does not provide the service to Virgin Blue, then the other party might. If the merger were to proceed, the bargaining power of Virgin Blue in seeking access to services that could be provided by the incumbent airlines would be drastically reduced.

4.14 Qantas and Air New Zealand have submitted that Virgin Blue is likely to be more successful and have a larger scale of operations with the Proposed Alliance than without. This appears to be based on the premise that the reduction in competition will provide a greater commercial opportunity for Virgin Blue. However, Qantas and Air New Zealand do not address their capacity to engage in strategic capacity dumping and to target the new entrant through their low cost operations without having to worry about each other competitive response. In fact the Proposed Alliance actually raises the risk Virgin Blue's entry will not be as substantial as it otherwise would be.

4.15 Furthermore, Virgin Blue does not expect to achieve the scale of operations that the Applicants have assumed in the NECG Report it will achieve through natural growth. The NECG Reports has assumed that under the factual scenario Virgin Blue will have operations in the trans Tasman services that equates to dedicating at least 6 aircraft in year 1, 15 aircraft in year 2 and 17 aircraft in year 3. Virgin Blue could not satisfy this aircraft demand under its arrangements with Boeing (which were only recently finalised) having regard to the natural attrition of the aircraft in its fleet, its plans to expand its Australian operations, its plans to commence domestic New Zealand services and its intention to fly a number of international routes other than to New Zealand.

4.16 To achieve this scale of operations would require Virgin Blue to put its Australian growth plans on hold and even withdraw from certain Australian domestic services. Virgin Blue will not do this. The only way in which Virgin Blue is likely to achieve the scale of capacity on which the Alliance scenario is based in the short to medium term is if the Applicants divest operational capacity.

4.17 It should also be recognised that it would take Virgin Blue time to achieve the scale of operations under the Proposed Alliance scenario, by which time the Proposed Alliance will be well entrenched. Virgin Blue would need to displace capacity from the Alliance parties, requiring that they withdraw capacity, to achieve the scale of operations suggested. The delay to market arising from natural growth significantly reduces Virgin Blue's ability to achieve the scale of operations the Applicants have suggested.

4.18 If the Proposed Alliance retains their strategic low cost operations such as, Freedom Air and Australian Airlines, these will provide a perfect vehicle to constrain the growth of Virgin Blue. These airline operating companies controlled by Air New Zealand and Qantas provide a fighting capacity to tackle Virgin Blue head on, while seeking to maintain their high yield passengers. The experience in Australia, as illustrated by figure 2 on page 23, supports this as a likely outcome.

4.19 There is evidence of this already occurring. Freedom Air was originally established as a response to the entry of a low cost operator, Kiwi Air, which subsequently went out of business. With the collapse of Kiwi in 1997, Freedom Air was kept in operation on a limited basis as a strategic checking device for any new entrant. In response to Virgin Blue's announced commencement of operations in New Zealand on 24 April 2001, Freedom Air announced three days later that it was expanding the fleet from two to four 737's, apparently to counter Virgin Blue's entry.[60] When Qantas commenced operations in New Zealand in May 2001, Air New Zealand withdrew Freedom Air from trans Tasman services and re-deployed Freedom Air on those domestic routes operated on by Qantas. Now, given the relationship with Qantas, Air New Zealand has re-deployed Freedom Air to operate out of Brisbane, the home base of Virgin Blue. Brisbane is the logical point from which Virgin Blue would enter the trans Tasman market as it has a relatively high proportion of leisure travel customers and it is Virgin Blue's home base. Virgin Blue believes that this re-deployment is a response by Air New Zealand to the anticipated commencement by Virgin Blue of trans Tasman services.

4.20 The use of Freedom Air in this manner can only be described as strategic conduct. It has no other rational commercial explanation as a return on a route may often only occur after several years of operation on that route due to the large sunk costs associated with commencing operations on any route.

Other Competitive Restraints

4.21 As discussed above there is little prospect of Virgin Blue reaching the scale the Applicants have assumed by natural growth in the time period proposed by the Applicants.

4.22 The only competitive restraint other than Virgin Blue on the Proposed Alliance identified by the Applicants are fifth freedom carriers. The Applicants state:

> *The constraint imposed by fifth freedom carriers is growing. To date these carriers have focused on the AKL-SYD and AKL-BNE routes, although there is no impediments to their commencing AKL-MEL or other trans Tasman services in response to any price increases.*[61]

---

60 *Forgive the Cynicism,* New Zealand Evening Post, 30 April 2001, Editorial p.4.

61 Supporting Submission at paragraph 6.88.

4.23 This misconstrues the nature of the fifth freedom carriers business and overstates their ability to respond to opportunities on the trans Tasman routes presented by increases in prices by the Proposed Alliance.

4.24 A fifth freedom carrier will establish a schedule of operations from its home market to Australia and New Zealand as part of an integrated schedule. The carrier seeks to combine New Zealand destination traffic and Australian destination traffic on one flight. Similarly, it seeks to aggregate New Zealand origin traffic and Australian origin traffic on one flight. This may leave unfilled capacity on the Australia – New Zealand leg, which can be made available under fifth freedom rights.

4.25 Critically, the fifth freedom carrier does not determine its schedule and its operations by reference to, and therefore does not competitively respond to, price and capacity signals on the trans Tasman route. Its decision is based upon the economics of the entire route, that is from its home market to Australia and New Zealand. This may mean that fifth freedom carriers take some portion of a trans Tasman route, but otherwise they place no competitive threat or discipline on that or any other trans Tasman route. Further Virgin Blue notes that fifth freedom carriers will only operate trans Tasman services and not domestic New Zealand routes.

4.26 Significant expansion on Asia/Pacific routes to and from New Zealand is also unlikely. Qantas has a significant shareholding in Air Pacific so any expansion by it cannot be considered a constraint. Other airlines are either too small to expand significantly (e.g. Polynesian Airlines) or are not driven by New Zealand market requirements but by scheduling requirements in their country of origin.

5. MARKET REFORM

Market reforms required to sustain substantial new entry

5.1 For the reasons set out below, Virgin Blue believes that behavioural undertakings will be of limited utility in addressing fully the competition concerns arising from the Proposed Alliance. These competition concerns can only be addressed if structural changes are made to the market in addition to imposing stringent and readily enforceable behavioural undertakings on the Proposed Alliance.

5.2 The Proposed Alliance should only be authorised if the Commission is satisfied that Virgin Blue (or someone else) is operating at a scale sufficient to offer a meaningful and sustainable competitive restraint on the Proposed Alliance. This can only be ensured if Air New Zealand divests Freedom Air. The divestiture of Freedom Air:

(a) provides a vehicle for a new entrant to immediately commence operations in New Zealand. As discussed above, any delay in entry by a new entrant after the formation of the Alliance will place it at a significant disadvantage in relation to the Proposed Alliance given the increased incentive and capacity of the Proposed Alliance to engage in strategic or predatory conduct;

(b) provides an immediate and substantial scale of operations, through four 737s, (similar in scale to Qantas' existing operations in New Zealand). As discussed above Virgin Blue will not reach the scale assumed by the Applicants through natural growth. The sale of Freedom Air would provide a vehicle from which a new entrant could reach the scale of operations outlined by the Applicants;

(c) off-sets the anti-competitive effects of the rationalisation of capacity under the Proposed Alliance, ie as more capacity remains in the market than otherwise and a greater share of that capacity is independent of the Proposed Alliance;

(d) removes from the Proposed Alliance's arsenal the more likely vehicle through which it would engage in strategic or predatory conduct; and

(e) is likely to result in the Applicants responding to entry by Virgin Blue using their core brands and services, which should result in more broadly based reductions in price that may otherwise occur.

5.3 To ensure that this outcome is not undermined through the establishment by the Applicants of a new low cost operator or the redeployment of an alternative existing low cost operator, there should be appropriate restrictions on Air New Zealand and Qantas from establishing another low fare airline and Qantas should be restrained from flying Australian Airlines and aircraft from its low cost operating vehicles (Impulse and Jet Connect) on trans Tasman, New Zealand and certain Pacific routes for a period of three years.

5.4 Virgin Blue believes that there should also be a number of other quasi structural or behavioural reforms imposed upon the market. These should, at the very minimum, address the following issues:

(a) delaying giving effect to the Proposed Alliance until new entry has occurred. Actual entry is a more effective competitive restraint than potential entry[62] and this will ameliorate the first mover advantage that the Proposed Alliance has ;

(b) equivalent access to terminal facilities is provided to the new entrants as that enjoyed by the Alliance, particularly during peak times. There are several airports which have substantial capacity constraints on gates and check-in facilities, including, without limitation, Sydney, Auckland and Christchurch. In critical respects, Air New Zealand, and to a lesser extent Qantas, control access to these facilities, particularly where they have contractual rights to the use of such things as gates and check in counters. A new entrant should have equivalent access rights, in terms of quality[63] and quantity, without that new entrant being obliged to finance new facilities at an Airport. At capacity constrained Airports this can only occur if the Proposed Alliance is required to relinquish some of its rights of access to the new entrant;

(c) sufficient suitable peak time slots and airside facilities at capacity constrained airports, for example, Sydney and Auckland are available to the new entrants such as Virgin Blue. In order to achieve a scale necessary to offer an effective competitive constraint on the Proposed Alliance, a new entrant will ultimately require a significant amount of slots and airside facilities at peak times. In order to achieve this the Proposed Alliance will need to relinquish a significant amount of its existing rights;

---

62 Virgin Blue supports Qantas' position in the *Bodas* proceedings where Dr Trethaway submitted that the threat of entry is a much less powerful constraint on incumbent airlines than was hoped 15-20 years ago. See *Bodas* at paragraph 467.

63 For example, to overcome capacity constraints at some airports buses are offered as an alternative to aerobridges. It would be unacceptable if a new entrant was relegated to use buses instead of aerobridges, unless a significant cost advantage is offered to the new entrant.

(d) finalisation of satisfactory commercial arrangements with Air New Zealand and Qantas for maintenance services, spares and parts, ground handling services and equipment at all major airports and route reprotection; and

(e) an undertaking to limit the capacity response to new entry. The undertaking should prevent the Proposed Alliance from increasing capacity for a period of two years on any route following new entry.

5.5 Finally, given the inherent risks to competition of the Proposed Alliance, authorisation should not be granted under any circumstances for a period greater than three years.

General Comments – The Limits of Behavioural Undertakings

5.6 The Applicants have proposed to address certain competition concerns and the achievement of certain public benefits through enforceable undertakings. The Applicants have principally proposed behavioural undertakings, although there are some limited quasi-structural or access undertakings. The Commission has long recognised the inherent problems in using behavioural undertakings alone to address competition issues in a market as opposed to structural or quasi-structural undertakings. For example, in its *Merger Guidelines* the Commission identifies a number of problems with behavioural undertakings, including that:

(a) behavioural undertakings may well interfere with the ongoing competitive process through their inflexibility and unresponsiveness to market changes;

(b) the duration of such undertakings is highly problematic – such undertakings should not be perpetual, yet it is often impossible to identify with any certainty a time in the future when they will no longer be required;

(c) they are extremely difficult to make certain and workable in detail, particularly in the short time frames in which mergers are considered;

(d) they require continuing monitoring, and where breaches are detected they are often dependent on enforcement after the event; and

(e) there are substantial associated costs to the Commission of compliance and enforcement.

5.7 Each of the difficulties with behavioural undertakings identified by the Commission in its Merger Guidelines will be relevant to any consideration of the undertakings offered by the Applicants. Many of these difficulties will be magnified by the complex and often opaque nature of pricing and capacity allocation in the aviation industry.

Comments on proposed Undertakings provided to Commission

5.8 Virgin Blue has had a limited opportunity to review the undertakings outlined to the Commission. However on a preliminary review they appear deficient in a number of regards.

(a) In general the undertakings should apply for the period for which the Alliance is authorised and in effect.

(b) In relation to the facilities undertaking, it is critical that there is an undertaking in place assuring a new entrant of access to airport facilities. However, the undertaking proposed is inadequate, for example:

(i) it does not provide for the relinquishment of capacity at relevant facilities;

(ii) it only applies to facilities not being used by the Applicants and is therefore unlikely to apply in peak periods;

(iii) licence fees are proposed which include a margin for the Applicants, so that a new entrant pays more than the Applicants for access to the same facilities; and

(iv) it may provide no more than what is required under contractual "make available" requirements already in place with the airport.

(c) In relation to the capacity undertaking, it is critical that there are capacity limits on the response of the Applicants to new entry. However, the undertaking proposed is inadequate, for example:

(i) it applies only to those routes at the date of the commencement of the Proposed Alliance on which the Proposed Alliance is the sole operator. It does not apply on a number of key trans Tasman routes (AKL – BNE and AKL – SYD) or new routes that Virgin Blue may wish to serve upon entry; and

(ii) it provides that the Applicants can actually increase capacity significantly. It is *very* telling that while Qantas/Air New Zealand contend that they wish to reduce inefficient capacity, the one scenario where they contemplate an increase in capacity is in response to new entry.

(iii) In relation to public benefit undertakings, it is noted that in effect these bind the Applicants to a strategy which may lock out new entrants on new routes. These undertakings should be rejected. If there is not a public benefit inherent in the Alliance Proposal, the parties should not seek to create one in effect by establishing a binding legal commitment. It will either be appropriate and rationale to commence these operations under the Alliance Proposal or not. Undertakings may only lock in inefficient and potentially anti-competitive arrangements.

6. THE APPLICATION OF THE AUTHORISATION TEST

6.1 The Applicants have sought authorisation of the Proposed Alliance pursuant to ss 88(1) and 88(9) of the Trade Practices Act 1974 (**TPA**) on the grounds that the public benefits of the Proposed Alliance outweigh the public detriments.

6.2 In order to authorise the agreements underpinning the Proposed Alliance, the Commission must be positively satisfied that giving effect to the Alliance would result or be likely to result in a benefit to the public and that that benefit would outweigh the detriment to the public constituted by any lessening of competition that would result if the Alliance was given effect.[64]

6.3 In order to authorise the acquisition by Qantas of up to 22.5% of the equity in Air New Zealand, the Commission must be positively satisfied that in all the circumstances that the proposed acquisition would result, or be likely to result, in such a benefit to the public that the acquisition should be allowed to take place.

6.4 In Australia, while the two formulations of the test for authorisation of acquisitions and agreements differ, in effect they are likely to be substantively similar. [65]

6.5 The assessment of the public benefits and detriments must be undertaken from the perspective of the jurisdiction in question. Accordingly, only a public benefit to Australia is relevant in Australia.

6.6 The concept of a public benefit has been described as:

> *anything of value to the community generally, any contribution to the aims pursued by society including as one of its principal elements (in the context of trade practices legislation) the achievement of the economic goals of efficiency and progress.*[66]

6.7 It is the Commission's task to weigh or balance public benefits and detriments, as contemplated in ss 88(1) and 88(9). However, this does not imply that the Commission must apply some quantitative assessment to each item. Nor does it determine what the Commission must weigh in the balance as a public benefit or a public detriment. For example, in Australia, there has been no acceptance that a quantitative total welfare

---

64 See s 90(1) of the TPA.

65 *Re Media Council of Australia (no 2) (1987) ATP 40-774*

66 *Queensland Co-Op Milling Assn Ltd and Defiance Holdings Ltd* (**QCMA**) (1976) ATP 40-012 at 17,242.

analysis is required or even desirable. Furthermore, in Australia it is clear that greater weight is to be accorded benefits which flow through to the public generally. Similarly, if the gains accrue privately (even to shareholders in public companies) and the detriments impact upon the public generally the Commission should be slow to grant authorisation.

6.8 Historically, in Australia, there has been an understandable reluctance to allow a private benefit to fully off-set a public detriment. In practice, such a model may not properly factor in the erosion of productive and dynamic efficiency that will flow from a lessening of competition.[67] This is also reflected in decisions of the Tribunal which indicate that less weight is to be given to benefits which do not flow through to consumers and the public generally.[68]

6.9 Importantly, the Applicant bears the onus of establishing its case.[69] This requires that the Applicant provide substantive and probative material which would establish its case.[70] Further, it requires that the Applicant establish a causal connection between the claimed benefits and the conduct.[71]

6.10 Virgin Blue engaged Frontier Economics to review the NECG Modelling of the benefits and detriments of the Alliance. That Report is enclosed at Attachment 1. In summary, Frontier Economics found that the Applicants have:

(a) understated the detriments;

(i) the price increases and capacity decreases identified by the Applicants have been substantially understated, and the dead weight loss associated with the Proposed Alliance has been underestimated as a result; and

(ii) the Applicants have failed to identify a likely detriment in that the Proposed Alliance is likely to have a similar effect on freight services as it has on passenger services, namely to increase prices and reduce capacity;

---

67 See the decisions of the Commission in *(Aust) Pty Ltd* (1996) ATPR (Com) ¶50-232; Decision of the Commission in Australian Pharmaceutical Industries Limited in respect of Proposed merger with Sigma Company Limited Date: 11 September 2002 Authorisation No:A30215.

68 *Re Westralian Farmers Cooperative Ltd* (1979) ATPR 40 -110; *Re Howard Smith Industries Pty Ltd and Adelaide Steamship Industries Pty Ltd* (1977) ATPR 40-023 (**Howard Smith**).

69 *QCMA* at 17,224 and *Re John Dee (Export) Pty Ltd* (1989) ATPR 40-938 at 50,206.

70 See *Re Howard Smith.*

71 *Re 7-Eleven Stores Pty Ltd* (1994) ATPR 41-357 at 42,677.

(b) overstated the benefits. The principal reasons for this are:

(i) there is no basis for the tourism benefits the Applicants have alleged will occur should the Proposed Alliance proceed;

(ii) the cost savings are unsubstantiated and appear to be cost savings attributed to the Applicants failing to engage in inefficient and potentially unlawful conduct, which in any event is implausible;

(iii) the Applicants have not measured scheduling efficiencies arising between the factual and counterfactual scenario, but instead have compared the schedules if the Proposed Alliance were to proceed, which has the effect of overstating the scheduling efficiencies; and

(iv) there is no reason why the Proposed Alliance should not result in any new direct services that otherwise would not have occurred.

6.11 As a final point, the NECG model includes no allowance for losses in productive and dynamic efficiency. Virgin Blue notes that in *Bodas*, the Commerce Commission concluded that allowing there to be a dominant firm in the market would result in:

(a) increases in productive inefficiency to levels between 1-10% of current costs; and

(b) losses in innovative efficiency of between 1% and 2.5%.

Approved for Public Register and
to be published on the Internet

YES / NO

....

12/2/13

Virgin Blue : 2.

ATTACHMENT 1

FRONTIER REPORT

Prepared in consultation with John Feil

New Zealand Institute of Economic Research Inc (NZIER)

Critique of the NECG Report on the Qantas Air New Zealand Alliance

Report prepared for Gilbert & Tobin

11 February 2003

© Copyright Frontier Economics

Frontier Economics Network

Frontier Economics Pty Ltd is a member of the Frontier Economics network, which consists of three separate companies based in Boston, London and Melbourne. Each company is independently owned and legal commitments entered into by any one company do not impose any obligations on other companies in the network. All views expressed in this report are the views of Frontier Economics Pty Ltd.

Disclaimer

None of Frontier Economics Pty Ltd (including the directors and employees) make any representation or warranty as to the accuracy or completeness of this report. Nor shall they have any liability (whether arising from negligence or otherwise) for any representations (express or implied) or information contained in, or for any omissions from, the report or any written or oral communications transmitted in the course of the project.

1. Introduction

Frontier Economics has been asked by Gilbert & Tobin for its opinion of the NECG Report that Qantas and Air New Zealand (ANZ) rely on in their applications ('the Applications') for authorisation before the Australian Competition and Consumer Commission (ACCC) and the New Zealand Commerce Commission (NZCC) of their proposed coordination and integration of services ('the proposed alliance').[1] This report is that opinion. This report is arranged in the following sections:

- The Proposed 'With' and 'Without' Scenarios;
- The Relevant Markets;
- The Modelling of Detriment Caused by Lessening of Competition;
- The Claimed Net Public Benefits; and
- Conclusions.

All page references are to the NECG Report, unless the contrary is indicated.

As discussed in this report, we consider there are significant problems with the analysis outlined in the NECG Report. We question the scenarios that NECG uses as the basis for its modelling of the future with the proposed alliance and the future without the proposed alliance (referred to as the 'with' and 'without' scenarios in the remainder of this report). We also question the logic of some of the modelling itself. In summary, we consider that:

- The 'without' scenario used by NECG as the basis for assessing the net public benefits of the proposed alliance is not credible. NECG assumes that, without the proposed alliance, Qantas and ANZ will compete aggressively for three to five years by increasing capacity on trans-Tasman and domestic New Zealand routes. This will result in both ANZ and Qantas incurring losses on selected routes, and ultimately, at some point after the five year modelling period, cause the demise of ANZ.

[1] NECG, 'Report on the Competitive Effects and Public Benefits Arising from the Proposed Alliance between Qantas and Air New Zealand', 8 December 2002.

This scenario is problematic for two reasons. First it is only rational for Qantas to compete in this manner if it will cause a competitor to exit, and enable Qantas to recoup the losses incurred by earning high (monopoly) profits in the future. Secondly, if ANZ's demise is as foreseeable as NECG suggests, it is not rational for ANZ to compete and incur losses over a five year period. ANZ would be expected to cease operations immediately.

- The approach used to model the net public benefits of the proposed alliance is inappropriate and substantially underestimates the expected dead-weight losses. The modelling approach assumes that marginal costs (and prices) do not fall as a result of the significant excess capacity that emerges in the 'without' scenario. NECG's model predicts that, all else being equal, prices will rise when Qantas and ANZ undertake their capacity war because it results in an increase in demand at any given price. The capacity war is said to increase demand because of a very-crude uniform application of a capacity elasticity of demand. In practice, a capacity war such as that described in the 'without' scenario would be expected to result in substantial decreases in airfares. NECG's estimate of dead-weight losses arising from the proposed alliance ignores this.

- The results presented for the 'with' scenario, and the magnitude of the detriments derived, are highly questionable even when one adopts the assumptions NECG states are used in their model.

- The sources and estimated quantity of public benefits that NECG suggests will arise from the proposed alliance are highly questionable and should be significantly discounted, if not disregarded, in considering the effects of the proposed alliance. For example:

  - The $1,086 million[2] in estimated 'cost savings' appears to consist of the costs ANZ and Qantas expect to incur without the proposed alliance that would be avoided because the proposed alliance would prevent the period of aggressive competition predicted in the 'without' scenario.

[2] The figures quoted here are NECG estimates of public benefits. in net present value (NPV) terms, arising in the first five years after the alliance. These estimates are outlined in Table 1 of the NEGC Report (p 35).

- NECG appears to give little or no value to the types of cost savings typically identified as sources of public benefits associated with mergers (e.g. cost savings arising from economies of scale). This in itself should be cause for concern to the NZCC and ACCC given that merger activity is generally driven by the desire to achieve efficiencies and synergies rather than to simply 'monopolise'.

- The $60 million of public benefits estimated to arise due to 'scheduling efficiencies' are based solely on reductions in customer waiting times compared with *current* schedules. If instead the 'without' scenario is used as the basis for comparison, the proposed alliance could even result in zero or negative scheduling efficiencies (i.e. scheduling inefficiencies).

- NECG's estimate of $1,134 million in 'tourism' benefits arising from the proposed alliance is considered highly improbable. No cogent argument is provided why Qantas Holidays does not already pursue the strategy the Report states it would pursue with the proposed alliance given the expected profitability. Any increase in tourism may be considered unlikely given NECG's view that the proposed alliance will lead to a decrease in competition and capacity and an increase in airfares.

- NECG estimates that the proposed alliance will create new direct services to a value of $116 million. The Report argues that these services will be viable under the alliance but not viable without the alliance because traffic could be aggregated under the alliance. The essence of competition is rivalry for customers. The Report does not explain why one airline (acting alone) could not offer a direct service and so capture sufficient passengers to make it viable.

- Approximately $15 million in net public benefit is expected to arise from the proposed alliance due to increased freight capacity. This result directly contradicts NECG's description of the effects of the proposed alliance on passenger services, despite the fact that 85%-90% of freight is carried on passenger services.

In summary, the various approaches adopted in modelling the net public benefits of the proposed alliance substantially underestimate the costs of the proposed alliance and overstate any potential benefits.