



11 January 2005

Mr Scott Gregson  
General Manager, Adjudication  
Australian Competition and Consumer Commission  
PO Box 1199  
Dickson ACT 2602  
AUSTRALIA

Direct Line: +44 1293 747 064  
Fax: +44 1293 747 073

Dear Mr Gregson

### Qantas/ British Airways Restated Joint Services Agreement

I am writing to express Virgin Atlantic's annoyance at Qantas and British Airways' behaviour with regards to submitting final comments to the Commission on this matter.

Despite stating at the Pre-Determination Conference of 1 November that they had few additional comments to make, the Qantas/ BA submission of 12 November is 22 pages long, and contains many new points.

Virgin Atlantic does not wish to delay further a final decision on this matter: Qantas and BA's current agreement has already been extended from three years to four-and-a-half years (via conferral of "interim authorisation") partly as a result of the late submission for further approval. Nevertheless we feel it is only fair that we are given the opportunity to respond to Qantas and BA's submission, and in particular the new points contained therein.

Virgin Atlantic has therefore prepared a short response, which is attached to this letter. The section headings correspond to those in Qantas and BA's submission. For the avoidance of doubt, the fact that a particular point raised by Qantas and BA may not be addressed specifically should in no way be construed as an admission on Virgin Atlantic's part. Rather, we believe that we have dealt with these points in previous submissions (and that they do not improve with repetition).

Yours sincerely

A handwritten signature in dark ink, appearing to read "Barry Humphreys".

BARRY HUMPHREYS

Director, External Affairs and Route Development



Response to

Qantas/ British Airways Submission dated 12 November 2004

### Introduction

In the introduction to their submission dated 12 November, Qantas and BA make a number of assertions about outcomes in the markets impacted by their Restated Joint Services Agreement (JSA) and benefits to the Australian public resulting from the JSA.

With regards to the former, Qantas and BA are selective in the outcomes they report. As stated in Virgin Atlantic's submission dated 18 November, despite the liberalisation of routes between Australia and the UK, allowing some entry and expansion by airlines based at mid-points, Qantas and BA still have some 60% of the Australia-UK business market (almost 70% of the Australia-originating business market) and the lion's share of the Australia-UK leisure market.

Moreover, the Commission's own analysis shows that the JSA has had, and will continue to have, severe adverse effects on both business and leisure markets, particularly between Australia and the UK.

In the case of business markets, the Commission's analysis demonstrates:

(a) a reduction in service quality and output, including evidence that:

- Qantas has delayed its introduction of Business Class sleeper seats
- Qantas has reduced services to Paris and Rome
- load factors to/from the UK are "very high" [9.41]

- passengers have been “spilled” due to high load factors [9.41]
- capacity growth to/from the UK will be significantly lower than market growth [9.38-9.41]
- passenger access to services to/from the UK will become increasingly difficult over the next five years, given the significant contribution in capacity terms Qantas and BA make to this route and the barriers to entry facing other airlines wanting to expand their services to/from Heathrow [9.43]

(b) a “cost-plus” approach to competition/ an increase in prices:

- Qantas has stated it intends to apply a 10% surcharge to fares to recoup its investment in new business class seats, an approach simply not possible in a truly competitive market
- Qantas claimed that the 10% surcharge was intended to account for the extra space that the new business class seats occupied (Virgin Atlantic’s new business class seats, and the sleeper seats they replaced, also necessitated a reduction in the number of seats provided, yet Virgin Atlantic was not able to increase its fares)
- premium cabin fares have risen substantially under the JSA [11.30]
- fares for many business travellers are likely to increase under the JSA [11.30]

(c) increasing barriers to entry and expansion for other airlines:

- the JSA has coincided with the withdrawal of several European carriers from the Australian market
- the JSA has contributed significantly to the delay in Virgin Atlantic entering the Australia-UK markets

In the case of leisure markets, the Commission's analysis demonstrates:

- higher yielding passengers such as business passengers contribute disproportionately to the overall revenue of the carrier [10.76]
- airlines' supply of services (to both high yielding and economy passengers) is correlated closely to demand from high yielding passengers rather than economy passengers [9.44], and hence outcomes in business markets will affect outcomes in leisure markets
- Qantas has reduced services to Paris and Rome
- load factors to/from the UK are "very high" [9.41]
- passengers have been "spilled" due to high load factors [9.41]
- capacity growth to/from the UK will be significantly lower than market growth [9.38-9.41]
- the JSA will lead to constraints in the supply of economy capacity between Australia and the UK [9.43]
- passenger access will become increasingly difficult over the next five years, given the significant contribution in capacity terms that Qantas and BA make to this route and the barriers to entry facing other airlines wanting to expand their services to/from Heathrow [9.43]
- fares will not reduce under the JSA in the short to medium term [11.32]
- the JSA has coincided with the withdrawal of several European carriers from the Australian market
- the JSA has contributed significantly to the delay in Virgin Atlantic entering the Australia-UK markets
- the above have occurred/ will occur even though some entry has occurred

The adverse effects on leisure markets flow directly from the anti-competitive effects of the JSA on business markets identified above.

With regards to Qantas and BA's assertions about benefits to the Australian public resulting from the JSA, they are just that - assertions. The Commission rejects most of Qantas and BA's public benefit arguments, accepting only claims in relation to some cost reduction and enhanced service provision. Even in this regard, the Commission does not appear to be convinced that there is likely to be a major enhancement in service provision or cost reduction compared to the position without the JSA.

Furthermore, the Commission does not actually appear to have satisfied itself that there are any cost savings. Rather, it states:

“... it would be surprising if two substantial businesses such as Qantas and BA were not able to achieve substantial cost savings through a joint rationalisation of aircraft operations and support services. No material presented to the Commission provides a basis for the Commission to resile from that position” [11.13]

In short, it would appear that the Commission presumptively concludes that there are such savings, without being satisfied on the evidence. This is clearly an impermissible basis on which to grant authorisation.

The only analysis of the evidence of cost savings [11.14] makes it clear that the Commission has rejected the attribution of cost savings to the JSA.

The Commission also rejects Qantas and BA's claimed commercial rationale for the JSA. The Commission:

- (a) does not accept that Qantas and BA are actually materially disadvantaged in relation to mid point carriers and identifies a number of substantial cost and logistical advantages available to Qantas and BA [9.92 and following]
- (b) does not accept that the JSA has actually resulted in a reduction in fares [11.24-32 and 11.106] or increase in capacity compared to what would otherwise be expected [11.107]

(c) identifies a number of reasons as to why there is unlikely to be a material reduction in services by Qantas and BA compared to the position under the JSA [9.106 and following]

Indeed, given the Commission's findings that the JSA has had, and will continue to have, severe adverse effects on both business and leisure markets, particularly between Australia and the UK, and the Commission's rejection of most of Qantas and BA's public benefit arguments and their claimed commercial rationale for the JSA, it is difficult to see how the Commission could approve the JSA, save in the case it were to apply the sorts of remedies set out in Virgin Atlantic's previous submissions.

#### Market definition

In this section, Qantas and BA make a number of statements about the relevant markets for the purposes of the JSA, some of which are new and some of which are pure repetition of statements made in previous submissions which were rejected by the Commission in its Draft Decision.

Virgin Atlantic therefore wishes to make just two comments in relation to this section. First, since the Commission issued its Draft Decision, the UK CAA (Economic Regulation Group) has issued its decision on which UK airlines should be granted the additional frequencies between the UK and India now available as a result of the recent substantial liberalisation of the UK-India Air Services Agreement (this decision is currently under appeal to the UK Secretary of State for Transport). In this decision, the CAA, following Office of Fair Trading guidance<sup>1</sup>, finds that time-sensitive and non-time-sensitive passengers are distinct, and adopts a narrower definition of the relevant geographic markets than the Commission, stating that the relevant geographic markets are city-pair markets for both types of passenger:

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<sup>1</sup> Office of Fair Trading, *Competition Act Guidelines: Market Definition*, OFT 403.

“In the Authority’s view, the relevant market in the case of London-Delhi and London-Mumbai should be defined as that for direct, non-stop air services between these city-pairs and that time sensitive passengers ( ) are separate to non-time sensitive passengers”<sup>2</sup>

Second, Qantas and BA assert that the fact that business and leisure passengers are linked on the supply-side means that they are part of the same market.

This ignores demand-side characteristics, which, as the Commission states in its Draft Decision<sup>3</sup>, the Courts have established must also be taken into account in determining the relevant markets. On the demand-side, it is clear from passenger purchasing behaviour that many passengers do not view products designed primarily for leisure travellers as effective substitutes for those designed primarily for business travellers, as they continue to buy the latter even given a substantial difference in price. This is presumably because products designed primarily for leisure travellers do not offer the required degree of flexibility and comfort. Similarly, many passengers do not view the two types of products as effective substitutes, as they continue to purchase products designed primarily for leisure travellers even given a substantial rise in their price. This is presumably because products designed primarily for business travellers are too expensive (or rather the price of such products is above their “willingness to pay”).

As passengers do not view the two types of products as close substitutes, they cannot be part of the same market.

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<sup>2</sup> CAA, *Decision of the Authority on its proposal to vary licence S/9 held by British Airways Plc, licence S/13 held by British Midland Airways Limited and licence S/33 held by Virgin Atlantic Airways Limited heard on 11 and 12 November 2004*, Decisions on Air Transport Licences and Route Licences 1/04.

<sup>3</sup> At paragraph 8.3.

## Cost of capital

In this section, Qantas and BA state that the Commission is wrong to focus on Qantas' annual reports as an indicator of Qantas' financial performance given the cyclical nature of the aviation industry, the industry's susceptibility to major exogenous shocks, and so on.

Virgin Atlantic notes that the last time Qantas made statements such as these about its financial performance, they were taken back quickly, according to *The Australian Financial Review*:

"Qantas chairman Margaret Jackson took aback those present at yesterday's results briefing at the ASX auditorium in Sydney when she rose from the back of the room to clarify comments she had made earlier in the day.

In the morning press conference, she had suggested the outlook was challenged for the airline, resulting in some early pressure on the share price. By the time the lunchtime results briefing rolled around, she was keen to ensure her earlier comments were not misunderstood by the analyst community.

She admitted to the audience of 100 or so analysts and fund managers that the comments were designed to spook the politicians as they tackled a myriad of airline issues and, in fact, the outlook for the airline was very good" (20 August 2004).



## Counterfactual

In this section, Qantas and BA state that:

“Without the ability to co-ordinate price and schedules under the JSA, the range of destinations and schedule flexibility ... offered by British Airways and Qantas would be more limited, despite strong demand on the Kangaroo Route.”

They also state:

“The particular economics of end point carriers on the Kangaroo Route mean that without the JSA it would be much more difficult to economically service the current number of destinations and frequencies presently offered to the public. Even if strong demand persisted on the route, the increased cost of having to service all of the current JSA destinations would not be recoverable by either carrier under the counterfactual, where each would be operating alone.”

Qantas and BA’s actions are not consistent with their words. Over the period the current JSA has been in effect, Qantas and BA have not jointly commenced operations in a single new market between Australia and London. Indeed, one of the first things that happened after the current JSA was authorised in 2000 was that British Airways stopped providing services between Perth and London in July 2000 and between Brisbane and London in November 2000. Qantas has, however, (unilaterally) commenced services to London via Hong Kong from Perth and Brisbane, a development hardly consistent with the argument that the JSA is vital for the maintenance of Qantas and BA’s current routes, let alone the introduction of new ones.

## Detriment

In this section, Qantas and BA list four reasons why, in their view, the market for business travel between Australia and the UK is highly competitive.

The first of these reasons is the fact that Qantas and BA's market share has been declining over the life of the JSA. Were this to be a relevant test for establishing whether or not there is effective competition in a market, then, following Qantas and BA's argument to its logical conclusion, markets in which a firm's market share had fallen from 100% to 95% would be deemed to be highly competitive. Clearly the (joint) market share of Qantas and BA as well as the market shares of their next largest competitors are important, as well as whether or not barriers to entry exist which will allow them to maintain this position over time.

The second of the reasons given is that there are:

“a range of alternative service providers all of whom compete vigorously with each other for all passengers, particularly with respect to product offering and service levels”

As stated in the Introduction above, despite the existence of such service providers, the data shows that Qantas and BA still have some 60% of the Australia-UK business market (almost 70% of the Australia-originating business market) and the lion's share of the Australia-UK leisure market. That is, the existence of *competitors* is not sufficient to ensure *effective competition*.

The third reason given is that certain business travellers are relatively price-sensitive, and hence:

“... if British Airways and Qantas were to attempt to raise prices for business passengers above competitive levels, it is likely that a proportion of “marginal” business passengers would switch to an alternative airline providing a comparable product offering at a better price...”

Yet the Commission found in its Draft Decision that premium cabin fares have risen substantially under the JSA [11.30]. Clearly in practice other airlines have not been an effective constraint on the pricing behaviour of Qantas and BA.

Qantas and BA go on to state that

“In the case of JSA routes, there is overwhelming evidence that barriers to entry and expansion are low to non-existent”

but fail to point to any such evidence.

Virgin Atlantic submits that the fact that Qantas and BA still have some 60% of the Australia-UK business market (almost 70% of the Australia-originating business market) and the lion’s share of the Australia-UK leisure market despite liberalisation of these markets is evidence of the substantial barriers to entry and expansion that exist to and within these markets. The Commission’s *Merger Guidelines* would appear to support this view:

“... where market structure has been highly concentrated and market shares have been stable for a long period, this will tend to suggest that there are barriers to the entry of new market participants which might otherwise undermine and constrain the exercise of market power.”

The fourth reason given is that there has been entry onto, and expansion on, JSA routes.

Once again, as stated in the Introduction, despite the existence of such service providers, the data shows that Qantas and BA still have some 60% of the Australia-UK business market (almost 70% of the Australia-originating business market) and the lion's share of the Australia-UK leisure market. That is, the existence of *competitors* has not been sufficient to ensure *effective competition*.

Virgin Atlantic confesses to being somewhat confused as to how the arguments advanced on page 10 support Qantas and BA's case. With regards to the statements about Virgin Atlantic, Qantas and BA appear, on the one hand, to be saying that Virgin Atlantic will be a formidable competitor, given the fact that we have been "successfully competing for 20 years out of London". On the other hand, the article from *The Sunday Times* of 26 September included in Annexure A appears to be saying that Virgin Atlantic's offerings in the Sydney-London market are not very competitive, and hence that our entry into this market will have little or no effect on outcomes in this market.

With regards to the statements about Emirates, Qantas and BA point out that, despite operating to Australia for over eight years, Emirates now accounts for just 5% of traffic between Australia and Europe. Simple extrapolation of Emirates' current share of traffic based on 34 services per week (or just under five services per day) to the 49 services per week (or seven services per day) Qantas and BA state Emirates will operate by October 2005, suggests that Emirates will account for just over 7% of total traffic between Australia and Europe by the end of this year, or approximately one-tenth of Qantas and BA's share of business passengers. Emirates' share of the business market is likely to be substantially less than 7%.

Similarly, the data in Qantas and BA's Annexure B shows that (assuming this data is accurate), even if we look at the number of passengers travelling on unrestricted and restricted tickets, Qantas and BA enjoyed by far the largest share of passengers travelling on each of these ticket types on both the Sydney-London route and the Melbourne-London route in Summer 2003 and Winter 2003. For example, Qantas and BA carried 60% of passengers travelling on unrestricted tickets and 42% of passengers travelling on restricted tickets between Sydney and London in Summer 2003; the next largest carrier of passengers carried just 11% of passengers travelling on unrestricted tickets and 14% of passengers travelling on restricted tickets, or less than one-fifth and one-third respectively of the number carried by Qantas and BA. Similarly, Qantas and BA carried 56% of passengers travelling on unrestricted tickets and 45% of passengers travelling on restricted tickets between Melbourne and London in Summer 2003; the next largest carrier of passengers carried just 13% of passengers travelling on unrestricted tickets and 19% passengers travelling on restricted tickets, or less than one-quarter and just over two-fifths respectively of the number carried by Qantas and BA.

Qantas and BA then show, courtesy of their evidence on airlines' slot acquisitions contained in their Annexure C, just how high the barriers to entry to and expansion within Australia-London markets truly are. They show that, even if slots acquired at Gatwick Airport (where slots are still available at some times of the day) are considered together with slots acquired at Heathrow, *even over an eleven year period*, the airlines listed have made only very limited progress in acquiring slots at the two airports.

For example, Qantas and BA show that over an eleven year period, Virgin Atlantic has increased its slot holdings from a number which would allow five services per day to that which would allow just over twenty services per day (to any destination world-wide). They also show that Virgin Atlantic added one daily service to the US in Spring 2004. Qantas and BA show that it has taken Emirates eleven years to acquire sufficient slots to operate four daily services from Heathrow to the United Arab Emirates, and that Etihad

operates just over one service per day from Heathrow to the UAE. They also show that it has taken Gulf Air eleven years to increase the services they provide from Heathrow per day by one.

Table 1 below, taken from the March 2004 report of Airport Coordination Limited, shows the thirteen *largest* holders of slots at Heathrow at the beginning of the (Northern Hemisphere) Summer 2004 Season. It shows that, even despite the gains over the last eleven years discussed above, these airlines still each have at most less than one-thirteenth of the slots held at Heathrow by Qantas and BA.

**Table 1: Slot holdings at Heathrow, Summer 2004**

<b>Airline</b>	<b>Share (%)</b>
British Airways	40.0
bmi	11.8
Lufthansa	4.4
Aer Lingus	3.2
Virgin Atlantic	3.0
SAS	3.0
American Airlines	2.4
Iberia	2.2
Air Canada	2.1
KLM	2.0
Alitalia	1.9
Air France	1.9
United Airlines	1.8

The fact that Heathrow is severely capacity constrained at almost all times of the day and the fact that the EU Regulation governing the allocation of slots at EU airports affords historical users of slots priority in the allocation process mean that in practice few, if any, commercially valuable slots become available via the slot pool each Season. Increases in capacity are rare and tend to be at non-commercially viable times of day. This means that even those airlines which qualify as “new entrants” for the purposes of the EU Regulation are usually not able to obtain anything of commercial value from the slot pool.

Qantas and BA state that slots are also available at Heathrow via trading, and state:

“From British Airways’ experiences, slot trading at London Heathrow has increased in recent years...”

In fact, any recent increase in slot trading activity has been caused by the fall-out of the events of 11 September 2001. During the immediate period following, the “use-it-or-lose-it” rule (requiring airlines to use slots 80% of the time) was suspended, so airlines unable to use slots fully had no need to sell them. When this rule was re-introduced there was a backlog, so it *appears* that there has been an increase in trading.

With regards to the potential for “Mixed Mode” operations at Heathrow, we respectfully draw the Commission’s attention once again to recent statements of BAA plc, the owner and operator of Heathrow (and Gatwick and Stansted) reported in *The Times* of 3 June 2004:

“BAA, which owns Heathrow, said it did not expect mixed mode to be introduced before terminal five opened in 2008”

#### Premium cabins and dynamic efficiency

In this section, Qantas and BA state that they compete on price as well as quality of service in premium cabins, and that it is perfectly reasonable of Qantas to charge more for a better product, such as its new flat beds in its business class cabin.

Virgin Atlantic wishes to re-iterate that it did not increase its published fares on a single route when it introduced its new flat bed. This is despite the fact that our flat bed is widely recognised as being a significant improvement over other premium product offerings in the market. The fact that Qantas has been able to sustain a fare increase with the introduction of its new product is clear evidence of Qantas' market power.

We would also once again respectfully draw the Commission's attention to its finding in its Draft Decision that premium cabin fares have risen substantially under the JSA [11.30]. That is, premium cabin fares rose when there was little, if any, change in Qantas' product offering or, to uses Qantas' words, Qantas was "getting more for the same product".

#### National interest

In this section, Qantas and BA argue that there is a public benefit associated with having a strong, viable international airline, and that the JSA has been an important determinant of Qantas' international competitiveness and the viability of its services on key routes.

History shows that the best way any country can ensure that its nationals are strong, viable and internationally competitive is not through promoting "national champions" or "picking winners", but rather by subjecting them to (fair) competition. John Kay puts it this way in the *Financial Times* of 11 January:

"... no industrial policy has been more comprehensively discredited than the notion that the best way to achieve competitiveness abroad is to suppress it at home ... it is competition, not size, that promotes enterprise."<sup>4</sup>

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<sup>4</sup> "Europe must not create national champions", *Financial Times*, 11 January 2005.



Virgin Atlantic would also once again respectfully draw the Commission's attention to the fact that over the period the current JSA has been in effect, Qantas and BA have not jointly commenced operations in a single new market between Australia and London, but rather *reduced* services.

Promoting consumers' interests is also in the national interest. The best way that this can be done is by promoting fair competition. As BA said in its submission to the Canadian authorities in connection with Air Canada's acquisition of Canadian Airlines:

"Competition is always the best solution to ensure consumers receive competitive prices, good service and product choices"<sup>5</sup>

#### Total surplus test

In this section, Qantas and BA argue that "producer" benefits should be accorded a weight no lower than that afforded "consumer" benefits in any assessment of the benefits resulting from applications such as theirs.

Were this to be the case, or equivalently were the size of "total surplus" something on which authorisation turned, then, following Qantas and BA's argument to its logical conclusion, an application from all firms in a market to collude with one another should be authorised, as such behaviour would maximise producer surplus. This is surely not the aim of Australian competition policy.

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<sup>5</sup> British Airways, *Competition in the Canadian Airline Industry: Bill C-26*, Summer 2000.

## Term

In this section, Qantas and BA state that five years is too-short-a-time to grant authorisation given the need in the airline industry for relatively long-term investment planning.

Virgin Atlantic notes that neither the current JSA's authorisation for three years nor its predecessor's authorisation for five years appears to have affected either Qantas or BA's ability to engage in long-term investment planning. Indeed, neither Qantas nor BA has submitted any evidence that Virgin Atlantic is aware of showing that their ability to engage in such behaviour has been affected adversely by the length of time for which the Commission has granted authorisation.

With regards to the considerable time period and transaction costs associated with preparing for, and completing, the authorisation process, Virgin Atlantic has also borne transaction costs (yet supports a shorter authorisation period), and of course Qantas and BA have benefited from an extension of their current JSA for the entire period that their proposed agreement has been under consideration.

11 January 2005