

RECORD OF MEETING BETWEEN

ACCC and Virgin Blue

25 May 2006, 12pm

Participants:

ACCC	Scott Gregson, General Manager, Adjudication Isabelle Arnaud, Director, Adjudication Carl Toohey, Assistant Director, Adjudication Gina D'Ettorre, Adjudication
Virgin Blue	Leigh Balderson, Senior Legal Counsel Karam Chand, Head of Commercial – International

Scott Gregson explained the authorisation process, the Public Register and the expected timetable. SG provided a summary of the current Qantas and Air New Zealand application and advised the ACCC is seeking factual information about the trans-Tasman market and Virgin Blue's operation and experience in that market.

CURRENT OPERATIONS

Schedule

Virgin Blue (VB) currently has 4 Boeing 737-800 aircraft in its international fleet which service all of its Pacific and trans-Tasman destinations. Around 47 per cent (measured in ASK terms) of its international flights are 'trans-Tasman'.

VB provided the ACCC with a copy of its latest schedule for the period 19 June 2006 onwards.

In this latest timetable, VB has increased capacity on some routes (i.e. Brisbane-Christchurch and Brisbane-Auckland) and decreased capacity on others (i.e. Melbourne-Christchurch and Sydney-Christchurch). Overall capacity has remained fairly consistent. VB indicated that these latest changes are a result of rescheduling, and not the addition/withdrawal of any aircraft from its international fleet. VB indicated that its trans-Tasman schedule represents 2.8% of the airline's weekly flights.

VB noted that the trans-Tasman routes it is currently operating are primarily leisure driven such as Brisbane-NZ routes, and routes into Christchurch.

Apart from the Brisbane – Christchurch route, VB's schedule is sub-optimal from a market need point of view, ie VB does not have enough frequency to service the routes adequately.

The ACCC noted VB's current share of trans-Tasman passengers is significantly less than what its share of Australian domestic passengers was after the same period of operation.

VB indicated that the situation it encountered in the Australian domestic market was unique following the collapse of Ansett and is very different to that which it faces on the trans-Tasman.

VB also noted that passengers behave differently with trans-Tasman services compared to Australian domestic services – despite the fact that flight times are often not that much different. Trans-Tasman routes are still 'international' flights with passports and more planning required. People do not treat it like a domestic market. The market cannot be stimulated the same way as the Australian domestic market, as people do not just hop on a plane at the last minute for a weekend away. This, and the fact that NZ has a small population base, also prevents the growth rate VB has experienced in the Australian domestic market. VB considers that its growth rate on the trans-Tasman will never be of the same magnitude as it has been in Australia.

Load factors

[Excluded from Public Register] VB's trans-Tasman load factors are better than some of its competitors, and better than the load factors for its other Pacific routes.

Capacity shares

VB commented that when a fifth freedom carrier (FFC) operates on the trans-Tasman, not all the carrier's seats are made available for sale in that market, as the carrier will have a proportion of through passengers. Seats for those long-haul passengers are booked well in advance.

VB considered that the capacity shares provided by the Applicants in Table 1 for Emirates may be misleading because they do not factor in that many of Emirates trans-Tasman flights contain through-passengers from Dubai. Accordingly, in Virgin Blue's view the Emirates capacity shares as presented in Table 1 of the Applicants submission are overstated. VB considered that Emirates would have about 12 to 15 % of the capacity on the Sydney-Christchurch route and about 18 to 20% of the capacity on the Brisbane-Auckland route.

[Excluded from Public Register]

Entry/Exit from routes

VB indicated it exited the Sydney-Wellington and the Gold Coast-Christchurch routes because the loads did not improve/increase and therefore was not profitable. VB operated the Sydney –Wellington route from 10 April 2004 to 12 May 2005. As a low cost carrier (LCC) VB grew the traffic on this route. VB commented that since its exit from the route, the additional traffic has disappeared.

VB commented that the Sydney–Wellington route was more a business/government route. To be competitive, an airline needs the right schedule and frequency. With one

flight a day, an airline would not be suited for business travellers. A minimum of 4, ideally 6 sectors a day is required. VB had one return flight per day prior to withdrawing from the route.

VB replaced the Sydney-Wellington route with the Wellington-Brisbane route. VB saw good potential on this route and considered this a more attractive proposition for its business model as it is largely a leisure route. Not being a business route, scheduling and frequency would be less of an issue.

VB has not entered other trans-Tasman routes because Qantas and Air NZ have a stranglehold on those routes and therefore the routes would not be profitable. VB noted that when it and other airlines have announced they would enter a route, Qantas and more so Air NZ have increased capacity on that route. If VB were to announce its entry into other routes, there is a real threat of a capacity response (i.e. increase) from Qantas and Air NZ, and that VB may have to pull out from the new route. VB noted that by operating more flights with a greater schedule spread, it perceived that Qantas and Air NZ have been able to target VB's flights, by releasing additional 'cheap' seats which are close in time to a VB flight. As a general observation, VB noted that since it entered the trans-Tasman market, the Applicants had increased capacity and on some markets even doubled capacity.

New Zealand domestic market

The ACCC queried why VB had not entered the NZ domestic market. VB noted that capacity is ahead of demand in this market and that pricing is low. VB also noted that Qantas and Air NZ have a 'stranglehold' on this market. [Excluded from Public Register] It would require a major increase in fleet size, and crew employment (i.e. extra pilots which are hard to find), which represent a serious investment. [Excluded from Public Register] This would represent a significant commitment, and therefore the profit case would have to be very strong. In addition, VB would face constraint at Auckland domestic airport. The airport could make room for VB but at a cost (which would be a cost that Qantas and Air NZ do not have to face). There is no alternative airport available. [Excluded from Public Register]

Profitability

VB indicated that when determining where to deploy its aircraft, it considers its network as a whole (i.e. domestic and international). With regard to profitability, VB considers its domestic and international operations separately. VB's international business is a 'stand alone' company, which must be profitable in its own right.

[Excluded from Public Register]

EXPANSION PLANS

Trans-Tasman

[Excluded from Public Register]

Barriers to entry/expansion

VB notes that when faced with competitor entry on a particular route, Qantas and (particularly) Air NZ's competitive strategy is to increase capacity in response. [Excluded from Public Register] VB also confirmed that because of the strategy of its competitors, there needs to be a 'very strong' profitability case for entering a certain route. [Excluded from Public Register]

Auckland Airport – In the past, VB investigated the possibility of gaining access to more facilities/slots at Auckland international airport. However, good time slots (in particular to service the Auckland-Sydney route at peak time) were not available. A bigger issue at Auckland airport, however, related to gates and the capacity to process passengers

Sydney Airport – VB indicated there are capacity issues at Sydney airport in relation to parking in the morning and gates at peak times.

Runway at Wellington – There are a number of constraints at Wellington airport, in particular the length of the runway which does not permit the long-haul aircraft used by FCCs to take-off.

VIEWS ON THE MARKET

VB commented that the trans-Tasman is not a homogeneous market - each route has different dynamics, different competition constraints and the business and leisure segments have very different dynamics.

Business/leisure passengers

VB indicated that the Brisbane-Christchurch route and all of the Gold Coast routes are more 'leisure' routes. The Brisbane-Wellington route is largely a leisure route. Similarly, the Brisbane-Auckland route has a higher proportion of leisure passengers. The other routes from Sydney and Melbourne to Wellington are mostly business/government. The Sydney-Auckland route is similar to Sydney-Melbourne in that it has a high volume of business traffic, though as the busiest trans-Tasman route, it also carries substantial amount of leisure traffic.

VB indicated that the key to attracting business passengers is operating the right schedule and frequency, but to do this on the trans-Tasman route would require VB to double or triple its fleet.

VB commented that business travellers prefer to travel with one airline, are willing to pay for the flexibility of changing flights easily. Having frequent flights is a necessity to attract business passengers. To compete effectively on the Auckland route (apart from Brisbane Auckland which is more of a leisure route), an airline needs at least 4-6 flights a day in order to be attractive to business travellers. Other routes need 2-3 flights a day to attract business travellers. The key impediment to VB's ability to compete for business travellers is its limited schedule.

VB noted that it has implemented strategies in the Australian domestic market to attempt to capture more business passengers. These include the “Blue Plus” fare, which offers flexibility, however it is rarely used. This has been introduced on trans-Tasman flights. Its frequent flyer program is open to Australian and New Zealand residents but is not Pacific Island residents as yet.

VB tries to keep its product the same on its entire network, both domestic and international. However, VB has not offered a lounge model internationally as its international routes are more leisure routes. In order to introduce additional products VB requires the models to operate profitably in their own right.

Pricing

VB indicated that ‘price’ is a function of capacity. Therefore, unless over-all capacity is reduced on trans-Tasman routes, prices will remain low.

VB noted that on many routes, its LCC business model allows it to price below Full Service Airlines (FSA) such as Air NZ and Qantas by 10-15 per cent. This pricing structure allows it to target the leisure market, and stimulate market growth. That said, VB considers that Air NZ is in fact the real day-to-day price leader in the trans-Tasman market (with the most air fare ‘sales’) as it has a continuing strategy of increasing capacity when faced with competition. Jetstar is following the NZ lead whilst Qantas is more the follower unless the sale is part of a global initiative. VB commented that it would have expected Air NZ to take the opportunity to reduce its capacity when the last alliance did not eventuate. Instead Air NZ opted to increase capacity on certain markets.

VB commented that its pricing strategy aims to grow the market, rather than simply capture existing market share. As an example, while on the Sydney-Wellington route, traffic growth was stimulated.

VB is of the view that it does not represent a pricing constraint on Qantas and Air NZ on the routes it does not serve. As evidence of this, VB observed that since its exit from the Sydney-Wellington route, the traffic growth it had stimulated has now disappeared. VB considers that with only an eight (8) percent share of the trans-Tasman passengers it could not effectively constrain the Applicants on the entire trans-Tasman market. VB considered it would need in the vicinity of 20 to 30 percent share of the market to effectively constrain the Applicants.

Jetstar

VB noted the entry of Jetstar is another change to the competitive landscape since 2004. It is VB’s view that Jetstar was deliberately deployed onto Christchurch, which is VB’s base in New Zealand. Qantas now has the ability to direct its own LCC against VB. **[Excluded from Public Register]**

VB pointed out that since Jetstar’s entry on the Australian domestic routes it has matched (or bettered) VB’s capacity on certain routes (i.e. Hobart-Adelaide, Sydney-Hervey Bay) that Qantas did not previously fly.

Fifth Freedom Carriers (FFCs)

VB commented that FFCs are really long-haul carriers and for this reason do not have a competitive schedule on the trans-Tasman.

VB considers that Emirates is a formidable competitor generally, being one of the leading airlines in the world. However on the trans-Tasman, Emirates only operates on certain routes, and in certain time slots. VB commented that it believed Emirates will never be able to compete with the Applicants on frequency, as it is constrained (as an FFC) by the scheduling windows for its long-haul flights. Despite its superior product, Emirates does not have the frequency to be attractive to a high proportion of business travellers. VB considered that even if Emirates does reach agreement with the Government to double its capacity to Australia, it is unlikely to put more than one extra flight per route on the trans-Tasman, and may not even have an incentive to do that.

THE APPLICATIONS

VB commented that Qantas and Air NZ are not only FSAs with high market share, but they also both now have their own LCCs. Qantas now has the ability to direct Jetstar against VB on the trans-Tasman. VB considers the TNA will create a very powerful force and will be a real threat to the viability of other airlines on the trans-Tasman and deter new entrants. VB is of the view the TNA is anti-competitive.

VB indicated the Applicants' joint scheduling of flights and pricing coordination will make it easier for them to target their competitors' flights. For instance, the Applicants together will have a far greater number of flights than VB and can release a lot of low fares on flights which are close to the times of VB's flights. The TNA will also enable the applicants to re-direct their capacity jointly onto specific routes where VB is currently operating or is planning to enter. VB considers that a key question for the ACCC to consider is where the Applicants plan to direct capacity as a result of the TNA.

VB noted that Qantas and Air NZ already have a significant share of business passengers. However, VB is concerned the TNA will result in the Applicants having an even superior schedule spread and greater frequency, and this will mean that VB and other airlines will lose the business passengers they had managed to capture on the trans-Tasman.

VB urged the ACCC to consider what would happen on the minor trans-Tasman routes where the Applicants currently do not face competition. VB notes these would become monopoly routes for the Applicants.

VB considers that with the TNA, there is a risk that some trans-Tasman routes will become marginal or unsustainable for VB. VB stated that if it could no longer make money on those routes, it would seriously consider pulling out of those routes, as it has done in the past.