nine counters, but Virgin Blue understands that Air New Zealand has already applied to tie up that capacity for its own use.
- 3.24** Other airports which have space or other access constraints including, without limitation, Sydney and Christchurch, which are critical to building a trans Tasman or New Zealand domestic network.

³² Supporting Submission at Paragraph 6.50.

Strategic Response of Incumbents

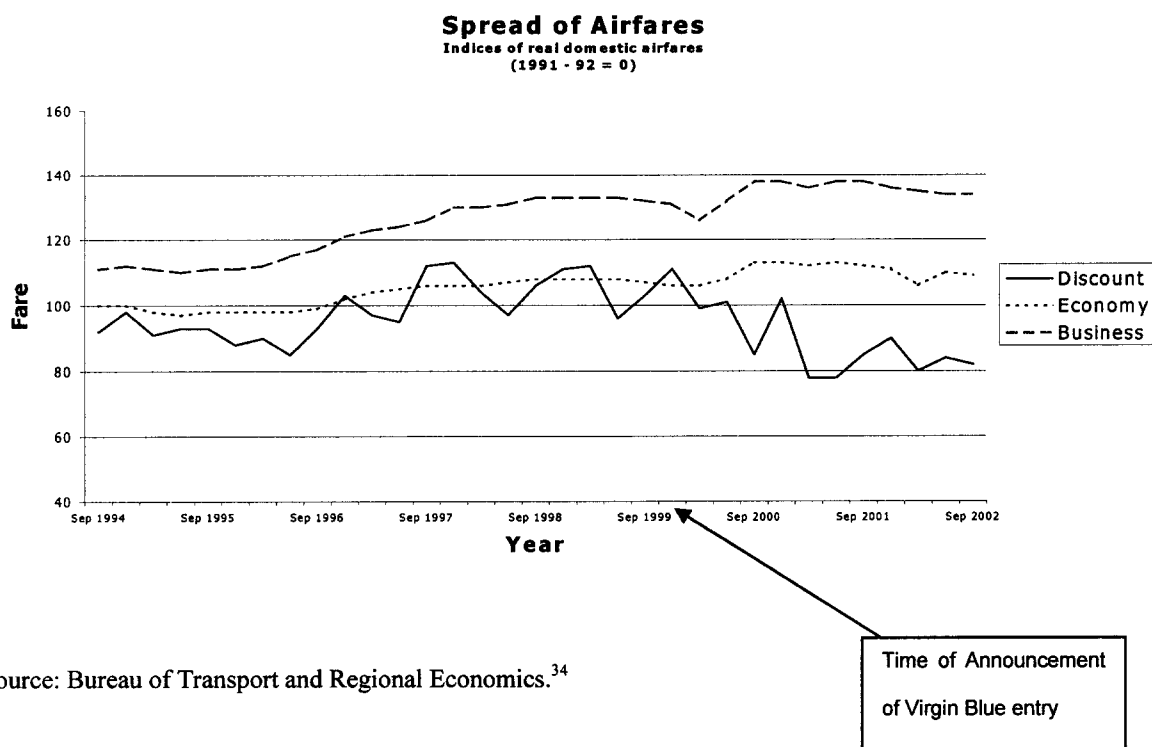
3.25 Virgin Blue's experience is that the strategic response of incumbent airlines is a substantial barrier to successful and substantial entry for any new entrant airline. There are particular characteristics of airline markets that facilitate effective strategic conduct:³³

- (a) strategic capacity deployment. Incumbent airlines can shift resources rapidly in order to add capacity to routes threatened by new entry;
- (b) yield management. Incumbents can price discriminate effectively which ameliorates the impact of declining prices for low fares. Figure 2 illustrates that in the period since the announcement of Virgin Blue and Impulse that they would enter the Australian market (November 1999) there has been a substantial decrease in discount fares, a modest increase in economy fares and a substantial increase in business fares;
- (c) flexible price adjustments. The prices for airline tickets can be adjusted continuously and instantaneously in response to new entry and other demand characteristics, since they are sold directly by airlines or through travel agents with live access to the airlines' reservations systems. Qantas has on numerous occasions instantly decreased fares in response to new services offered by a low cost airline; and
- (d) information on competitor activities. In order to operate each flight as profitably as possible, airlines must forward-book a high proportion of their seats and generally must advertise a new route and begin selling tickets at least a month in advance.

³³

These characteristics are discussed in more detail in Virgin Blues submissions to the Dawson Inquiry which can be found at http://tpareview.treasury.gov.au/content/subs/159_Submission_VirginBlue.pdf

Figure 2: Spread of Air Fares



3.26 It is well recognised that a typical strategic response of incumbent airlines to new entry is to engage in targeted expansion of capacity in order to reduce yields and load factors and undermine the financial viability of the new entrant.³⁵ The Commerce Commission has found that:

The incumbent is likely to seek to share that market expansion, through heavy fare discounting, and the addition of capacity. This might be achieved by the introduction of a rival value based airline, much the same way that Freedom has been established trans Tasman in response to Kiwi's entry. Sharing the expanded

³⁴ <http://www.dotars.gov.au/btre/docs/indicate/airfares.htm#Top>. The data is based upon information obtained through SABRE Pacific's Computer Reservations System, a computer reservation system used by travel agents. Accordingly, this data will not include the effect of Virgin Blue prices as 90% of its sales are made through the Internet. This means that the graph understates the decreasing trend in discount airfares and as such will understate the overall spread of airfares.

³⁵ See in particular US DoT, *Findings and Conclusions on the Economic, Policy and Legal Issues*, 17 January 2001 (**Findings and Conclusions**) and Canadian Competition Bureau *Enforcement Guidelines on the Abuse of Dominance in the Airline Industry* February 2001.

*market will put pressure on the entrant by reducing its load factors and thus increasing the period of operating losses which it must sustain.*³⁶

*The Commission, however, based on its understanding of previous examples of incumbent airlines reacting to entrants such as Compass, Kiwi and Ansett NZ, observes that it is likely that the incumbents would react aggressively in terms of price and capacity.*³⁷

- 3.27** Substantial costs can be incurred in withstanding the ensuing price war resulting from this strategy. These costs are sunk in the sense that if the new entrant fails or withdraws from a route, it is unable to recover the losses incurred during the price war. To this end Virgin Blue notes the evidence provided by Dr Trethaway on behalf of Qantas in *Bodas*:

*Dr Trethaway, for Qantas, said that sunk costs in the aviation industry are very significant, and their magnitude would depend upon the scale of entry into the market, and subsequent growth. He said a significant proportion of sunk costs could be incurred by sustained operating losses which arise from operating for a considerable period of time after entry with load factors which are significantly less than break-even.*³⁸

- 3.28** Virgin Blue also supports the submission of Qantas to the Commerce Commission during the *Bodas* hearing that:

*.....incumbents can act to increase start-up costs and sunk costs for a new entrant.*³⁹

- 3.29** These sunk costs are not symmetrical. Capital is more expensive and more difficult to obtain for new entrants since the capital lenders will factor in the risk of successful predation (given that there is likely to be only very weak, slow and imperfect enforcement of rules against predation).
- 3.30** There is a well established economics literature on the incentives of incumbents operating in multiple areas (e.g on multiple routes) to predate when a new entrant threatens to enter

³⁶ Commerce Commission Decision No 278 Determination Under the Commerce Act 1986 in the matter of a business acquisition proposal involving Air New Zealand Limited, Ansett Holdings Ltd and Bodas Pty Limited (**Bodas**) at paragraph 325.

³⁷ *Bodas* at paragraph 330.

³⁸ *Bodas* at paragraph 246.

³⁹ *Bodas* at paragraph 247.

in any one area.⁴⁰ The Proposed Alliance will have a strong incentive to respond aggressively to entry by Virgin Blue on any given route to seek to deter it from commencing services on other routes and thereby protect its profits. This type of strategic response will substantially increase the sunk costs incurred by a new entrant in the market for air services.

- 3.31** Nor are these costs easily avoided by a new entrant. It is not an option available to new entrants to commence providing services on a route and then withdraw from that route if those losses become excessive and plan to re-enter later. As the US DoT has noted:

*Contestability has proven inapplicable. (Levine, "Airline Competition in Deregulated Markets", at 405.) First, an airline entering a market incurs certain sunk costs that cannot be recovered if it exits, for example, advertising costs and the cost of setting up facilities at the new airport. Travellers will be reluctant to book an airline that exits and reenters a market, moreover, given the significant possibility that the airline may again leave the market before the date of their planned trips. As a result, airlines cannot freely enter routes.*⁴¹

- 3.32** Further, the incumbent may not even need to undercut the prices offered by the entrant, but rather it is sufficient that it offers fares at an equivalent price for the behaviour of the incumbent to pose a barrier to entry and expansion. In this regard Virgin Blue notes the position of Qantas in the *Bodas* proceedings, where :

*Dr Trethaway, for Qantas, commented that the incumbent could drop fares across the board to match the entrant's fares. He pointed out the fares only have to be matched, not undercut, for passengers still to patronise the incumbent. The entrant might then drop fares further, increasing the magnitude of its operating losses during the start-up period.*⁴²

- 3.33** The Applicants have, in the Supporting Submission, supported their contention that the barriers to entry caused by the strategic behaviour of an incumbent are low by pointing to the success of Virgin Blue in Australia.⁴³ However, it is clear that the fact that Virgin Blue withstood Qantas' strategic behaviour during its critical start up phase in Australia was, in large part, because it was better placed to withstand the actions of Qantas than Impulse and Ansett, which both collapsed.

⁴⁰ See for example, Kreps and Wilson "Reputation and Imperfect Information" *Journal of Economic Theory*, 1982, and Milgrom and Roberts, "Predation Reputation and Entry Deterrence" *Journal of Economic Theory*, 1982.

⁴¹ US DoT, *Findings and Conclusions* at page 22.

⁴² *Bodas* at paragraph 328.

⁴³ Supporting Submission at paragraphs 6.71 – 6.77

- 3.34 Ultimately there is a high degree of inconsistency in the treatment of barriers to entry by the Applicants. For example, the following comments attributed to parties giving evidence on behalf of Qantas before the Commerce Commission in the *Bodas* decision:

Mr Davies, for Qantas, stated that the barriers to entry to the domestic market are very high, and would become even higher in a post acquisition situation. Dr Trethaway for Qantas said that individual barriers to entry, which might be solved on paper, might together form an insurmountable barrier, interacting in complex ways to preclude successful sustained entry. Mr Copeland, for Qantas, commented that if the barriers to entry were as low as Air NZ maintained, then Ansett NZ would not have lost as much as \$200 million, and there would have been entrants to the aviation markets over the past few years.⁴⁴

- 3.35 Furthermore, the view that barriers to entry are low is inconsistent with the stated strategy of Qantas that without the Proposed Alliance it will engage in a costly “war of attrition” for supremacy in the relevant market.⁴⁵ In itself this is a predatory strategy. While Virgin Blue considers that the counterfactual is implausible, it would be rational to incur such losses only if there were to be some pay-off in terms of excessive profits in the future. If there were low barriers to entry, Qantas would not be able to raise its prices in order to earn these excessive profits as this will only encourage new entry.

- 3.36 Virgin Blue notes that the Applicants have quoted from the findings of the Commerce Commission in a very selective fashion and in such a way as to give the impression that *Bodas* is authority for the general proposition that there are low barriers to entry to the market it has proposed. Importantly, after a detailed analysis in *Bodas* the Commerce Commission concluded:

.....that, together, the factors affecting entry as listed above indicate that a new entrant, whether as a value based airline of full service airline, must prepare for considerable practical and financial difficulty. This strongly suggests that, cumulatively, the barriers to entry to the domestic main trunk passenger air services market are such that entry is deterred. This is also evidenced by the fact that there has been no entrant of a type to constrain Air NZ and Ansett NZ since the entry of Ansett NZ in 1987, and that Ansett NZ's entry has been marked of years of sustained losses.⁴⁶

⁴⁴ *Bodas* at paragraph 232.

⁴⁵ Interestingly, Qantas' position in this regard has been inconsistent. In February 2002, for example, Qantas denied statements attributed to Geoff Dixon that he aimed to knock Air New Zealand out of the sky, *The Dominion*, 6 February 2002.

⁴⁶ *Bodas* at Paragraph 337.

- 3.37 Further, while the Commerce Commission did state that there were low barriers to entry to the trans Tasman market, the analysis was understandably limited (focussing on regulatory barriers) no doubt due to the fact that it was clear that Air New Zealand would not acquire a dominant position in that market, in circumstances where Qantas held a 35% market share.⁴⁷

Virgin Blue's Views as to the Counterfactual

- 3.38 There is a high degree of uncertainty as to the state of the market over the next five years, with a reasonable degree of uncertainty in the short term which increases over time as one tries to predict a range of competitive responses of various parties. However, as discussed below, Virgin Blue considers that the particularly stark counterfactual scenario advanced by Qantas and Air New Zealand is implausible and unlikely.

- 3.39 Starting at this point in time, Virgin Blue considers the likely strategies of the three airlines without the Proposed Alliance are as follows:

- (a) Air New Zealand would consolidate its presence in domestic and trans Tasman routes, and continue to operate other important, profitable, international routes;
- (b) Qantas would maintain its presence on trans Tasman routes, and may *gradually* increase services on New Zealand domestic routes, perhaps particularly targeting those routes for which Virgin Blue chooses to commence services; and
- (c) Virgin Blue will enter the trans Tasman and the New Zealand domestic markets. The timing and scale of entry will depend on its access to key bottleneck facilities and the extent to which Qantas and Air New Zealand respond to Virgin Blue's entry with strategic and predatory conduct. However, a general entry case is discussed at 2.22 to 2.24 above.

- 3.40 Each of these responses is discussed in more detail below.

Air New Zealand

- 3.41 Air New Zealand has strong brand value among New Zealand residents; and the Government of New Zealand is a committed majority shareholder. The New Zealand Government's strong political/nationalistic interest in seeing the continuation of the brand was demonstrated by its decision to invest in Air New Zealand in 2002. If the Proposed Alliance were not to proceed, the key question for the shareholders would be how best to

⁴⁷ Bodas at paragraphs 377.

use the brand to maximise returns to shareholders. Almost certainly, the answer would be to withdraw (over time) from some international routes which are net loss-making activities (taking into account the aggregate effects on revenue and costs of withdrawing from any route) but to consolidate Air New Zealand's presence on profitable international, domestic and trans Tasman routes.

- 3.42** Consolidating Air New Zealand's position on domestic routes may mean vigorously challenging the attempt by Qantas to capture sales on domestic routes. In this battle, Air New Zealand has strong brand loyalty and first-mover advantages. So, although Qantas and Virgin Blue may make gains on these routes at the expense of Air New Zealand, it is highly unlikely that Air New Zealand would withdraw from these routes within the foreseeable future.

Qantas

- 3.43** In the event that the Proposed Alliance does not proceed, Qantas (like Air New Zealand) is likely to maintain something like its current presence on trans Tasman routes. The interesting question is what it would do on domestic New Zealand routes if the Proposed Alliance were not to proceed. Qantas says that it is losing money on these routes. It also said that a bigger operation might not be profitable either.⁴⁸ Because it enjoys less brand loyalty than Air New Zealand in the domestic New Zealand market, Qantas is likely to, and realise it would, suffer cash losses on these routes for some time. Qantas has shown that it is prepared to bear these short-term losses as an investment in brand loyalty that will yield a pay-off in the future. In the absence of the Proposed Alliance, Qantas is likely to continue gradually to expand its activities in the domestic New Zealand market. This moderate and gradual competitive response is to be contrasted, however, to the extreme and inefficient war of attrition described by the Applicants in the counterfactual which is discussed below.

- 3.44** Qantas' determination to service domestic New Zealand routes is likely to be strengthened by the entry of Virgin Blue on to these routes. Virgin Blue considers that Qantas is unlikely to sit back and watch Virgin Blue gain access to networking and interlining synergies that may advance its cause at the expense of Qantas.

Virgin Blue

- 3.45** Virgin Blue is actively developing plans to enter both the trans Tasman and the domestic New Zealand markets. Virgin Blue considers that there is substantial scope for a low fare

⁴⁸ Geoff Dixon quoted in the *The Dominion* 6 March 2002.

airline to stimulate demand on trans Tasman and New Zealand domestic routes, as well as a number of other Pacific Routes.

- 3.46** Virgin Blue would be interested in operating on all the key trans Tasman routes, as well as certain underserviced or non-serviced routes, such as Auckland-Adelaide, which it has already made clear to the market. In addition, Virgin Blue would be actively interested in operating on all key domestic trunk routes in New Zealand. Virgin Blue is also currently considering a number of Pacific destinations.
- 3.47** Virgin Blue entered the Australian market with two incumbent operators, and the fact that there are two incumbent operators on the trans Tasman and the New Zealand domestic route would not of itself stop it from seeking to enter those routes.
- 3.48** For the reasons set out below, Virgin Blue does not believe that the proposed counterfactual scenario of a sustained five year capacity/price war between the Applicants is credible. In any event, the Applicants' contend that this war of attrition will be directed to high yield business customers who are important for network connectivity⁴⁹, and as such does not pose a direct threat to Virgin Blue. Furthermore, in a three way fight, Virgin Blue believes its cost structure and business model will succeed.

Virgin Blue's Observations on the Applicants' Counterfactual

- 3.49** Virgin Blue notes that it is not possible to fully assess and test the counterfactual scenario as the Applicants have claimed confidentiality in relation to Annexure D and F which sets out the counterfactual.
- 3.50** Quite apart from the inability of interested parties to assess it, Virgin Blue submits that the Commission should have some scepticism over a future scenario represented as fact by the Applicant which is entirely within the Applicants' control and happens to perfectly suit their arguments on the merits of the Alliance. The inconsistencies between the Applicants' position now and Qantas' previous statements to the Commerce Commission suggest that the Applicants are willing to take a convenient position on what the likely counterfactual might be.
- 3.51** In any case, it is important to carefully assess the claimed counterfactual as it appears that all the cost savings are attributed to the avoidance of an inefficient capacity war as opposed to any stand alone cost savings. In effect, the Applicants make a threat that if the Proposed Alliance is not authorised they will behave inefficiently and that therefore the

⁴⁹ Supporting Submission at paragraph 6.8.

Proposed Alliance should be authorised. The Commission should be very wary of finding such savings to be a public benefit.

- 3.52** In this regard, Virgin Blue considers that it is simply not plausible that, if the Proposed Alliance were not approved, Air New Zealand and Qantas would enter a costly five year war of attrition whereby both Qantas and Air New Zealand would increase their capacity to gain supremacy over the other.
- 3.53** This would require the parties to incur losses (which are likely to be large) over a five year period, with a highly speculative uncertain outcome (while there is a thinly veiled threat that Air New Zealand will retire from the market, nowhere is it said that that Air New Zealand will actually fail).
- 3.54** On the other hand, the threat of Air New Zealand's failure suggests that Air New Zealand will engage in irrational behaviour. The Applicants have stated that "*Air New Zealand is not well placed to win the battle nor does it have the financial resources to credibly signal to Qantas that it can successfully engage in a long term fight for market share*".⁵⁰ This suggests that Air New Zealand (and the New Zealand Government) would fund a five year war to the death that it cannot win.
- 3.55** In the counterfactual Qantas appears to be proposing to increase capacity by 60%⁵¹ on domestic routes which are already operating at a loss. The NECG Report assumes that the competitive strategy of both Qantas and Air New Zealand will result in both airlines incurring losses on selected routes over the five year period.
- 3.56** A five year capacity war can only be a rational, profit maximising strategy if Qantas expects to drive competitors from the market and as a result earn above normal returns in the future. This would require Air New Zealand to withdraw and that either there be no entry by Virgin Blue or that Virgin Blue only provide a weak form of competition (which is completely inconsistent with the position adopted by the Applicants regarding the effective competitive restraint that Virgin Blue will impose on the Proposed Alliance).
- 3.57** The counterfactual overstates the likely success of Qantas in any war of attrition. As discussed above, Air New Zealand has a strong brand identity as a New Zealand company, similarly Qantas is strongly identified as an Australian company. In any battle for supremacy of the New Zealand domestic market, particularly if a national flag carrier is as important as the Applicants have suggested, then it can be expected that the New

⁵⁰ Supporting Submission at page 4.

⁵¹ Supporting Submission paragraph 6.8.

Zealand public and the New Zealand Government would provide considerable support and brand loyalty to Air New Zealand ahead of the interests of Qantas.

3.58 If the war of attrition placed pressure on the costs of Air New Zealand, a rational response of Air New Zealand would be to adopt many of the features typically associated with a VBA in order to decrease those costs. The Applicants have discarded this as a plausible response, principally upon the premise that the VBA and FSA models are distinct, mutually exclusive models.⁵² However:

- (a) as discussed above, there is nothing to suggest that by adopting elements of a low cost airline that an airline has to surrender interconnectivity or high yield passengers; and
- (b) this is not consistent with what has occurred in practice. Air New Zealand and Qantas are both adopting elements of a low cost model in their New Zealand operations⁵³ nor is it consistent with their publicly stated intentions.⁵⁴

3.59 The counterfactual scenario also appears highly contrived. If either Qantas or Air New Zealand were not to engage in the inefficient capacity war or to withdraw from the market earlier, then the “cost savings” under the Proposed Alliance scenario would not be achieved. However, without the prospect of Qantas or Air New Zealand leaving the market, there is no rational explanation for the conduct in the counterfactual scenario. The solution is to adopt a five year modelling period in which neither party withdraws, but it is intimated that some time thereafter one might.

3.60 The claim that New Zealand is critically important for Qantas, which would underpin its commitment to the war of attrition, also looks to be overstated and is not substantiated in any way. The Applicants have stated that “*For Qantas, abandoning New Zealand would be tantamount to abandoning Victoria*”.⁵⁵ This comparison is clearly difficult to substantiate. According to the Applicants only five of Qantas’ fleet of 194 aircraft (2.5%) currently operate in New Zealand and these operate at a loss. Further, Qantas first

⁵² *NECG Report at page 15* “One possibility is that of converting Air New Zealand as a whole into a VBA. We do not believe this strategy to be credible. Air New Zealand is fundamentally a network carrier. For its long haul operations to be viable, they must be based on interconnectivity with its domestic network, and be able to draw on a customer base that includes the higher yield segments. Conversion into a VBA would prevent this, and hence would force Air New Zealand’s withdrawal from long haul operations”.

⁵³ See discussion at footnote 24.

⁵⁴ “We see Freedom as a growth platform going forward and would consider other opportunities for Freedom,” Mr Ralph Norris “Meals go, jobs cut at Air NZ – Restructure for air carrier” *Daily Telegraph* 29/5/02.

⁵⁵ Supporting Submission at page 44.

commenced operations in New Zealand in its own right in May 2001. Prior to that it only had a series of interlining arrangements with various airlines.

- 3.61** The counterfactual assumes that Virgin Blue will not commence trans Tasman services until year two of the Proposed Alliance and domestic New Zealand services until year three. This is wrong. Virgin Blue intends to commence trans Tasman and domestic New Zealand operations within that time frame.
- 3.62** The counterfactual is also premised upon the assertion that New Zealand and Australia are part of the one market and cannot sustain more than one full service network carrier with the presence of a VBA.⁵⁶ No analysis or evidence is provided by the Applicants to support this assertion. There is an implicit suggestion that the demise of Ansett provides evidence for this, however, contrary to the suggestions of the Applicants, the entry of Virgin Blue did not cause the collapse of Ansett.⁵⁷ The party most culpable for the collapse of Ansett is Qantas.

⁵⁶

Supporting Submission at paragraph 6.4

⁵⁷

Virgin Blue commenced operations in August 2000, Ansett was placed in administration in September 2001 and ceased flying in March 2002. At the time of the demise of Ansett Virgin Blue was operating nine Aircraft over five routes. The scale of the competitive overlap indicates that Virgin Blue was not the cause of the collapse of Ansett. Indeed the cause of Ansett's demise was its inefficient cost structure which meant it was unable to sustain the losses incurred as a result of Qantas' dramatic expansions in domestic capacity following the entry of Virgin Blue and Impulse. Qantas also directly targeted Ansett when it considered it weak and vulnerable. For example, when Ansett's vulnerability became apparent Qantas increased operations on key Ansett routes such as Perth-Darwin. Ansett's vulnerability was exacerbated by the grounding of its aircraft during Easter 2001.

4. COMPETITION EFFECTS OF THE PROPOSED ALLIANCE

- 4.1** The main competition effect of the Proposed Alliance will be the reduction in the number of existing competitors in the trans Tasman and main trunk domestic markets from two to one. In the provincial New Zealand markets a similar effect may also occur – although Qantas is not currently active in that market, competition to Air New Zealand is provided by Origin Pacific, which has a feeder arrangement with Qantas. There will also be a reduction in competition on Asia/Pacific routes to and from Australia and New Zealand.
- 4.2** Under the Proposed Alliance the rivalry between Qantas and Air New Zealand for revenue in both the trans Tasman and the domestic New Zealand markets will cease. The two independent businesses will operate like a classic cartel. They will co-ordinate their key strategic decisions; set prices jointly; and they will share profits. The profit-sharing arrangements will have the effect of removing any incentive for either company to seek to expand its sales at the expense of the other. The Proposed Alliance is a prime example of “formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities”.⁵⁸
- 4.3** If the Proposed Alliance were not to proceed, Qantas and Air New Zealand would be independently fighting for revenue in the trans Tasman and in the domestic New Zealand market. As discussed further below, another consequence of the removal of this competition between Qantas and Air New Zealand, is that under the Alliance they will have an increased incentive and power compared to the individual airlines in the counterfactual to raise barriers to entry and to act in a predatory manner against any potential new entrant.
- 4.4** In order to address the substantial lessening of competition inherent in the proposal, the Applicants rely on the prospect of new entry. Virgin Blue is the only likely new entrant and is the only one cited. The Applicants claim that the Alliance will actually increase the prospect of new entry.
- 4.5** It is true that a reduction in head to head competition between Qantas and Air New Zealand resulting in higher prices and reduced capacity on key routes, represents an opportunity for Virgin Blue to expand its intended scale of operations.

⁵⁸ *Queensland Co-Op Milling Assn Ltd and Defiance Holdings Ltd (QCMA)* (1976) ATP 40-012 at 17,246.

- 4.6 However, at the same time, the combined forces of Qantas and Air New Zealand have a greater incentive and capacity to target the low fare sector of the market, while keeping other fares high.
- 4.7 The Proposed Alliance appears to be a strategic response to Virgin Blue's prospective entry which is intended to enable Qantas and Air New Zealand to adopt a containment strategy, targeting routes that Virgin Blue may operate, even where the routes themselves are not profitable for them. It is clear, that incumbent airlines have engaged in strategic capacity and pricing conduct to hinder the growth of low fare airlines.
- 4.8 Compared with the future state of competition with the Proposed Alliance, retaliatory increases in capacity are less likely to be profitable, and may therefore be less likely to occur, without the Proposed Alliance. For example, if a market is shared between two incumbents, any incumbent that considers a retaliatory increase in capacity on a route will be faced with bearing the full cost of the extra capacity but may stand to gain only some proportion of the benefit of the increase in sales if the strategy is successful in getting rid of the new entrant. Each of the incumbents may delay, or reduce the extent of its retaliatory response in the hope that the other incumbent will retaliate and bear a greater proportion of the associated costs. So retaliatory increases in capacity would be less likely in the future without the Proposed Alliance than they would be with the Proposed Alliance.
- 4.9 Consequently an important barrier to entry is likely to be lower without the Proposed Alliance, encouraging Virgin Blue to enter faster and on a larger scale than it would if the Proposed Alliance proceeds.
- 4.10 Not only do the Applicants have the incentive under the Proposed Alliance to engage in a strategy of delaying and defeating new entry, they have an increased capacity to do so:
- (a) on any given flight, the Proposed Alliance will have a higher proportion of high fare customers than the Applicants would have without the Proposed Alliance.⁵⁹ The consequence is that they are able to sustain the availability of more low fare tickets in a strategy designed to erode yield and load factors for Virgin Blue;
 - (b) the Proposed Alliance frees up capacity, providing the Applicants with more lower fare seats within the JAO Network, than would be available as individual competitors, which can be used to reduce Virgin Blues' yield and load factors;

⁵⁹ The counterfactual assumes that the war of attrition would be mainly targeted at high yield business class customers. See Supporting Submission at Paragraph 6.8.

- (c) the Proposed Alliance enables Qantas/Air New Zealand to commence operation at times and on routes that individually may not be viable in order to block or deter the entry of Virgin Blue. There is already evidence of this with the proposal to commence Adelaide – Auckland flights in the event that it is approved. Virgin Blue has publicly indicated that it would consider flying this route. It is unlikely that Virgin Blue will fly this route in the presence of the Proposed Alliance;
- (d) Qantas and Air New Zealand remove the risk that their competitive response to each other will erode their ability to directly compete with Virgin Blue. In particular, Qantas and Air New Zealand will not have to compete against each other for customers who are largely price inelastic and will be attracted by the service offering of the incumbent airlines, such as lounges, loyalty schemes and other service differentiators; and
- (e) the combined financial resources of the Applicants *enhances* their capacity to sustain the operating losses incurred by strategic pricing and capacity conduct for periods of time far longer than that which Air New Zealand and Qantas could sustain individually, competing against each other.

4.11 Another key determinant of the degree of competition in the future without the Proposed Alliance will be Virgin Blue's access to essential inputs. The key inputs are:

- (a) access to terminals during peak times at commercial terms comparable to those of the incumbent airlines. As noted at 3.21 to 3.24 above there are substantial limits on access to terminals ; and
- (b) access to ground service, equipment spares and parts, ground handling services, maintenance and route re-protection on reasonable terms. Air New Zealand is currently the only supplier of many of these services in New Zealand.

4.12 Critically, Air New Zealand and to a lesser extent Qantas control these key inputs. For example, even in relation to access to airport facilities, these can be effectively controlled by Air New Zealand and Qantas simply by not releasing capacity. Air New Zealand can simply refuse to enter into commercial arrangements for ground support and handling services with Virgin Blue.

4.13 Virgin Blue's experience is that it is more likely to be able to conclude satisfactory agreements for the supply of these services, where there are multiple providers of a service. There is less prospect of Qantas and Air New Zealand refusing to agree to supply services to Virgin Blue than there would be if the Proposed Alliance were to proceed. If one of them has some unused capacity to provide the service, it is likely to reason that if it