Virgin Atlantic Airways Ltd.
The Office, Manor Royal
Crawley RH10 9NU
tel: 01293 562 345
fax: 01293 561 721
telex: 877077
www.virgin.com/atlantic

Ref: w-07766bh/adm

Direct Tel No: 44 (0)1293 747065
Direct Fax No:44 (0)1293 747073

18 February 2003

Tim Grimwade
General Manager
Adjudication Branch
Australian Competition & Consumer Commission
P O Box 1199
Dickson ACT 2602
Australia

By Post and Fax: +61 2 6243 1199

Dear Mr Grimwade

QANTAS/AIR NEW ZEALAND EQUITY PROPOSAL & QANTAS/AIR NEW ZEALAND STRATEGIC ALLIANCE PROPOSAL

I refer to our recent correspondence and in particular to the list of questions contained in your letter of 19 December 2002. The response of Virgin Atlantic Airways is attached.

Virgin Atlantic is a UK airline majority owned and controlled by UK citizens. 49% of the shares are owned by Singapore Airlines. Virgin Atlantic operates wholly independently of Virgin Blue, despite the involvement of Sir Richard Branson in both airlines. We currently serve nine destinations in the United States and three in the Caribbean, as well as Hong Kong, Shanghai, Tokyo, Delhi, Johannesburg, Cape Town and Lagos. We are the second largest UK scheduled airline with a reputation for innovative, high quality, value-for-money service. We are not a member of a global airline alliance.

For many years Virgin Atlantic has campaigned to reduce the barriers to market entry in international air transport, particularly those that benefit the established dominant airlines such as British Airways in the UK, Qantas in Australia and Air New Zealand in New Zealand. Our plans to enter the UK-Australia market were put on hold when the Qantas/BA alliance was approved. Those plans are now being revisited. This is why the market power enjoyed by Qantas and Air New Zealand in the Australian/New Zealand market is so important to us. We note the comment by Qantas and Air New Zealand that their strategic alliance will result in "increased international competitiveness" for the combined group. This increased competitiveness will result from increased market power rather than increased efficiency.

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Our submission focuses on the key issues of barriers to market entry and market power, particularly in relation to long-haul international air services, such as Australasia-Europe. We understand why the current Qantas/Air New Zealand proposals cannot be considered simultaneously with the likely application by Qantas and BA to renew approval for their alliance. However, both proposals clearly impact each other. We look forward to being invited to comment further when/if Qantas and BA file their application.

Yours sincerely

Barry Humphreys
Director of External Affairs and Route Development

PUBLIC VERSION

Response to the
Australian Competition and Consumer Commission

Qantas/Air New Zealand Equity Proposal
and
Qantas/Air New Zealand Strategic Alliance Proposal

18 February 2003

Introduction

Virgin Atlantic is concerned by the applications by Qantas and Air New Zealand for authorisation of the acquisition by Qantas of ordinary shares comprising up to a 22.5% voting equity interest in Air New Zealand (the Equity Proposal), and for authorisation of their proposed collaboration (the Strategic Alliance Proposal).

Virgin Atlantic believes that, if these applications are authorised, they will severely adversely affect competition in the relevant markets, including Australia-Europe markets, given the level of market power that they would permit Qantas/Air New Zealand to enjoy. These anti-competitive effects will not be outweighed by public benefits arising from the proposals, as claimed by the applicants. Indeed, the study prepared for the applicants by Network Economics Consulting Group (NECG) substantially over-estimates the benefits, and under-estimates the costs of the proposals in several ways.

The costs and benefits associated with the proposals, and their relative magnitudes, are discussed in Virgin Atlantic's responses below to the questions contained in the ACCC's letter dated 19 December 2002.

Public benefits

It is difficult to see how there will be any substantial public benefits arising from the two proposals, let alone of the magnitude estimated by NECG, for several reasons. First, NECG make assumptions about Virgin Blue's behaviour with authorisation of the proposals which are unrealistic. Second, it is extremely unlikely that there will be substantial cost-savings associated with the proposals. Third, a reduction in competition will not lead to market growth.

<u>The ability of Virgin Blue to act as a competitive constraint on Qantas/Air New Zealand will depend crucially on the terms and conditions attached to authorisation of the proposals by the ACCC</u>

NECG's analysis relies crucially on Virgin Blue acting as a competitive constraint on Qantas/Air New Zealand. Yet in its submission to the ACCC dated 12 February 2003[1], Virgin Blue states that the timing and scale of its entry will depend crucially on barriers to entry:

> "Critically the timing and scale of Virgin Blue's entry will depend on the barriers to entry. There are two main barriers to establishing a substantial scale of operations:
>
> (a) access to facilities (including for example, Sydney, Auckland and Christchurch airports) and commercial agreements for necessary ground support and handling. Air New Zealand and Qantas, through existing arrangements with airports, control key capacity at these and other airports. Further, Air New Zealand is the monopoly supplier of many ground support and handling services in New Zealand; and

[1] *Virgin Blue Submission in Response to Applications for Authorisation of the Proposed Qantas/Air New Zealand/Air Pacific Alliance*, 12 February 2003.

(b) the threat of strategic capacity and pricing conduct by Air New Zealand and Qantas, particularly through their low cost operations, Freedom Air, Australian Airlines and entities within the Qantas brand with low cost structures such as Impulse and Jet Connect.

The Proposed Alliance raises these barriers. That is, an additional anti-competitive effect of the Proposed Alliance is that it enables the Alliance parties to limit the scale and timing of Virgin Blue's entry and limit its competitive presence.

...Under the Proposed Alliance, Qantas and Air New Zealand have a greater incentive and capacity to target Virgin Blue, in order to deter and delay its entry.

...The Proposed Alliance raises a substantial risk that Virgin Blue's entry into New Zealand may not be as substantial as it otherwise would be. In any event, it is unlikely on current planning, that Virgin Blue would be able to provide the scale of operations, and in the time frame, on which the Applicants' case is founded."[2]

Given that the proposals would raise these barriers to entry, Virgin Blue states that they should only be authorised if:

"...Virgin Blue (or someone else) has actually entered on a substantial scale on the trans Tasman and New Zealand routes prior to the Proposed Alliance coming into effect. The need for actual and substantive competition was acknowledged by Qantas as an essential pre-condition when it first announced its consideration of the proposal in May 2001."[3]

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[2] Ibid; 1-3.
[3] Ibid; 3.

Virgin Blue states that in order for this to occur, the proposals set out in its paragraph 1.11 would need to be adopted.

Virgin Blue goes on to say:

> "In any case, given the inherent risks to competition from the Proposed Alliance, it should not be authorised under any circumstances for more than three years."

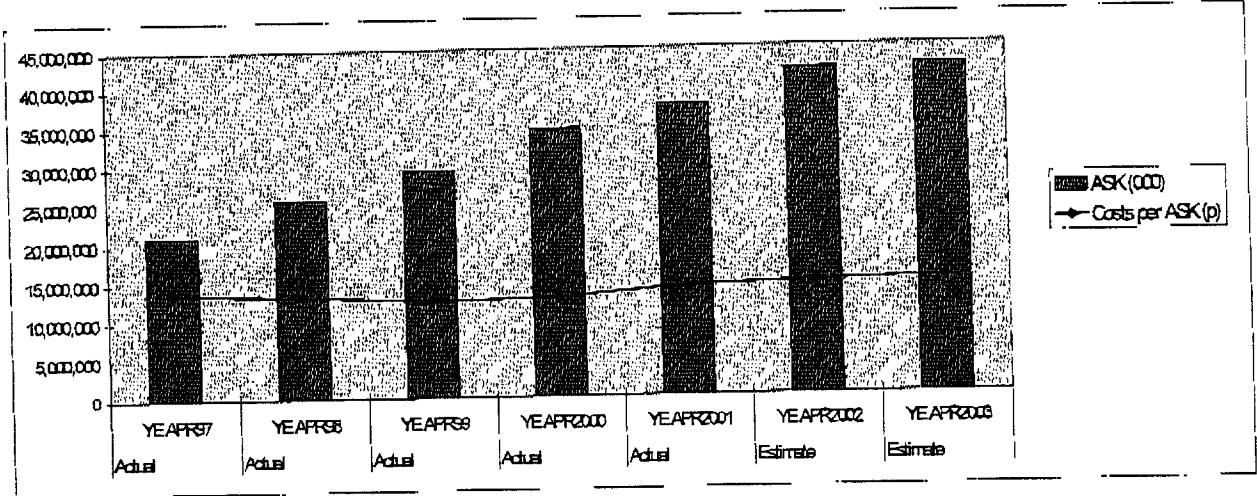
In making these (unrealistic) assumptions about Virgin Blue's behaviour with authorisation of the proposals, NECG has significantly under-estimated the dead-weight loss, or, conversely, over-estimated the benefits associated with authorising the proposals.

No returns to scale

Studies have shown that there are approximately *constant returns to scale* in the provision of air transport services[4], and hence that there are no reductions in per unit costs associated with 'getting bigger'. Figure 1 below shows that this is certainly true for Virgin Atlantic: Virgin Atlantic's unit costs continue to be the same as they were in 1997, despite output (measured here as Available Seat Kilometres (ASKs)) increasing by more than 175% over this time.

[4] Caves, D. L Christensen and M Tretheway (1984). "Economies of Density Versus Economies of Scale: Why Trunk and Local Service Airline Costs Differ", *Rand Journal of Economics*, 15(4), Winter; 471-489.

Figure 1: No Returns to Scale



No reductions in overheads

According to their submissions, Qantas/Air New Zealand will retain both Qantas and Air New Zealand's current management. There will therefore be no reduction in overhead costs. Indeed, these costs will increase, as Qantas/Air New Zealand will create a "Strategic Alliance Advisory Group":

> "Air NZ's management of the JAO Networks will be supported by a Strategic Alliance Advisory Group that comprises three representatives appointed by each airline."[5]

It is therefore difficult to see how NECG conclude that cost-savings to Qantas/Air New Zealand will be almost A$400 million in net present value terms over five years.

[5] Air New Zealand Limited and Qantas Airways Limited, *Submission to the Australian Competition and Consumer Commission in Support of the Application for Authorisation*, 9 December 2002, page 3.

Reduced competitive pressures

It is also difficult to see how the two proposals will lead to the other benefits claimed by the applicants. The proposals will allow Qantas and Air New Zealand to act jointly across their route networks. They will cease to compete with each other, as confirmed in their submissions:

> "All Air NZ flights will be part of the [Joint Airline Operation (JAO)] Networks, together with all Qantas flights into, within and departing from New Zealand. There are also extensive reciprocal rights for codesharing on each others' services...
>
> In respect of the JAO Networks, the Parties will co-ordinate pricing, capacity and all other aspects of the normal business operations of an airline. The two airlines also agree, as part of the Alliance, that where it is effective and efficient for them to do so they will co-ordinate on their non-JAO networks."[6]

As stated above, whether or not this reduction in competition will be offset to any extent by entry by Virgin Blue will depend on the timing and scale of Virgin Blue's entry, which in turn will depend crucially on the terms and conditions attached to authorisation of the proposals by the ACCC.

The reduction in competition will provide little incentive on Qantas/Air New Zealand to provide output levels, prices and levels of service quality similar to those which are produced in competitive markets.

[6] Ibid.

Given the decrease in output, increase in prices and reduction in service quality that will occur as a result of the reduction in competition, it is difficult to see how tourism to Australia will increase, as claimed by the applicants. Similarly, it is difficult to see how freight operations will be improved given that 85%-90% of freight is carried on passenger services.

It is also difficult to see how the de-facto merger will lead to "scheduling benefits" or the provision of new direct services, as claimed. Qantas and Air New Zealand can already easily improve their schedules and provide new direct services, given the slots that became available at most Australian airports at most times of the day after the collapse of Ansett and their existing slot portfolios (which they retain in perpetuity given the priority afforded historical users of slots in the slot allocation process). Furthermore, NECG appear to have compared schedules which they state would occur with authorisation of the proposals to *current* schedules, rather than to schedules that would occur without authorisation of the proposals. If, instead, the latter is used as the basis for comparison, authorisation of the proposals could lead to negative scheduling benefits (i.e. scheduling costs), given that competition will reduce.

The applicants claim that a number of benefits will arise from their proposals in addition to those whose value has been quantified by NECG, including "increased international competitiveness of Qantas and Air NZ", "preservation of a commercially viable full service Australasian airline and network", and "furtherance of the national interest".

Virgin Atlantic cannot think of a single example where protecting a firm (i.e. "picking winners") has enhanced that firm's competitiveness. Firms facing effective competition in the markets in which they operate, on the other hand, are continually forced to minimise their costs. Indeed, it would seem to Virgin Atlantic that the best way to ensure that Qantas' and Air New Zealand's competitiveness improves is to continue to subject them to the discipline of competition, including from each other.

Qantas is in a strong financial position. Virgin Blue has stated that it will enter New Zealand domestic markets and trans-Tasman markets (although the timing and scale of its entry will depend crucially on the terms and conditions attached to approval of the proposals by the ACCC). It is therefore difficult to see how not approving the proposals will mean that there will no longer be a commercially viable full service Australasian airline and network.

Virgin Atlantic fails to see how it can be in "the national interest" to allow two overwhelmingly dominant airlines to effectively merge, given that there will be few, if any, resulting benefits. Moreover, there are substantial costs associated with the proposals. These are discussed further below.