APPLICANTS' FURTHER RESPONSE TO THIRD PARTY SUBMISSIONS – TASMAN NETWORKS AGREEMENT

21 August 2006

INTRODUCTION

1. On 4 July 2006 Qantas Airways Limited (**Qantas**) and Air New Zealand Limited (**Air NZ**) (together, the **Applicants**) filed a Response to Third Party Submissions, which responded to submissions to the Commission by third parties in relation to the Tasman Networks Agreement (or TNA) (the **Original Response**).

2. Since the Original Response was filed, additional submissions and records of meeting have been made available on the Commission's public register. Of these, the Applicants are providing a further comprehensive response in relation to the further submission of Wellington International Airport Limited (**WIAL**), which was filed with the Commission on or around 4 August 2006 and the record of the Commission's meeting with Virgin Blue on 25 May 2006, which was made available on 26 July 2006.

Further WIAL Submission

3. The first WIAL submission of 15 May 2006 was dealt with in the Applicants' Original Response. A further WIAL submission has now been filed with both the Commission and the New Zealand Ministry of Transport (**MOT**) and relevantly incorporates the following additional material:

   (a) A report prepared by LECG entitled "Benefits and costs to the public of proposed Air NZ and Qantas Code Share: Trans-Tasman services to Wellington" (July 2006) (Schedule 2); and

   (b) A summary of the empirical findings of Professor Tim Hazledine (Schedule 3).

4. Where the further WIAL submission raises new submissions or arguments, they are comprehensively addressed in **Annexure A** to this submission. The Applicants also rely upon the Original Response and these two documents should be read concurrently. The Applicants' response to the further WIAL submission also includes a document entitled "Comments of Dr Michael W. Tretheway", which responds to the LECG report (**Tretheway Response to LECG**). This document is attached as **Annexure B** to this submission.

Virgin Blue Record of Meeting

5. Many of the issues raised by the Virgin Blue record of meeting were canvassed at length in the Applicants' Original Response. However, certain comments and submissions made by Virgin Blue warrant further treatment and are addressed in greater detail below. These matters include:

   (a) The competitive constraint exercised by Virgin Blue on the Tasman;

(b) Barriers to entry or expansion;

(c) Emirates;

(d) The "time" component of the Commission's analysis; and

(e) Market definition.

COMPETITIVE CONSTRAINTS

6. In its record of meeting with the Commission on 25 May 2006, Virgin Blue makes the following points:

(a) Air NZ is the real "day to day" price leader in the Tasman market.

(b) Virgin Blue's capacity on the Tasman has remained fairly consistent in the recent past.

(c) Virgin Blue will only enter a route if it is profitable in its own right and that it has not entered more routes on the Tasman (or in domestic New Zealand) because Air NZ and Qantas have a stranglehold on certain routes and it would therefore not be profitable to enter.

(d) Qantas and particularly Air NZ move to increase capacity in response to the threat of competitors entering a particular Tasman route, which means a competitor needs a "very strong" profitability case to enter a new route.

(e) Virgin Blue does not represent a pricing constraint on Qantas and Air NZ on the routes it does not serve. Furthermore, Virgin Blue cannot effectively constrain the Applicants across the Tasman with its current passenger share of approximately 8%. It suggests around a share of 20 – 30% is required.

(f) There is a risk that some Virgin Blue routes will become marginal or unsustainable under the TNA.

(g) Virgin Blue does not compete with Qantas and Air NZ for business (or other time or service sensitive) passengers.

7. Taking these points collectively, it appears Virgin Blue's primary submission is that for a variety of reasons it is unlikely to act as a sufficient competitive constraint on the Applicants in a future with the TNA. Such a characterisation is inaccurate and instead, for reasons expanded upon below, the conclusion of the Australian Competition Tribunal (the **Tribunal**) in *Qantas Airways Limited* [2004] ACompT 9 (the **Qantas/Air NZ Decision**) is still directly applicable today:

"*..[Virgin Blue] acts as a pricing constraint on routes it currently serves as well as some routes which it does not currently serve. This is primarily because it poses a threat to other airlines that it will enter routes where fares are artificially high*".[1]

Virgin Blue Business Model

8. Based on the evidence before it in May 2004, the Tribunal concluded that:

"*Virgin Blue is an LCC* [low cost carrier] *which seeks to minimise costs by adopting efficient business strategies and cutting out extras, such as free meals. It passes on cost savings to passengers through low airfares. An important part of Virgin Blue's brand and business model is to be seen always to offer low fares. Accordingly, if demand is strong, Virgin Blue is likely to increase capacity by putting on additional services rather than increasing fare levels.*"[2]

9. Virgin Blue's current structure continues to incorporate all of the features of a low cost carrier (or LCC), despite the introduction of a range of innovations since the Qantas/Air NZ Decision designed primarily to appeal to business and corporate travellers. These features include:

(a) (**Aircraft**) Virgin Blue operates a single type of aircraft, with a fleet of Boeing 737 planes. In its half yearly results announcement in May 2006, Virgin Blue signalled that this was set to continue, with 4 new 737-800s to be added in 2006 and 9 737NGs ordered for 2008 – 2010.[3]

(b) (**Labour**) When it commenced operations in Australia Virgin Blue implemented flexible labour arrangements, which it works to maintain with its "people costs" down 2.8% in the six months to 31 March 2006, relative to the previous six months.[4]

(c) (**Route Expansion**) There remains significant emphasis on point-to-point routes that offer Virgin Blue the opportunity to both win market share from incumbent operators and grow demand through lower fares. This was apparently highlighted by Brett Godfrey in a recent address to the Asia Pacific Aviation Summit in Brisbane, where he was quoted as saying: "I'm interested in every single route that can make us some money."[5]

(d) (**Low Cost Operations**) Maintaining a low cost base that can drive affordable airfares continues to be a focus for Virgin Blue. Its "controllable" costs (i.e. excluding fuel) have continued to decline on a c/ASK basis, falling from

[1] Qantas/Air NZ Decision at para. 355.
[2] See **note 1** at para. 37.
[3] Virgin Blue "Half Year Results for the six months ended 31 March 2006" Presentation
[4] Virgin Blue "Half Year Results – May 2006, Supplementary Information", which also notes that "EBA negotiations progressing for Flight Crew and Cabin Crew"
[5] "No Virgin rush on US routes" The Australian 26.07.06 and "Virgin Blue again says that it is looking at domestic flights in NZ" NZPA Newswire 26.07.06

6.09c/ASK to 5.93c/ASK in the six months to 31 March 2006 relative to the same period the year before (falling 2.6%).[6]

(e) (**Pricing Structure**) Virgin Blue continues to emphasise that a key platform of its business model is the ability to offer everyday low airfares to consumers and grow the markets in which it operates. Indeed, even the record of meeting notes that Virgin Blue stated: "… its LCC business model allows it to price below Full Service Airlines (FSAs) 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. …. Virgin Blue commented that its pricing strategy aims to grow the market, rather than simply capture existing market share."[7]

10. These facts should be accorded significant weight by the Commission as it seeks to assess the nature and extent of the competitive constraint exercised by Virgin Blue on the Tasman. Such structural features are akin to the “hard evidence” the Commission calls for in its recently released paper entitled “Media Mergers” (August 2006). In that paper the Commission notes the following:

“… media mergers that do not substantially lessen competition on the basis of the best available current evidence should not be hindered due to speculation about either unproven future technological developments or changes to the media industry.”[8]

11. Though drafted in the context of merger assessment under section 50 of the Act, the Commission’s comments are nonetheless pertinent. Whilst observers can endlessly speculate as to Virgin Blue's likely future growth plans the matters outlined in paragraph 9 represent the “best available current evidence” on Virgin Blue, particularly given present uncertainties about its future ownership structure and long-term strategy.

12. Upon these facts, there is little substantive difference between Virgin Blue today and the airline the Tribunal described as follows:

"*Virgin Blue's practice is to enter markets as a price-leader and to maintain its low fare position. It is becoming increasingly attractive to the corporate sector. Virgin Blue's entry and the prospect of entry onto further routes has therefore resulted in a reduction of fares across all trans-Tasman sectors*."[9]

13. Indeed, the innovations being introduced by Virgin Blue (some of which are currently only available on its Australian domestic network)[10] all serve to increase the breadth of Virgin Blue's appeal to passengers across its network, particularly corporate or business travellers. These innovations contradict Virgin Blue's assertion that it does not compete with the Applicants for business (or time and service sensitive) passengers. They were highlighted in the Applicants' original submission of 13 April 2006, but also include several new initiatives:

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6 See **note 3** –Virgin Blue’s costs (inclusive of fuel) rose from 7.72c/ASK to 7.96c/ASK over the same period
7 ACCC "Record of Meeting between ACCC and Virgin Blue, 25 May 2006" at p.3
8 ACCC, “Media Mergers” August 2006 at pp. 4,11 & 27
9 See **note 1** at para. 340
10 There is no obvious reason why Virgin Blue would not extend any of the services that are currently only available on its domestic Australian network to its Tasman services.

(a) A commitment to a faster check-in process with the roll-out of Blue-Check self check-in kiosks in airports across Australia and the introduction of "Web Check-in Facilities" from 1 October 2005.

(b) The introduction of the "Velocity" loyalty program in November 2005.

(c) The re-launch of the Virgin Blue lounges in Sydney, Melbourne, Brisbane and Adelaide (called "The Lounges") in May 2006 as upgraded, all-inclusive facilities offering complimentary food and beverages, a redesigned environment as well as enhanced business facilities.

(d) The overhaul of Virgin Blue's business friendly Blue Plus fare to offer a number of new benefits in August 2006. This enhanced "Corporate Plus" fare comes with benefits including priority check-in and a higher baggage allowance. This fare is also available on the Tasman and has been introduced since the Virgin Blue meeting with the Commission in May 2006.

(e) Virgin Blue's intensive advertising campaign ("Don't follow suit"), which is aimed at business travellers and has featured on television, billboards and in print media on both sides of the Tasman since its launch on 30 July 2006 (see: http://www.virginblue.com.au/business/).

14. There is a clear contradiction between Virgin Blue's statement to the Commission that it does not compete for business passengers and its actual conduct in the market. The Applicants strongly submit that the Commission should prefer evidence of Virgin Blue's actual behaviour above contradictory statements made by or on behalf of Virgin Blue.

Virgin Blue Schedule & Capacity Expansion

15. Virgin Blue's record of meeting with the ACCC indicates that it is unlikely to change its capacity allocation on the Tasman in the short term (i.e. for the next scheduling period). It notes that "… its growth rate on the trans-Tasman will never be of the same magnitude as it has been in Australia."[11] Furthermore, Virgin Blue considers its schedule is generally "sub-optimal" from a market need point of view and its current Tasman passenger share is insufficient to meaningfully constrain the Applicants.

16. The Applicants do not believe these points support a conclusion that the competitive constraint exercised by Virgin Blue has been dampened in any way.

17. Though a more limited schedule may potentially reduce the appeal of Virgin Blue for business travellers, it is generally acknowledged that leisure travellers (who make up the vast majority of travellers on the current Virgin Blue Tasman network, as well as on the Tasman overall) are likely to place less emphasis on frequency and more on price.[12]

[11] See **note 7** at p. 2

[12] See Record of Meeting between the ACCC and the Australian Consumers Association (ACA) by way of example – "… the lowest possible fare was the highest priority for a consumer. The ACA commented the 'ordinary' traveller is prepared to put up with a lot to ensure the lowest possible fare."

18. A more subdued speed of expansion by Virgin Blue is likewise simply indicative of the degree of surplus capacity and competition currently on the Tasman, relative to an Australian market where Virgin Blue was able to reap the benefit of Ansett's untimely collapse and the resultant vacuum in airline capacity. These market features are not new or unusual and were explicitly noted by the Tribunal:[13]

"*We accept that the trans-Tasman market has generally been more competitive than the Australian domestic market in which Virgin Blue has been a successful competitor. We also recognise that the surplus capacity on certain trans-Tasman routes may delay Virgin Blue's plans for entry and expansion on those routes*."

19. Furthermore, there appears to be some inconsistency in Virgin Blue's submission to the Commission, which downplays the potential for further expansion of the Virgin Blue network on the Tasman and in domestic New Zealand (where Qantas and Air NZ apparently have a "stranglehold") and statements attributed to Brett Godfrey, Virgin Blue Chief Executive Officer at a recent seminar:[14]

"*Virgin Blue chief executive Brett Godfrey today said his airline was still looking at "multiple destinations" for new routes, including flying domestically in New Zealand … "I'm interested in every single route that can make us some money," he told the Asia Pacific Aviation Summit in Brisbane.*"

20. More importantly, the Tribunal itself acknowledged there is nothing to stop Virgin Blue expanding its network if it identifies routes that meet its profitability criteria and this has not changed. As the Applicants emphasised in the Original Response, it is the ability and capacity of Virgin Blue to respond to the Applicants, should they seek to exploit their position and raise fares above the competitive level, which creates a competitive constraint.

Conduct of Air NZ & Qantas

Capacity Allocation

21. Virgin Blue appears to imply that its efforts to expand its Tasman network have been stymied to some degree by the strategic conduct of the Applicants. More specifically, that any announcement of Tasman route expansion provokes Air NZ and Qantas to offer increased capacity on the relevant routes, such that the case for competitor entry is placed in jeopardy.

22. It does not appear from the record of meeting that Virgin Blue provided any evidence to support these claims, other than the fact that capacity (particularly Air NZ capacity) has increased on the Tasman since the Qantas/Air NZ Decision. In contrast, the Applicants draw the Commission's attention to the following:

(a) Air NZ's response to Q3 of the Commission's questions, which was provided on 20 June 2006. Q3 sought an explanation for Air NZ's increase in capacity on Auckland and Wellington routes since May 2004. Air NZ's response:

[13] See **note 1** at para. 324
[14] See **note 5** – NZPA Newswire, 26.07.06

(i) illustrates that total Air NZ Group capacity has increased since May 2004, but this should be viewed in the context of the substantial reduction in capacity share Air NZ experienced between 2000 and 2004 (see Figure 1); and

(ii) explains the specific capacity increases noted on the Auckland and Wellington routes since May 2004, which have been primarily driven by a shift by Air NZ to wide-bodied capacity and new fleet introductions on those routes.

(b) A trend analysis of the capacity offered by Air NZ and Qantas on the routes served by Virgin Blue over the past few years, which reveals that Virgin Blue's claims are generally unsubstantiated (see **Annexure C** for supporting tables prepared by Air NZ). These graphs illustrate that in fact Air NZ's capacity has trended downwards on most routes where Virgin Blue operates.

23. Moreover, to the extent that Qantas and Air NZ do respond swiftly to the announced route entry or expansion of a competitor such as Virgin Blue, this is simply further proof that the Applicants cannot afford to ignore Virgin Blue's pricing, scheduling and product initiatives, even on routes where entry is only mooted. It illustrates the truth of the Tribunal's view that: "The Applicants will be compelled to respond to the competitive initiatives of Virgin Blue and Emirates".[15] It highlights again that Virgin Blue is an effective competitive constraint across the Tasman routes, to the ultimate benefit of consumers.

24. Finally, the Applicants submit that the Commission should dismiss Virgin Blue's suggestion that under the TNA the Applicants will re-direct their capacity jointly onto specific routes where Virgin Blue is currently operating or planning to enter, thereby imperilling Virgin Blue's Tasman operations. Virgin Blue has no basis upon which to make this claim and it is contrary to the entire raison d'etre for the TNA, which is to reduce both airlines costs through the removal of some surplus Tasman capacity without adversely affecting the frequency of flights, the network offering and the city presence of each airline.

Air NZ Pricing

25. Virgin Blue has also expressed the view that Air NZ is currently the real day-to-day price leader in the Tasman market. This view is apparently based on two grounds: (i) Air NZ has the most airfare sales; and (ii) Air NZ increases its capacity when faced with competition. The Applicants' response to (ii) has already been outlined above.

26. The fact that Air NZ institutes airfare sale periods in relation to the Tasman is not in dispute. However, this does not automatically lead to a conclusion that Virgin Blue has relinquished a price leadership role in this market. Indeed, the remarks of Virgin Blue in the record of interview contradict such a conclusion – "Virgin Blue noted that on many routes its LCC business model allows it to price below Full Service Airlines (FSAs) such as Air NZ and Qantas by 10 – 15 per cent"[16] (emphasis added). The facts are that Virgin

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[15] See **note 1** at para. 420
[16] See **note 7** at p.5

Blue has entered a range of Tasman routes as price leader and has maintained its low fare position since the Qantas/Air NZ Decision.

27. It must also be borne in mind that the threat of entry of Virgin Blue, and to a lesser extent Emirates, was the principal reason why Air NZ deployed the Express model on the Tasman, accompanied by a reduction in Tasman fares by around **[RESTRICTION OF PUBLICATION CLAIMED]**. In addition to the reduction in usual fares on the Tasman brought about by Virgin Blue and Emirates, Air NZ also institutes *tactical* fares in response to the short-term pricing initiatives of Virgin Blue and Emirates. Where a tactical fare is not a *direct* result of a Virgin Blue or Emirates initiative, the particular reason for the initiative must be considered in the context of the low fare Tasman environment where Air NZ must be seen as price competitive (the very environment brought about principally by Virgin Blue and the LCC model).

28. Furthermore, Air NZ’s policy and practice in relation to tactical fares contradicts Virgin Blue’s submissions. Tactical fares (or airfare sales) are short term, promotional fares, which are designated in K class in Air NZ’s booking system. Air NZ primarily initiates tactical fares in response to the tactical activity of other airlines, in the majority of cases, in response to Virgin Blue and/or Emirates (i.e. "reactive fares"). Where Air NZ does lead on tactical fares (i.e. "proactive fares"), this is done for specific business reasons.

29. **Annexure D** sets out the instances of Air NZ’s tactical pricing on the nine main Tasman routes (Auckland/Wellington/Christchurch – Sydney/Melbourne/Brisbane) between October 2004 and June 2006. The Air NZ position in relation to use of reactive and proactive tactical fares is set out in **Annexure E**.

Jetstar

30. In the record of meeting Virgin Blue also asserts that Qantas deliberately deployed Jetstar onto Christchurch because it was Virgin Blue's home base. It goes on to suggest that Qantas can now strategically deploy Jetstar against Virgin Blue at will on the Tasman.

31. These submissions ignore the commercial reality of Qantas Group operations on the Tasman. Jetstar is a lower cost airline with a focus on predominantly leisure-based routes, which operates on the Tasman in conjunction with the Qantas mainline. It cannot operate independently of Qantas Group considerations and deploy its services at will across the Tasman, with or without the TNA.

32. The basis upon which Qantas selects appropriate routes for Jetstar and the reasons why Christchurch met the criteria is outlined in Qantas' response to Q15 of the Commission's questions. Qantas' likely strategies for deployment of Jetstar on the Tasman under the counterfactual are also addressed in Qantas' response to Q20. These provide the Commission with a full answer to Virgin Blue's submissions.

Virgin Blue's Competitive Constraint

Marginal Passengers

33. Despite any suggestions to the contrary, the Applicants repeat that the strength of Virgin Blue's competitive constraint is not a function of its market shares or its rate of expansion. Instead, the constraint lies in the fact Virgin Blue is a genuine competitive alternative to the Applicants in the contest for the price-sensitive marginal passenger on the Tasman and faces no barriers to its expansion. The Applicants must respond to its pricing and initiatives.[17]

34. This competition for the marginal passenger has an effect beyond the fares offered to these passengers. The Tribunal explained and endorsed this effect in the Qantas/Air NZ Decision:[18]

"*The competition for the customer at the margin does not stay with that customer, but those fares necessary to attract the marginal customers will be available to all buyers in the market. The competition for an extra 1% of market share has an advantage and benefit for all passengers who are within a similar passenger profile as the marginal passengers. All customers have the ability to get the same advantage and benefit. Therefore, the competition for the marginal passenger spreads throughout the market*."

35. It could be argued that the Qantas/Air NZ Decision does not take proper account of the potential for competitive detriment to arise under the TNA in relation to infra-marginal passengers[19], because unlike in a "perfectly competitive" market environment, the infra-marginal passenger does not necessarily pay the same price for air travel as the marginal passenger.[20] However, a thorough consideration of the Tribunal's reasoning does not support such an argument:

(a) The Tribunal's economic analysis is not primarily focused upon competition for the marginal passenger. Instead, it placed most emphasis on:

(i) the absence of natural or strategic barriers to entry or expansion;

(ii) the existence of two committed competitors in the form of Virgin Blue and Emirates; and

(iii) the fact that those two competitors were in a position to expand their operations and were considered likely to do so in the face of the Applicants seeking to increase prices above the competitive level or reduce more than excess capacity.

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[17] See also the Applicants' Original Response at para. 46 – 51

[18] See **note 1** at para. 429

[19] For clarity, in a perfectly competitive market where the product is homogeneous, price is set by the marginal consumer (i.e. the person whose willingness to pay for the last unit consumed just exceeds the cost of supply). That same market price is then paid by all other consumers due to competition from alternative suppliers, even though many of them would be willing to pay more. These other consumers are termed the "infra-marginal consumers".

[20] This point was postulated by Dr Stephen King (Commissioner) in discussions with the Applicants.

(b) Whether or not the proposed alliance was likely to have an effect on fares paid by infra-marginal passengers (in other words, average fares) was given explicit and detailed consideration by the Tribunal in its discussion of the factual and counterfactual scenarios (see paragraphs 455 – 498 of the Qantas/Air NZ Decision).

Market Share & Indirect Constraint

36. The Applicants strongly contest Virgin Blue's assessment that a 20% – 30% Tasman market share is required to constrain the Applicants under the TNA. This assessment is inconsistent with:

(a) The views expressed by Virgin Blue's Head of Strategy & Communications and accepted by the Tribunal in the Qantas/Air NZ Decision: "Mr Huttner generally agreed that an LCC such as Pacific Blue <u>required only 5% of traffic on a route before it became an effective constraint on an FSA</u>"[21] (emphasis added).

(b) The fact that Virgin Blue still demonstrably operates according to LCC principles (see paragraph 9 above) and its existing Tasman presence continues to constrain the Applicants and contributes to significantly lower prices on the Tasman, despite a passenger share of approximately 8% across all routes. As some commentators have noted: "After Virgin Blue brought affordable air travel to the domestic market in Australia, it also did on the Tasman."[22]

(c) The fact that competition is a process, rather than a snapshot analysis and low market shares do not, of themselves, guarantee that firms cannot have a significant impact upon the competitive process. The Tribunal makes this point strongly in the Qantas/Air NZ Decision: "A structuralist approach that …. [uses] market shares as a proxy to assess market power fails to assess the whole picture."[23]

(d) The findings of regression analysis conducted by Dr Michael W Tretheway in relation to Tasman average fares and contained in a report prepared for Air NZ dated 21 August 2006 (the **Tretheway Report**). Some relevant key findings are:

(i) The effect of the presence of Virgin Blue (and Emirates) was to reduce average fares on Tasman routes. This finding was consistent over variations of the statistical analysis and was highly statistically significant.[24]

(ii) This effect was present even at modest combined Emirates and Virgin Blue capacity levels of less than 12.5% capacity on a particular route. In the words of Dr Tretheway: "… a little bit of a low cost carrier such as

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[21] See **note 1** at para. 338
[22] M Meier "Virgin Blue - Defining a New World Carrier", http://airsider.net/files/2006/0606/018/virginblue.htm (Airsider website)
[23] See **note 1** at para. 438
[24] Dr Michael W Tretheway, Report to the ACCC dated 21 August 2006, prepared at the request of Air NZ, at 5.11.7

Pacific Blue or a long haul low cost carrier, such as Emirates, produces the lion's share of the price reducing effect of entry by these carriers".[25]

37. The Applicants also strongly contest Virgin Blue's submission that it is not a constraint upon the Applicants on those routes where it does not operate. This submission is inconsistent with:

(a) The views expressed by Virgin Blue's Head of Strategy & Communications and accepted by the Tribunal in the Qantas/Air NZ Decision: "Mr Huttner also agreed that entry by Pacific Blue onto routes such as those to Christchurch had a constraining effect upon fares on trans-Tasman routes into Auckland"[26] (emphasis added).

(b) The findings of the Tretheway Report, which relevantly includes:

(i) A survey of existing empirical literature that identifies an "... LCC effect is not confined to actual routes served by an LCC, but extended, at least in part, to parallel routes … and to routes where the LCC only served one end point."[27] That is, the presence of a low cost carrier can significantly reduce air fares on routes which it does not directly serve.

(ii) The results of regression analysis conducted on Tasman average fares, which indicate that the impact of Virgin Blue (and Emirates) is felt in a sizeable way even on routes they do not serve. More particularly, the results indicate that when Virgin Blue (or Emirates) entered the Tasman market, fares on routes which neither served fell by an average of $24.91.[28]

38. Based on the matters raised above the Commission should place little, if any, weight on Virgin Blue's unsubstantiated submissions regarding the importance of the size of its market share and its posited assessment of its impact upon the Applicants beyond the Tasman routes it serves directly.

BARRIERS TO ENTRY OR EXPANSION

39. It appears from the Virgin Blue record of meeting that Virgin Blue has submitted to the Commission that certain barriers to entry or expansion exist on the Tasman. The Applicants do not agree with this submission. They submit that each of Virgin Blue's concerns do not represent genuine barriers to entry or expansion and the Tribunal's conclusion in the Qantas/Air NZ Decision continues to apply:[29]

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[25] See **note 24** at 5.7.11
[26] See **note 1** at para. 338
[27] See **note 24** at 4.2.12
[28] See **note 24** at 5.9.4 – this compares with an average of $36.87 fare reducing impact when the carriers actually entered a route, but with 12.5% or less of combined seat capacity.
[29] See **note 1** at para. 419

"*If the Alliance were to go ahead, there would not be any barriers to significant entry nor would there be any barriers to effective expansion by either or both of Virgin Blue or Emirates*."

40. From a structural perspective, Virgin Blue raised concerns in relation to limited time slots, gates and facilities out of Auckland Airport at key times; parking and gate issues at key times at Sydney Airport and limitations associated with the Wellington Airport runway.

41. The Applicants submit Virgin Blue's concerns do not amount to barriers to entry or expansion for the following reasons:

(a) In response to queries from the Commission, a submission from New Zealand slot co-ordinator, Mr Hannan, is available from the Commission's public register. This submission does not indicate any specific problem with access to Auckland Airport, above recognising the not unsurprising fact that it is "more difficult to get slots in the peak".

(b) Any limitations on wide-bodied aircraft on routes into and out of Wellington, due to aircraft size restrictions at Wellington Airport, do not apply to Virgin Blue and in any event this barrier is not absolute over the medium term.

(c) In relation to morning peak apron constraints at Sydney Airport, which are acknowledged in a response to questions from Airport Co-ordination Australia, as Dr Tretheway notes in the Tretheway Report[30], Virgin Blue already has a large number of slots allotted to it between 7am and 10am at Sydney Airport. As such, it could expand its Tasman services by reallocating a domestic slot or by operating flights immediately prior to or after the peak period. This is not a barrier to expansion for Virgin Blue.

42. More generally, Air NZ also refers the Commission to Dr Tretheway's analysis of barriers to entry/expansion faced by Emirates and Virgin Blue contained in the Tretheway Report, which concludes that there are no significant barriers to entry or expansion in the Tasman market.[31]

43. Virgin Blue also appears to suggest that the conduct of Air NZ and Qantas (to a lesser extent) in response to announced entry of a competitor upon a particular route amounts to a "strategic" barrier to entry. That is, by increasing capacity and thereby lowering price, Qantas and Air NZ are preventing entry. The flaw in this reasoning is obvious, given the publicly stated cost advantage Virgin Blue appears to exercise over the Qantas and Air NZ Groups (see page 5 of the record of meeting), and was clearly articulated by the High Court in *Boral Besser Masonry Limited v ACCC* [2003] HCA 5 at [313]:

"*It is true that BBM cuts its prices and that in some circumstances price-cutting may constitute a signal to potential competitors that entry into the market is not worthwhile – that is to say, the price-cutting may constitute a strategic barrier to entry. However, if pricing below cost is to be considered a strategic barrier to entry through its signalling*

[30] See **note 24** at 9.4.10
[31] See **note 24** at section 9 (Barriers to Entry)

effect, information asymmetries in the market would need to be considered. Signalling is effective when rivals are not aware of each other's cost structures and are led to believe a rival can produce more efficiently at a lower price" (emphasis added).

44. Furthermore, the Commission is referred to paragraph 22 above, which outlines Air NZ's rationale for the identifiable increases in Air NZ capacity on the Tasman over the past few years.

EMIRATES

45. In its meeting with the Commission, Virgin Blue speculated that if Emirates does double its capacity to Australia, it is unlikely to put more than one extra flight per route on the Tasman, and may not even have an incentive to do that. The Applicants note that even this simple act would actually double Emirates' capacity on the Tasman. In any event, as far as the Applicants can tell, this suggestion is no more than conjecture on the part of Virgin Blue, given it presumably does not have access to Emirates' strategic business plans, proposed Australasian schedule or the specific costs associated with Emirates engaging in Tasman flying relative to keeping planes parked on the tarmac at Australian airports.

46. Instead, the Commission should take into account the following, apparently undisputed, facts in relation to Emirates which render it a potent competitive constraint on the Tasman:

(a) Since its Tasman entry in 2003, Emirates has expanded its capacity share of the Tasman market and its share of Tasman origin/destination passengers, capturing 9.8% for the year ended 31 December 2005 (see DoTaRS submission).

(b) Without any change to its existing schedule, Emirates has one A340 aircraft on the ground in Melbourne, which could be readily deployed on the Tasman.

(c) In the event Emirates is able to double its capacity to Australia this will deliver Emirates an even greater prospect of exploiting profit-maximising opportunities on the Tasman, if one or both of the Applicants is so "commercially inept".

(d) Emirates is a "formidable competitor" with a "superior product", in the words of Virgin Blue. This product is competitively priced on the Tasman and offers those business travellers who do not have a high frequency imperative an attractive alternative to the Applicants.

47. Each of the facts listed above means that Emirates continues to remain a competitive threat to both Qantas and Air NZ on the Tasman, poised to take advantage of any attempt under the TNA to raise prices above competitive levels or remove more than surplus capacity.

48. Finally, Virgin Blue has asserted that the capacity shares quoted by the Applicants in their original submission of 13 April 2006 (Table 1) may be misleading because they do not take into account "through passengers" travelling on the Tasman en-route to Dubai and

therefore presumably do not accurately reflect the Emirates' capacity genuinely available to Tasman origin/destination passengers.

49. The Applicants are puzzled by this criticism and submit the Commission should dismiss it, particularly given a similar comment could be made about Qantas, Air NZ and indeed Virgin Blue (to the extent the passengers it carries on the Tasman may also be connecting at either end to further onward itineraries). Table 1 is simply based upon the number of seats flown on the Tasman by each of the relevant airlines at a particular point in time. It was included to give the Commission an indication of the capacity share of each carrier on the Tasman – no more and no less.

"TIME" COMPONENT

50. Ultimately, when considering whether Virgin Blue (or Emirates) will operate as a genuine competitive constraint upon the Applicants under the factual or counterfactual scenarios, the Applicants strongly submit that the Commission should have regard to the Tribunal's direction:[32]

"… *the proper question to ask in this regard is not what is the current position but what is it anticipated will be the position under either a factual or counterfactual scenario over the next five years?*"

51. That is, the Applicants argue that significant weight should be given to the "time" dimension in the Commission's analysis, with a genuine regard to the relevant time horizon, keeping in mind that competition is a "long-run phenomenon". From this perspective:

(a) specific capacity issues that may exist in relation to Wellington Airport or Auckland Airport in the short run should not be given unwarranted emphasis;

(b) there has been nothing put before the Commission to counter the Tribunal's view that Virgin Blue and Emirates each represented relatively unfettered "latent threats" to the Applicants acting jointly, if they determined to raise prices above the competitive level or reduce more than surplus capacity under the TNA.

MARKET DEFINITION

52. Another issue raised in the Virgin Blue record of meeting is the question of a meaningful distinction between business and leisure passengers travelling on the Tasman routes. In this regard, the Applicants repeat and emphasise the statements made in the Original Response. That is, the extent to which separate product markets exist primarily depends upon the degree of discontinuity in substitution possibilities between business and leisure passengers on the Tasman.

53. In relation to the Tasman (as with other short-haul routes), business travellers are increasingly under pressure to minimise cost and are therefore increasingly price

[32] See **note 1** at para. 357

sensitive. Corporations are now more demonstrably cost conscious and will seek the lowest cost fare to suit their travel requirements. This is reflected in:

(a) Virgin Blue undertaking to increase its appeal to business, as well as leisure, travellers in domestic Australia and on the Tasman through a range of initiatives canvassed in the Applicants' original submission of 13 April 2006;

(b) the fact that the economy cabins of the Applicants on the Tasman will contain a mix of both business and leisure passengers[33] and the difficulty distinguishing between them; and

(c) the Commission's own Statement of Facts, Contentions and Issues to the Tribunal, which stated: "*Given the mainly short haul nature of the routes involved here it is unlikely that separate markets would be an issue in this matter*."[34]

54. The Applicants submit that given the short-haul nature of the routes, the number of frequencies offered by the Tasman's competing airlines and the practical reality that the Applicants, Virgin Blue and Emirates seek to concurrently target leisure and business travellers with the same or similar products, the required discontinuity in substitution possibilities simply does not exist on the Tasman routes.

[33] This is illustrated by contrasting the Applicants' response to Q6 (13 June 2006), which identified the proportion of Qantas and Air NZ customers (respectively) who nominated the purpose for their Tasman travel as for "business or convention", and the percentage of fares sold in by Qantas and Air NZ in the business cabin classes on Tasman routes (see Tables 1 and 2 of the Original Response).

[34] *Commission Statement of Facts, Contentions and Issues* at [48] (filed with the Tribunal on 02/02/04)

ANNEXURE A: WIAL SUBMISSION – APPLICANTS' RESPONSE

ANNEXURE A

APPLICANTS' RESPONSE TO FURTHER WELLINGTON INTERNATIONAL AIRPORT LIMITED SUBMISSION – TASMAN NETWORKS AGREEMENT

21 August 2006

INTRODUCTION

1. Qantas Airways Limited (**Qantas**) and Air New Zealand Limited (**Air NZ**) (together, the **Applicants**) have prepared this document in response to the submission filed with the New Zealand Ministry of Transport on 31 July 2006 by Wellington International Airport Limited (**WIAL**) in relation to the Tasman Networks Agreement (or **TNA**). WIAL also lodged a copy of its submission with the Australian Competition & Consumer Commission (the **Commission**).

2. In the Applicants' Response to Third Party Submissions filed with the Commission on 4 July 2006 (**Original Response**), the Applicants commented that WIAL's initial submission to the Commission focused narrowly on a snap-shot view of the Tasman market and appeared to lack a credible factual basis for a large number of its assertions. As such, its submission was of limited probative value.

3. WIAL's latest submission essentially repeats its earlier submission to the Commission, albeit in a more colourful, emotive and verbose manner. However, WIAL provides no new or compelling reason why the Commission should accept WIAL's assertions.

4. In respect of the LECG Report and other information provided by WIAL in its submission, the Applicants' summary response is set out below:

   (a) (**LECG Report**) The LECG Report seeks to assess price increases on certain Wellington routes using a number of methods. <u>However, LECG computes its price effects assuming that under no circumstances would Virgin Blue/Pacific Blue ever enter the routes in question</u>.

   "Our calculations have not accounted for the possibility of entry, for instance by a low cost airlines such as Pacific Blue."[1]

   The Applicants' submit that such an assumption renders the conclusions of the LECG Report highly suspect. In addition, the Applicants refer the Commission to a short response to the LECG Report prepared by Dr Michael W. Tretheway, which is attached as **Annexure B** (**Tretheway Response to LECG**).

[1] LECG Report page 25.

(b) (**Professor Hazledine**) The draft papers of Professor Timothy Hazledine which are attached to WIAL's submission should be given little or no weight. As explained in a Report prepared by Dr Michael W. Tretheway for Air NZ in relation to Tasman fare movements (**Tretheway Report**), there are fundamental flaws with Professor Hazledine's methodology/analysis. In summary, the analysis is overly simplistic in its approach and does not include a number of important features of the market. Dr Tretheway concludes:

"It is my opinion that the statistical evidence does not support a finding that higher concentration leads to higher fares on trans-Tasman routes. No statistically significant result was obtained".[2]

And:

"*These results are consistent with the findings in the academic/professional literature. That is, a large and seemingly statistically significant impact of market concentration on airline fares can be found with simplistic analysis, but these findings are spurious. But, after controlling for route distance, the presence of a low cost carrier, time trends and seasonal variation, this result disappears. Market concentration has little or no impact on average airline fares in markets where an LCC is present. Of far greater importance for the impact of market structure on average airline fares is the presence or absence of a low cost carrier on a route*".[3]

5. The reality is that WIAL is as self-interested as any other business and is motivated by a desire to earn greater profits. Indeed, WIAL's comments suggesting that the Applicants should raise prices if they are not profitable, or impose a tourism tax on travellers reflect the thinking of a monopolist rather than a consumer champion. In contrast, while the TNA will improve the Applicants' profitability, this will only result from reduced costs and enhanced efficiency, which can be translated into tangible benefits for consumers in the competitive Tasman market.

6. The Applicants' Original Response already provides a sufficient response to the vast majority of WIAL's submissions and arguments. Accordingly, the Applicants have limited their comments to those aspects of WIAL's latest submission that require further elaboration. For convenience, the Applicants have adopted the issue headings used in the Original Response in this submission.

ISSUE ONE: THE TASMAN MARKET

7. In considering the appropriate market definition, courts and tribunals will treat as persuasive the behaviour of the Applicants and their competitors. The commercial reality is that the

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[2] Tretheway Report at 2.2.15.
[3] Tretheway Report at 2.2.17.

Applicants treat the Tasman (including Wellington) as part of a single market and this is evidenced by their pricing, marketing and selling practices.

8. In arguing that the Tasman market is in fact a range of smaller geographic markets because passengers do not treat indirect flights as substitutable for direct flights, WIAL refer to an analysis by LECG of best available fare data between Wellington and Sydney. WIAL submit that the LECG Report illustrates that indirect fares on Pacific Blue and Emirates are much more expensive than direct flights from Wellington on Air NZ and Qantas and, therefore, applying a *ssnip* test[4] there cannot be a single market. This argument is clearly contradicted by:

   (a) WIAL's own statements elsewhere that 20% of Wellington passengers fly to Australia over Auckland or Christchurch;[5]

   (b) the commercial practice of the Applicants, which is to generally common rate Tasman sectors and to apply broadly similar tactical promotion levels to all Tasman routes[6]; and

   (c) the fact that Virgin Blue/Pacific Blue already offers indirect services from Wellington to Sydney via Brisbane.

9. Passengers do not make a purchase decision in a vacuum. The commercial reality is (as the Applicants have already pointed out) that passengers make purchase decisions taking into account a matrix of factors. Indeed some passengers might make a travel decision in the way implicitly presumed by WIAL.[7] However, that proportion of travellers is likely to be very limited. As the Applicants pointed out in the Original Response, price-sensitive Tasman passengers will examine prices and options within a matrix of factors simultaneously, including:

   (a) which airline they wish to fly;

   (b) the time at which they wish to travel (i.e. morning, afternoon or evening);

   (c) the time the journey takes relative to the price (i.e. direct vs. indirect);

   (d) which destination they wish fly to in New Zealand or Australia (in the case of leisure passengers); and

   (e) whether to travel to New Zealand/Australia or elsewhere (in the case of leisure passengers),

[4] A *ssnip* is a small but substantial non-transitory increase in price.
[5] WIAL Submission at 173.
[6] See the Applicants' response to the Commission's Q11 for further details.
[7] That is, a two stage process involving: (i) selection of a destination on a particular day; and then (ii) what airline/route.

and they might be indifferent as to one or more of these factors.

10. This is one of the reasons why the Applicants are incentivised to treat the Tasman as a single market and why fares and availability of seats are generally common rated across all routes.[8] It also helps explain why average fare levels on all routes show similar trends. LECG's argument does not account for the basic commercial drivers faced by the Applicants.

ISSUE TWO: MARKET DEVELOPMENTS

Prices have fallen

11. WIAL accepts that there is no debate that prices on the Tasman came down a long way in 2003.[9] They also submit that "Air NZ and Qantas have dominated the Tasman since its inception".[10] In those circumstances, the question must be asked why prices fell so significantly in 2003 and have remained low since. If it were continued competition between Qantas and Air NZ why did it take over 50 years for these real price decreases to manifest themselves in 2003?

12. In fact, the driving force was the entry (and potential expansion) of Virgin Blue/Pacific Blue and Emirates:

    (a) Virgin Blue commenced operations in Australia in August 2000 initially flying Sydney-Brisbane. However, it was not until March 2002 that Virgin Blue became majority Australian owned and was, therefore, able to operate on the Tasman. In 2003 it was granted authorisation to fly the Tasman and announced its Tasman roll out in September 2003.

    (b) Emirates also commenced flights on 3 Tasman routes in 2003: Melbourne-Auckland and Sydney-Auckland (1 August 2003), and Brisbane-Auckland (26 October 2003).

    (c) Air NZ and Qantas both pre-emptively and competitively responded to the threat of Virgin Blue/Pacific Blue entry by overhauling their short haul product including introducing one way fares, significantly reducing the complexity of their fare structures and lowering fares. These responses have already been documented for the Commission. That Tasman Express was a competitive response to the arrival of Virgin Blue/Pacific Blue was substantiated before the Tribunal with evidence of internal documents.

13. The effect Virgin Blue/Pacific Blue and Emirates have had on average Tasman fares is evidenced by the Tretheway Report. The entry of one of Virgin Blue/Pacific Blue or

[8] See also the high degree of publicity associated with the pricing of Tasman fares, which means it is difficult, if not impossible, to discriminate against Wellington passengers (see para. 12 of the Original Response).
[9] WIAL Submission at 202.
[10] WIAL Submission at 260.

Emirates on a Tasman route decreases average fares by between $36.87 and $55.52.[11] However, Dr Tretheway also finds that the most significant pricing impact that Virgin Blue/Pacific Blue and Emirates have had is their presence on Tasman routes. Indeed, the presence of Virgin Blue/Pacific Blue or Emirates on the Tasman has reduced fares on all routes including on routes on which neither of those airlines operate on by $24.91.[12] Actual entry onto a route, and then the addition of greater capacity is shown to have a diminishing pricing impact. Air NZ submits that the findings contained in the Tretheway Report undermine entirely WIAL's suggestions that Emirates and Virgin Blue/Pacific Blue are weak competitors in the Tasman market[13] or that their constraint is limited.[14]

14. From one perspective, WIAL's suggestion that a solution to any lack of profitability was to simply raise prices by $10[15] is even more surprising to the Applicants, though it does reflect classic monopolist thinking and behaviour. Nonetheless, it is inconsistent with WIAL's protestations that the TNA will lead to increased prices due the loss in competition between Qantas and Air NZ.

LECG's analysis on likely price impacts of the TNA

15. WIAL's submission and the LECG Report suggest that the TNA will result in a range of price increases on the Tasman. Both suggest that there is an inherent (or automatic) link between capacity and average fares. For the reasons explained by Dr Tretheway in the Tretheway Response to LECG there is no such inherent link and LECG's claim is inconsistent with the mathematics and practice of airline seat management:

"…Capacity, and associated costs, can be removed from the market (creating a public benefit) without a corresponding reduction in demand served. Costs will be reduced and load factors will go up, removing the basis for the argument put forth by LECG that capacity reduction must imply higher fares".[16]

16. LECG also claims that fares on the Wellington-Sydney and Wellington-Melbourne routes will increase by 19% under the TNA. LECG make this claim relying on the Cournot model used by the New Zealand Commerce Commission during its investigation of the previous proposed Alliance. As noted by the Tribunal and the New Zealand High Court, the use of the Cournot model in this context is fundamentally flawed:

(a) The Tribunal noted the following regarding the Cournot model presented by Professor Hazledine (Professor Hazledine's model was for current purposes identical to the model used by LECG and the Commerce Commission):

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[11] Tretheway Report at 2.2.18.
[12] Tretheway Report at 2.2.18.
[13] WIAL Submission at 269.
[14] See for example, WIAL Submission at 366-367.
[15] WIAL Submission at 118-120.
[16] Tretheway Response to LECG at 3.4.11.

> *"We have formed the view that Professor Hazledine's modelling did not take account of the actual or potential interactive rivalry between the incumbents, new entrants, and potential entrants, and proceeded mechanistically to its conclusions based on static and structural assumed market share parameters. In such circumstances, we regard Professor Hazledine's evidence as having little probative value".*[17]

The accuracy of the Tribunal's assessment is illustrated by the fact LECG's analysis assumes that there will never be competition from Virgin Blue/Pacific Blue on the routes under investigation (Sydney/Melbourne – Wellington), regardless of whether or not the TNA is authorised or the magnitude of price increases predicted by the model.

(b) The New Zealand High Court concluded:

> *"The limitations of the Cournot model (and its implementation) have been clearly shown. It has been inadequate to deal with the complexities of dynamic markets, particularly the interactions between established FSAs and an LCC newcomer. It has been unable to capture the reactions of players to one another let alone the overall dynamism of the airline industry. In addition, the simplifying assumptions required have severely limited the model's ability to replicate realworld outcomes".*[18]

17. Furthermore, in the Tretheway Response to LECG, Dr Tretheway outlines the problems inherent in using Cournot models for predicting aviation market outcomes in general, and LECG's application of that model in particular. Notably, Dr Tretheway states[19]:

> *"<u>More importantly, their model assumes that there will be and can be no entry by competitors. This is a critical and fatal flaw in this approach.</u> It essentially assumes the answer they are supposed to investigate. They must find large competitive detriment since their model has no alternative. The model cannot allow for any other possibility and thus cannot test for or investigate in any other way, alternative outcomes in the market other than monopoly"* (emphasis added).

18. Finally, WIAL claims that LECG's route substitution analysis indicates that the Applicants could increase the lowest available fares from Wellington to Sydney by "at least 46%".[20] This would amount to a very significant price increase in the lowest available fares (for Air NZ, this would be approximately **[RESTRICTION OF PUBLICATION CLAIMED]** on a G Smart Saver one way fare) without attracting any entry. All else being equal (including fuel costs), the commercial likelihood of prices rising by 46% and entry not occurring where

[17] Qantas/Air NZ Decision at para. 347.
[18] *Air New Zealand & Others v Commerce Commission & Others* (No 6) (2004) 11 TCLR 347 at paragraph 269.
[19] Tretheway Response to LECG at 3.5.8.
[20] WIAL Submission at 465.

there are no barriers to entry can be assumed to be zero. The Tretheway Report supports the Applicants' view.

Professor Hazledine's analysis

19. The Applicants do not agree with the analysis of Professor Hazledine in his unpublished work, which WIAL have attached to their submission. The Tretheway Report explains why the analysis conducted by Professor Hazledine is erroneous and concludes that the statistical evidence does not support a finding that higher concentration automatically leads to higher fares on trans-Tasman routes.[21]

ISSUE THREE: MARKET SHARES

20. WIAL continues to rely on market shares and structural presumptions. No matter how they are presented, concentration ratios and market shares are not evidence of a lessening of competition. In response, the Applicants again refer the Commission to the then Trade Practices Tribunal's statement of principle in *Re Queensland Co-operative Milling Association Limited*[22] and the Tribunal's conclusion in the Qantas/Air NZ Decision that there would not be any barriers to the significant entry or effective expansion of Virgin Blue/Pacific Blue or Emirates[23], which remains applicable today for the reasons expanded elsewhere.

ISSUE FOUR: COMPETITIVE CONSTRAINTS

General

21. Despite its acceptance that prices fell substantially in 2003, WIAL continues to ignore the genesis of that price decrease, namely the entry and potential expansion of Virgin Blue/Pacific Blue and Emirates. If prices decrease, continue to stay low and entry does not occur, the reason is that competition is at work and the incumbents are being constrained. The findings of Dr Tretheway in the Tretheway Report support the view that Virgin Blue/Pacific Blue and Emirates provide a real constraint on the Applicants.

22. The Applicants do not accept that prices have increased above costs since 2003. Fuel prices have continued to increase to unprecedented levels. Further, the compound annual growth rate of inflation has been 9.3% in Australia and 9.5% in New Zealand from June 2003 to June 2006.

Virgin Blue/Pacific Blue expansion

23. WIAL has provided no evidence to support its contention that Virgin Blue/Pacific Blue would forfeit an opportunity to expand if the Applicants sought to raise prices to supra-competitive

[21] Tretheway Report at 2.2.15.
[22] *Re Queensland Co-operative Milling Association Limited* (1976) ATPR 40-012 at p.17,246
[23] Qantas/Air NZ Decision at para. 419.

levels. As Virgin Blue's CEO has recently stated: "I'm interested in every single route that can make us some money".[24]

24. WIAL reason that Virgin Blue/Pacific Blue expansion is unlikely because it has not expanded on the Wellington-Brisbane route despite earning profits on that route. It should be remembered that as at 31 March 2006, Virgin Blue/Pacific Blue had a capacity share of 30.4% of this route. This is a substantial presence.

25. Fundamentally WIAL ignores the fact that the lure of economic profits drives entry and expansion decisions. The evidence demonstrates that neither of the Applicants is earning at or above economic returns on the Tasman.

26. WIAL also states that entry in the New Zealand domestic market should have occurred if the Applicants' hypothesis was correct. It presents an analysis of fares per kilometre in the New Zealand domestic market compared with five Australian domestic routes. WIAL's analysis is simplistic:

    (a) It uses best available fares rather than average fares. As a result, it is extremely difficult to test the data set used. Average fares provide a more robust measure.

    (b) The average stage length for domestic Australian sectors is substantially longer than in New Zealand, which would account for the majority (if not all) of any difference in yield.

27. Commissioner King has rightly recognised that empirical analysis is only useful in decision making if it satisfied certain high standards.[25] WIAL's analysis does not meet those standards.

Virgin Blue/Pacific Blue targeting business passengers

28. WIAL submits that the Applicants are quite clearly wrong in asserting that Virgin Blue/Pacific Blue is targeting business passengers. In response the Applicants simply direct the Commission to the range of promotional activity being undertaken by Virgin Blue/Pacific Blue at present, which is directly targeted at business or corporate travellers. For further details, we refer the Commission to the body of the Applicants' Further Response to Third Party Submissions.

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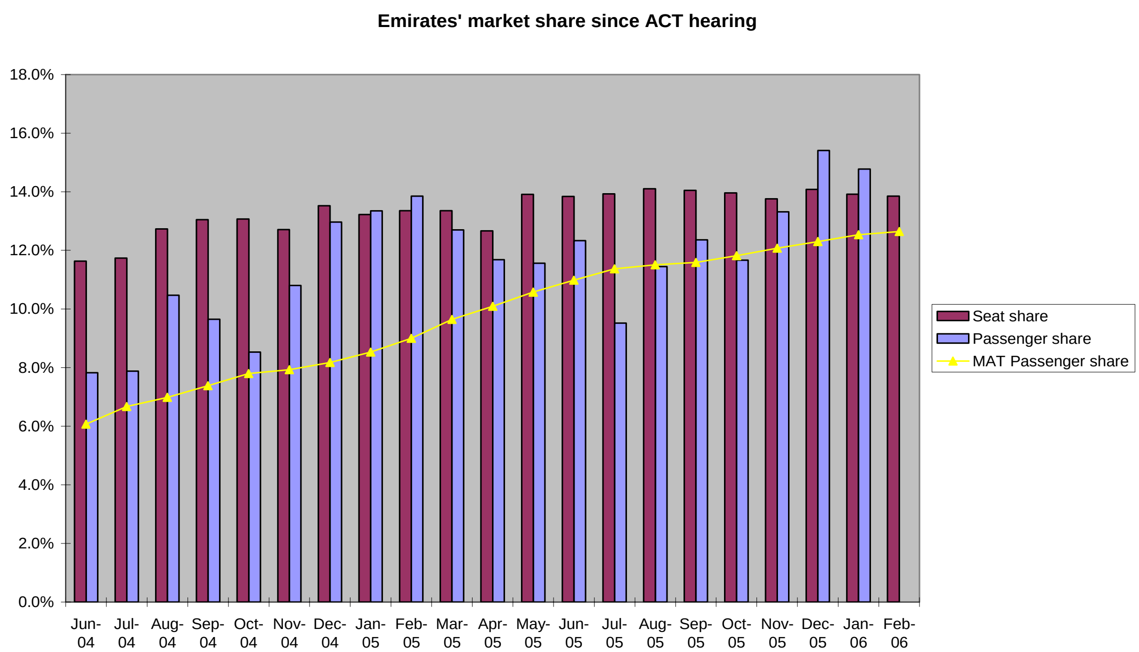
[24] Brett Godfrey, quoted in "Virgin in no hurry to launch US flights" Sydney Morning Herald, 26 July 2006.
[25] King S "The Use of Empirical Methods in Merger Investigations" (2006) 34 ABLR 227.

Emirates

29. Contrary to WIAL's submissions, Emirates has continued to expand since the Tribunal's decision. This is illustrated by Figure 1 below.

Figure 1: Emirates' market share since the ACT hearing



30. Emirates continues to impose a real constraint on the Applicants. WIAL argues that in order to expand, Emirates would have to run a new service from Dubai to Australia. This is not correct: two of Emirates' flights into Australia do not continue to New Zealand (Perth and Melbourne) and the Melbourne aircraft could be very easily deployed on the Tasman if a profitable opportunity presented itself.

31. In any event, elsewhere in its submission WIAL acknowledges that fifth freedom operators, of which Emirates is one, operate low load factors on the Tasman. These unsold seats would provide the simplest mechanism for expansion should prices rise to supra-competitive levels. Indeed Emirates has sufficient flights into Australia to alter its Tasman route structure by deploying more or less capacity to specific New Zealand destinations in response to demand. In addition, it could deploy its presently unutilised Melbourne capacity into Christchurch or Auckland if price increased to supra-competitive levels.

32. Air NZ notes that its internal research indicates that a significant and growing proportion of Tasman business travellers consider Emirates when making purchase decisions. This has only (and will only) served to add to the constraint imposed by Emirates on the Applicants.

No barriers to entry

33. The importance of barriers to entry has long been recognised by courts and the Tribunal. In the absence of barriers to entry, market power cannot survive. The Tribunal concluded that further entry and expansion by Virgin Blue/Pacific Blue on the Tasman is not precluded or inhibited by any barriers to entry or expansion.[26] There are no barriers to entry or expansion on the Tasman.

34. WIAL has referred to a recent New Zealand High Court decision[27] as authority for the proposition that practical likelihood of entry matters in terms of constraint rather than a theoretical possibility of entry. The practical likelihood (as found by the Tribunal) is that Virgin Blue/Pacific Blue will expand in the Tasman market if the Applicants give it an opportunity or incentive to do so. The High Court stated historic absence of entry should not be discounted when evaluating potential entry as a competitive constraint. The converse is also true. The Commission should not discount evidence of *actual* and substantial entry or expansion when evaluating potential entry or expansion as a competitive constraint. Virgin Blue/Pacific Blue and Emirates are actual entrants who have the potential to expand further in the Tasman market and have already established strong market positions on the routes on which they operate.

Marginal passenger

35. WIAL submits that the Applicants' reliance on the marginal customer is misplaced, but the reasoning they rely upon to reach this conclusion is erroneous:

    (a) (**Fixed costs**) WIAL's claim that the Applicants do not necessarily face high fixed costs (which drives a focus on marginal cost pricing) is simply wrong. For reasons previously explained[28], the Applicants cannot make significant adjustments to their capacity in the short run. On any given schedule, costs are fixed.

    (b) (**Secured passengers**) Contrary to WIAL's suggestion, the Applicants do not have the luxury of ignoring the marginal customer on the Tasman routes. WIAL's submission on this point is logically inconsistent and contradicted by a simple glance at the marketplace[29]. Putting all else to one side, WIAL's submission requires one to accept that the Applicants would be happy to forego additional profit by not chasing the marginal customer where they have unsold seats.

    (c) (**The marginal passenger**) The Applicants have never suggested that the marginal passenger is the passenger indifferent to everything. The marginal passenger

[26] Qantas/Air NZ Decision at para. 324.
[27] *Commerce Commission* v *New Zealand Bus Limited* (Unreported, 29 June 2006, High Court Wellington CIV 2006-485-585).
[28] See Applicants' response to ACCC's questions 3 and 4 and paragraph 41 below.
[29] For example, see Annexure B to the Original Response, which highlights the significant amount of tactical or sale fare pricing activity conducted by Qantas and Air NZ in the recent past.

identified by the Applicants and acknowledged by the Tribunal is, quite simply, the price-sensitive Tasman origin/destination passenger.[30]

(d) (**Marginal customer is not a small part of Applicants' business**) As the Tribunal noted in the Qantas/Air NZ Decision[31], the marginal customer is not a small part of the Applicants' respective businesses. Indeed the effect of Virgin Blue/Pacific Blue and Emirates entry on fares makes this readily apparent. As WIAL itself notes, Tasman fares are much lower in 2006 than they were in 2002 prior to Virgin Blue/Pacific Blue and Emirates entering the market.

ISSUE FIVE: THE APPLICANTS' RATIONALE

Excess capacity

36. WIAL has continued to submit that there is a "natural range of load factors" for airlines and that the Applicants' current Tasman load factors fall within that range. Based on the LECG Report, WIAL also argues that the airlines have adopted a false definition of "excess capacity".

37. The Applicants do not claim that all capacity in airline markets is excess. What they do claim is that under the TNA they will have a unique opportunity to remove some surplus capacity. Furthermore, the Applicants are aware that if they removed any non-surplus capacity they would simply be creating an opportunity for competing airlines with no barriers to entry or expansion to exploit.

38. The Applicants also refer the Commission to the international comparison of load factors contained in Annexure A to the Original Response.

Fuel costs

39. WIAL suggests that when considering the impact of fuel costs a number of factors should be considered. However, WIAL's use of these factors is either erroneous or factually incorrect:

(a) (**Impact of Hedging**) The Applicants agree that they hedge their fuel costs. Hedging only reduces volatilities in fuel prices around a trend. It does not change the fact that the cost of fuel is increasing. Fuel prices are increasing and as hedges roll-off, the cost of fuel will continue to escalate. Even net of hedging, Air NZ's full year 2005 fuel cost as disclosed in its Annual Report increased by NZ$144 million to NZ$626 million. Overall the average fuel price in full year 2005 was US$56 per barrel in 2005 compared with US$36 per barrel in 2004 – an increase of 61%. The

[30] Qantas/Air NZ Decision at para. 399 and 429
[31] Qantas/Air NZ Decision at para. 399

average fuel price in full year 2006 was US$75 per barrel, an increase of 34% since 2005.

(b) (**Applicants' are not recovering full costs of fuel price increases**) Airlines are not able to increase their fares sufficiently to recover the increased cost of fuel across their networks.

(c) (**Fuel prices are not a passing issue**) WIAL's submission that "fuel price is another passing issue"[32] is simply incorrect and without basis. All market evidence suggests fuel prices will continue at or above current unprecedented levels for at least the medium term.

ISSUE SIX: THE COUNTERFACTUAL

40. WIAL has submitted that the TNA is completely unnecessary as average load factors will only increase from 72.7% to 75-76% over three years.[33] WIAL also continues to assert that the Applicants can unilaterally reduce capacity on the Tasman.[34]

41. For the reasons previously outlined to the Commission, the size of the reductions in capacity attributable to the TNA cannot be achieved by either one of the airlines acting unilaterally. There is no paradox in the Applicants' position. If an airline unilaterally reduces the number of frequencies it offers in a market like the Tasman (for example, it withdraws a particular service) in many situations there are likely to be negative network consequences. However, that does not mean that the airline making that adjustment then ceases to be a competitive constraint as suggested by WIAL. While the Applicants' can make marginal adjustments to their total seat capacity, there is a limit to the steps that a network airline can take in implementing capacity reductions without significantly reducing the value of its overall network. Under the TNA the Applicants can achieve a reduction in surplus capacity while maintaining (and in some cases improving) network connectivity and city presence by code-sharing on each others' services and extending the number of flights that are available to passengers across the Tasman routes.

ISSUE SEVEN: JETSTAR & FREEDOM AIR

42. WIAL repeats its assertions that in the counterfactual the Applicants are likely to further develop their respective low cost carriers, Jetstar and Freedom Air.[35] The Applicants have responded to this assertion in full and refer the Commission to the Original Response (pp. 22 – 23), Qantas' response to Q15 and Q20 and Air NZ's responses to Q7, Q19 and Q20, which were provided to the Commission on 13 and 20 June respectively.

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32 WIAL Submission at 137.
33 WIAL Submission at 158.
34 WIAL Submission at 188.
35 WIAL Submission at 505.

ISSUE EIGHT: PUBLIC BENEFITS

43. WIAL's submission does not undermine the claimed public benefits associated with the TNA. The Applicants continue to submit that the TNA provides a package of significant benefits to the public, while also serving the commercial objectives of the Applicants. In this regard, we draw attention to the Applicants' response to Q39 and emphasise the following:

    (a) The primary commercial objective of the Applicants is to cut costs by removing some surplus capacity without adversely impacting upon the frequency of flights, the network offering and the city presence of each airline.

    (b) By code-sharing and jointly setting schedules under the TNA, the Applicants are able not only to maintain but also to improve their network connectivity and schedule spread, creating a higher standard of service offering for passengers while at the same time achieving the business needs of the Applicants.

44. Furthermore, the benefits which flow from the TNA (both to the Applicants and the public as a whole) should be considered as a package. The TNA is the result of lengthy commercial negotiations between the Applicants and is the only commercial agreement on offer.

OTHER ISSUES

45. WIAL submit that the revenue sharing mechanism in the TNA will encourage the Applicants to reduce costs and capacity at the expense of travelling public.[36] LECG also submits that the Applicants would race to offer minimum quality and would minimise the marketing of New Zealand as a destination.[37] The Applicants do not accept that there will be any such incentives under the TNA because:

    (a) (**Variable cost adjustment**) **[RESTRICTION OF PUBLICATION CLAIMED]**

    (b) (**Tasman market only**) The TNA covers the Tasman market only. Both airlines are fundamentally network airlines and operate in extremely competitive global markets. A key competitive driver for the Applicants is to deliver a consistent and compelling service and product offering across the network. The Applicants would have no incentive to simply neglect the Tasman or allow poor service to pervade its Tasman offering as this would most likely result in a loss of custom on other routes. This point was also recognised and accepted by the Tribunal in the context of productive efficiencies, although it is equally applicable to LECG's argument:

[36] WIAL Submission at 74.
[37] LECG Report at 5.1 and 5.2.

"…being a network carrier, Qantas cannot have x-inefficiency on one route without it spreading to all routes. It would not, therefore, be commercially rational for Qantas to let costs rise on the trans-Tasman routes".[38]

(c) (**There is actual competition on the Tasman**) Of the nine main Tasman routes, there are only two on which the Applicants are the only current operators (three out of ten if Auckland-Adelaide is included). All Tasman routes will remain competitive and contestable under the TNA such that any reduction in service standards or marketing would only tend to encourage competitive entry (particularly if combined with the massive price increases WIAL is predicting). Whatever incentives might theoretically exist (and the Applicants believe there are none), the ability for the Applicants to manipulate service levels to ensure that service standards are maintained on seven routes but reduced on two is non-existent.

(d) **[RESTRICTION OF PUBLICATION CLAIMED]**

(e) (**Reduced marketing incentives**) There is quite simply no reason to believe that Air NZ will promote New Zealand any less under the TNA. As noted by Dr Tretheway:

"…[LECG's] 'analysis' is dependent on a single hypothetical example with outlandish numbers. Other hypothetical examples could be created with other numbers which would lead to opposite conclusions….Hypothetical answers do not constitute evidence as to what is likely to happen in the trans-Tasman market if the Alliance were to be approved".[39]

[38] Qantas/Air NZ Decision at para. 484.
[39] Tretheway Response to LECG at 3.2.3 – 3.2.4.

ANNEXURE B: TRETHEWAY RESPONSE TO LECG

Comments of Dr. Michael W. Tretheway:

A response to LECG's report, "Benefits and costs to the public of proposed Air NZ and Qantas Code share: Trans-Tasman services to Wellington", dated July 2006.

Non-confidential version

21 August 2006

prepared for counsel to Air New Zealand and Qantas

Table of Contents

1.0 Questions to be addressed

1.1 Question to be addressed

1.1.1 **Appendix A** contains a statement of my identity, interest and qualifications. **Appendix B** contains my curriculum vitae.

1.1.2 I have been asked by counsel for the Applicants to briefly comment on selected claims in the report prepared by LECG on behalf of the Wellington International Airport.[1]

1.2 General Response

1.2.1 My general response is :

- LECG's submission is a hypothetical exercise. It does not examine historical data or actual airline behaviour in this or other airline markets.
- many of the claims made by the authors reflect a lack of understanding of the economics of the airline industry.
- their hypothetical exercise requires a large number of assumptions, many of which are inappropriate for the airline industry or this market, and lead to erroneous conclusions.

[1] "Benefits and costs to the public of proposed Air NZ and Qantas code share: trans-Tasman services to Wellington," July 2006, prepared by Kieran Murray, Sally Barnes, Daniel Garrett

2.0 Reply Comments

2.1 There is no basis for their 46% price increase claim

2.1.1 LECG puts forth different numbers for potential price increases under the Tasman Networks Agreement (TNA) at different places in the paper.

2.1.2 In Section 3, they claim that fares will rise by *a minimum* of 46%.[2] This is based on an analysis of adding a minimum domestic New Zealand fare with the trans-Tasman fares of Emirates and/or Pacific Blue.

2.1.3 This analysis is incorrect for several reasons. First, they ignore the fact that Pacific Blue is already in the market and is already carrying passengers on indirect routes onto its Brisbane-Wellington route. For example, Pacific Blue carries Sydney – Wellington passengers via Brisbane. There is no need to undertake the LECG hypothetical analysis of adding a domestic New Zealand segment to a trans-Tasman segment. Pacific Blue is already providing competition via Brisbane.

2.1.4 More importantly, this LECG analysis ignores the potential for entry by Pacific Blue onto other non-stop routes into Wellington. If the Applicants were to attempt to increase their average fares by 46% on the Wellington trans-Tasman routes, it seems highly likely that Pacific Blue would enter new non-stop routes to Wellington which experienced such enormous average fare increases. Pacific Blue has already incurred the costs of establishing a Wellington station, and operates at all major Australian airports. Virgin Blue has indicated that it has the capability of redeploying aircraft to new profitable route opportunities, and faces no regulatory barriers to entry onto new trans-Tasman routes.

2.1.5 In Section 7.4, LECG claim that the fare increase on Wellington routes would be 19%,[3] less than half their earlier 46% claim. This number is based a hypothetical game theory model of how the airlines *ought to behave with the simplistic assumptions they impose on their behaviour*. This is discussed further, in Section 2.5 below.

2.1.6 In making their two conflicting claims, LECG introduce no data to back up their claims. They do no empirical statistical analysis of pricing in the trans-Tasman or other airline markets. They have made no attempt to examine any actual airline markets which had natural experiments resulting in higher concentration, similar to what may occur under the TNA. Their claims for 'at least 46%' and 19% not only contradict one another, they are based on suppositions, not on any evidence from airline markets.

[2] Section 3.2, page 6.

[3] Page 25.

2.1.7 In my recent statement to the Australian Competition Tribunal (ACT), I examined actual airline fares in the trans-Tasman market, as well as fares in other airline markets. The evidence I have put forth there does not have any observation of fare increases of 46% or even 19% in the trans-Tasman market, or in airline markets which experienced significant consolidation in the presence of low entry barriers and an existing low cost carrier in the market. Specifically, after the failure of Ansett, fares in Australia rose, but by a much smaller percentage than either of LECG's numbers, and these increases were transitory and not sustained. Similarly in Canada, following the merger of Canadian Airlines into Air Canada the observed fare increases were not of the magnitude that LECG claim for the trans-Tasman, and again were not sustained.

2.1.8 I am aware of no case, anywhere in the world, where an increase in market concentration similar to what may occur with the TNA resulted in non-transitory fare increases close to the magnitudes that LECG claim.

2.1.9 The hypothetical fare increases posited by LECG are untenable and not supported by any actual airline experience anywhere in the world.

2.2 More irrelevant hypothetical constructions

2.2.1 In Section 5.1, LECG put forth a claim that under the TNA the two carriers would race to offer lower quality.[4]

2.2.2 This claim is based solely on a single hypothetical example using numbers which have no relationship to actual practice in the airline industry. For example, their hypothetical example is based on a proposition that Air New Zealand can provide a quality service at a cost of $50 per passenger and a lower quality service for $20. Given that the bulk of airline operating costs are associated with the actual costs of safe operation of an aircraft, it seems incredible that they would posit such outlandish relative numbers. Another key assumption they make is that if a low quality service is offered, only half the passengers willing to travel would do so. This too seems unreasonable. Many passenger are demand elastic with respect to service quality, but not to a degree of cutting the total market size in half.

2.2.3 As indicated, LECG's 'analysis' is dependent on a single hypothetical example with outlandish numbers. Other hypothetical examples could be created with other numbers which would lead to opposite conclusions.

2.2.4 Hypothetical answers do not constitute evidence as to what is likely to happen in the trans-Tasman market if the TNA were to be approved. It would be more informative to the issues in this matter if LECG were to actually examine airline markets and airline

[4] Page 9.

economics and put forth evidence, rather than to offer unrealistic hypothetical constructs.

2.2.5 I also point out that the LECG analysis here also requires, once again, an assumption that there would be no expansion by Pacific Blue onto other Wellington routes.

2.2.6 Finally, I note that the hypothetical construct itself contains errors. LECG assumed, for example, that if the lower service quality is offered the airline would always incur the costs of providing the service but receive revenue only half the time. This is an unrealistic assumption in the realities of the marketplace. A carrier that experiences only a 50% traffic realisation, would reduce its capacity and thereby reduce its costs.[5]

2.2.7 The same applies to LECG's assumption that Air New Zealand would continue to incur costs for high quality service yet only receive half the revenue under the TNA. The two Applicants would be highly unlikely to allow a situation to develop where one carrier or the other was incurring costs which were not balanced by revenues. The TNA would be untenable under the assumptions made by LECG for their hypothetical example.

2.3 Adequacy of Airline Load Factors

2.3.1 In section 6.2 of their paper,[6] LECG claims that existing load factors on the trans-Tasman are adequate and that the market is not oversupplied.[7]

2.3.2 However, LECG presents no evidence to support these claims other than to compare the Air New Zealand and Qantas load factors to those of Freedom, Emirates, Pacific Blue and others.

2.3.3 The authors seem unaware of the concept of a break even load factor (BELF) and how changes in the average fare in a market change the breakeven load factor. As well, they seem unaware of the dramatic differences which can exist in the break-even load factors of different carriers in the same market.[8]

2.3.4 The break-even load factor is the percentage of seats on a flight which must be sold in order to exactly cover costs. There is a well known formula in airline economics which shows that the BELF can be computed by dividing cost per seat kilometre (CASM) by the

[5] Perhaps in the parlance of game theory, which LECG prefers, they fail to recognise that this would be a repeated game, and as such behaviour would be different than the one time 'prisoner's dilemma' game format they are trying to assume in order to make a claim that is not supported by any evidence from airline markets.

[6] Page 11 ff.

[7] This is further echoed in a related submission, "Joint Business," by Wellington International Airport, 31 July 2006. See page 40.

[8] In my 2004 Statement to the Australian Competition Tribunal, I provided examples of the differences in the breakeven load factors of a selection of LCCs and full service airlines.

revenue per passenger kilometre (yield).[9]

2.3.5 Since 2003, Air New Zealand's (and Qantas') yields on the trans-Tasman routes have declined markedly.[10] For example, on the Melbourne-Wellington route, Air New Zealand's average economy fare fell from roughly **[RESTRICTION OF PUBLICATION CLAIMED]** in January 2003 to **[RESTRICTION OF PUBLICATION CLAIMED]** by October 2005.[11] By itself, this would have dramatically increased Air New Zealand's break even load factor on trans-Tasman routes.[12]

2.3.6 In fact, over the past five years, legacy airlines in Australia, New Zealand, Canada, the United States, Europe, Brazil, Malaysia and others have reduced their fares and/or experienced significant declines in their yields (revenue per passenger kilometre). This has raised their break even load factors significantly, while the break-even load factors of LCCs have generally not increased, or at least not increased by the same magnitude.[13] Whether Air New Zealand and Qantas are experiencing *adequate* load factors requires more than a simple comparison to other airlines, especially airlines with lower costs per seat kilometre. The only way load factor adequacy can be assessed is by comparing unit costs to unit revenues. LECG has neither made any attempt to do this, nor even acknowledged how one would assess the reasonableness of load factors on a route.

2.4 LECG do not understand how airline seat management works

2.4.1 In Section 6.4, LECG claim that the reduction in seat capacity with the proposed TNA would inevitably result in reduced passenger traffic and higher average fares paid by consumers. They state "… an efficient operator *must* raise prices if it is endowed with less capacity."[14] [emphasis added.]

2.4.2 In their discussion of this point, LECG make reference to the concept of airline seat management. However, they fail to understand one of the most important principles underlying seat management theory and practice.

2.4.3 LECG are correct in their comment that an objective of seat management is to protect a

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[9] CASM stands for cost per seat-mile. While the analysis described uses costs per available seat kilometre, the industry tends to use CASM as the abbreviation.

[10] I have discussed average fares paid per passenger in my Statement to the ACCC dated 21 August 2006.

[11] This is based on a 12 month moving average of fares, so as to remove seasonality in the monthly fare data.

[12] It is not necessarily the case the break-even load factors of Pacific Blue and/or Emirates fell. For example, if Pacific Blue entered the trans-Tasman market (which precipitated Air New Zealand's drop in average fares hence yields) with yields and unit costs similar to what it experiences on similar routes in its system, then its break-even load factor would be the same.

[13] Several LCCs have realised lower break-even load factors, in part due to traffic growth which has reduced unit cost by allowing them to realise economies of traffic density.

[14] Page 20.

certain number of seats for late booking, low fare elasticity traffic. For LECG, withdrawal of capacity under the TNA *must* mean that in order to protect the same number of seats, fewer seats in total will be sold.

2.4.4 However, this is not necessarily the case, and is unlikely to be the case.

2.4.5 A key aspect of airline seat management is the strength of the ability to forecast the number of late booking passengers. The number of passengers wanting to purchase tickets for a given price is what economists call a 'stochastic process,' which simply means that it follows a probability distribution.[15]

2.4.6 If the *quality* of the forecast of passenger demand for airline seats is modest,[16] then seat management principles require protecting a large number of seats. If the forecast quality can be improved, then fewer seats need to be protected. This in turn will result in the sale of more seats overall, and specifically more seats at lower fares to the earlier booking price sensitive traffic.

2.4.7 The ability to forecast late booking passenger demand is improved as the market size for the carrier increases. This is a simple matter in statistics, where the standard error of a seat demand forecast decreases as the number of passengers in the market increases. The bigger the market, the more day to day variations in demand cancel each other out and the easier it is to forecast daily seat demand.

2.4.8 Empirically, one can observe this phenomenon by comparing the average load factors of regional carriers with trunk carriers. The load factors of the former are generally lower than the latter, largely as a consequence of the better ability to forecast late booking demand for the larger market sizes served by trunk carriers.

2.4.9 Under the TNA, the joint trans-Tasman operations of Air New Zealand and Qantas will be much larger than their current separate operations, which will enable each airline to more accurately forecast late booking demand. This will lead both carriers' seat management systems to protect fewer seats, and will result in a greater average percentage of seats sold per flight, with the increase concentrated in the lower fare classes.

2.4.10 In simple language, the pooling of traffic under the TNA will allow the carriers to increase their load factors.

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[15] For a description of airline seat management as being based on a consumer demand probability distribution, see "Airline Seat Management," Logistics and Transportation Review, Vol. 22 (2), June 1988, pp.115-130. Paper also appeared in Proceedings, Canadian Transportation Research Forum, University of Saskatchewan Printing Services, May 1986, pp. 232-245. This paper won the 1986 CTRF award for best paper on a management topic. Because of the award, the paper also appeared in the September 1986 Proceedings of the Transportation Research Forum [with D.J.H. Kraft and T.H. Oum].

[16] In the parlance of stochastic processes, the forecast has a larger standard error than a good forecast. Alternatively, one might say that the probability distribution of airline seat demand is more dispersed.

2.4.11 This is a well known phenomenon in the industry and among mathematicians who develop seat management systems. It is one of the keys to understanding why the proposed TNA will produce benefits. Under the TNA, capacity, and associated costs, can be removed from the market (creating a public benefit) without a corresponding reduction in consumer demand served. Costs will be reduced and load factors will go up, removing the basis for the argument put forth by LECG that capacity reduction under the TNA *must* imply higher fares.

2.4.12 The reduction in seat capacity in the market under the TNA *does not* result in a corresponding reduction in seats sold. This in turn means that the increase in fares as a matter of tautology, which LECG claims will occur under the TNA, is incorrect.

2.4.13 One can observe this phenomenon by looking at what happened after episodes of market concentration in the airline industry. These natural experiments can be quite revealing. When Ansett failed, the average load factor on Qantas increased, allowing it to serve a large share of the former market with greatly reduced total market capacity. This in turn meant that fare increases following the exit of Ansett were modest, certainly not in the range forecast by LECG. Further, the short term fare increases were transitory.

2.4.14 In another natural experiment in Canada, Canadian Airlines was merged into Air Canada, creating a market concentration level which was initially somewhat higher than what is likely to happen with the TNA. Immediately following the merger, the merged carrier reduced capacity, but traffic served did not fall nearly as much.

2.4.15 The claim by LECG that the withdrawal of capacity under the TNA *must* result in less demand being served, and thus also resulting in higher average fares, is incorrect. The error is due to their misunderstanding of both the mathematics and actual practice of airline seat management.

2.5 Cournot Modelling

2.5.1 LECG do not conduct any research on actual historical data as to what has actually happened in this or any other airline market. Instead, they chose to undertake Cournot game theory modelling of the trans-Tasman market.

2.5.2 This type of modelling exercise is hypothetical. It

- Imposes assumptions on how air carriers can behave, without reference to actual behaviour;
- Implicitly assumes a number of other, unstated assumptions (e.g., there is no price discrimination in the airline market, something that runs counter to LECG's own claims); and it

- Conducts a mathematical exercise to then derive how carriers *ought to behave* in the market.

2.5.3 This modelling is not linked to how carriers actually behave. It makes no appeal to historical data. Indeed, in LECG's paper, one finds the mathematical equations of the hypothetical model, but finds no data to support the assumptions they make. Cournot modelling is not evidence regarding the impact of market structure on average airline fares. It is hypothetical mathematical modelling which is not linked to any evidence of actual carrier behaviour.

2.5.4 Cournot modelling is based on a simplistic set of assumptions regarding behaviour of firms.[17]

2.5.5 There are a small number of aspects of the airline industry which are essential to understanding how their markets behave. These include:

- The presence of substantial economies of traffic density. This means that unit costs decline with higher traffic levels.
- The existence of price discrimination, whereby markets can be economically efficient so long as an adequate number of seats are available for sale at low, marginal cost based fares.
- The supply of capacity in the market is not continuous, but is delivered in discreet 'lumpy' units. Flights are operated with aircraft with a fixed number of seats.
- Consumers highly value quality attributes, such as frequency of service and non-stop flights.
- Airline services are not homogeneous, but differ between carriers in a number of dimensions, including service frequency.

2.5.6 The Cournot modelling approach put forth by LECG as 'evidence' is not able to deal with any of these critical attributes of airline economics. They assume constant, not declining costs. They assume uniformity of prices paid by consumers and no availability of deeply discounted fares for some consumers. It is not stated, but their model assumes capacity can be continuously varied. They assume that all airline services are the same. It is not stated, but they assume price is the only demand factor consumers consider.

2.5.7 More importantly, their model assumes that there will be and can be no entry by competitors. This is a critical and fatal flaw in this approach. It essentially assumes the

[17] There are severe limitations as to what the present state of the art can modelling under Cournot type modelling exercises.

answer they are supposed to investigate. By design, their approach must find a large competitive detriment since their model has no alternative. The model cannot allow for any other possibility and thus cannot test for or investigate in any other way, outcomes in the market other than monopoly.

2.5.8 Cournot modelling also makes the rigid assumptions that carriers decide what capacity to offer and then they let the market determine price. This is a very short run concept, and one not suitable for a SNIP test in the airline industry. Unlike the assumptions required for a Cournot model, air carriers in practice recognise the long run prices which are likely to prevail, and make their fleet purchase decisions based on this. This is counter to how the Cournot process works. While Cournot modelling might be an interesting abstract exercise for short run airline behaviour, when fleet capacity may be fixed, the assumptions required do not reflect the actual long run decisions carriers make. It is medium to long run carrier decisions which are the most important to judging the proposed TNA.

2.6 The threat of new entry

2.6.1 In Section 7.4.4, LECG deal with why there would be no entry.

2.6.2 Their claim is that the TNA carriers would expand capacity and lower price to forestall entry.

2.6.3 How can there be competitive detriment if this were to be the case? How can this be reconciled with their claims of 19% or 46% price increases?

3.0 Concluding remarks

3.1.1 In my examination of the LECG report, my findings are:

3.1.2 The LECG submission is a hypothetical exercise. It does not examine historical data or actual airline behaviour in this or other airline markets. It only deals with how airlines ought to behave based on assumptions, often unrealistic, made by LECG.

3.1.3 Many of the claims made by LECG reflect a lack of understanding of the economics of the airline industry. Their lack of understanding of airline seat management and the break even load factor concept are notable examples which have led them to erroneous conclusions.

3.1.4 The hypothetical exercise requires a large number of assumptions, many of which are inappropriate for the airline industry or this market.

Appendix A: Statement of Identity, Qualifications, and Interests

3.2 Statement of identity

3.2.1 I am Dr. Michael W. Tretheway. I reside at 12471 Alliance Drive, Richmond, British Columbia, Canada.

3.2.2 I am currently Executive Vice President Marketing and Chief Economist of Inter*VISTAS* Consulting Inc.

3.2.3 Inter*VISTAS* Consulting Inc. is an independent, employee owned consulting firm providing consulting services to various clients, largely in the transportation and tourism sectors. Our clients include airlines, airport operators, government (federal, state/provincial, and local), tourism authorities, hotel operators, rail carriers, urban transportation authorities, and chambers of commerce, among others.[18]

3.3 My qualifications to comment in this matter

3.3.1 A copy of my curriculum vitae is provided at **Appendix A**.

3.3.2 I hold a Ph.D. in Economics from the University of Wisconsin.

3.3.3 From 1983 to 1996 I was an Associate Professor in the Faculty of Commerce and Business Administration, University of British Columbia. I have taught courses in air transportation management, managerial economics, business statistics, transportation economics, project evaluation, the role of transportation in the economy, government and business, and business logistics. I am the author of over 40 scholarly papers and my research has been published in journals such as *The Rand Journal of Economics, The Review of Economics and Statistics, The Logistics and Transportation Review, Transportation, Transportation Research, The Journal of Transport Economics and Policy, The Journal of Air Transport Management, Annals of Aviation and Space Law, and the Transportation Practitioner's Journal.* I am the author of several books, including *Airline Economics, Airline Cost and Performance,* and *Airline Deregulation and Privatisation.*

[18] InterVISTAS Consulting Inc. had its genesis in the marketing and strategic planning department of the Vancouver International Airport Authority. In 1997, this group was formed into a wholly owned subsidiary of the airport authority, but has since added professionals from diverse areas of aviation, transportation, logistics and tourism and was sold to its employees in 1999. Inter*VISTAS* Consulting Inc. pays a royalty to the Vancouver International Airport Authority for the use of the "VISTAS" name. In 2004, the shareholders of InterVISTAS purchased Global Aviation Associates, based in Washington D.C., which now does business as InterVISTAS-ga².

3.3.4 Since 1 January 1997 I have held a position as Adjunct Professor of Transportation and Logistics in the Faculty of Commerce and Business Administration at the University of British Columbia.

3.3.5 I have served on the Board of Editors of the *Logistics and Transportation Review*, the *Journal of Air Transport Management*, and the *Quarterly Journal of Business and Economics*.

3.3.6 In 1994, I served as a visiting fellow at the Australian Bureau of Transport and Communication Economics.

3.3.7 In addition to my duties at the University of British Columbia, I have taught at the Université Canadienne en France, Shanghai Jiao Tung University, Sian Jiao Tung University and Nankai University.

3.3.8 From January 1994 to March 1997, I was Special Advisor to the President, Vancouver International Airport Authority. In this role I worked in many areas of the airport authority and its subsidiary companies, which operate other airports in Canada and abroad.

3.3.9 From March 1997 to December 1998, I was Vice President of Marketing Services for YVR-VISTAS, a wholly owned subsidiary of the Vancouver International Airport Authority, which was later purchased by the employees of what is now InterVISTAS Consulting Inc.

3.3.10 Since January 1999, I have been Senior Vice President Marketing and Chief Economist of Inter*VISTAS* Consulting Inc.

3.3.11 I have served as an advisor or consultant to government agencies: for example:

- the U.S. Civil Aeronautics Board;
- the Competition Bureau (Canada);
- the Canadian Transportation Agency;
- Transport Canada;
- the Minister of Transport (Canada); and
- The Canada Transportation Act Review Panel;

to labour organisations:

- The Air Line Pilots Association;
- Canadian Air Line Pilots Association;

- Association of Professional Flight Attendants;
- Wardair Pilots Association;
- Council of Canadian Airline Employees;
- The Canadian Union of Public Employees; and
- The Canadian Auto Workers;;

to a consumer group:

- The Consumers Association of Canada;

to the following airlines:

- Canadian Airlines International Ltd.;
- Pacific Western Airlines;
- Qantas;
- Air New Zealand;
- British Airways;
- American Airlines;
- Comair (South Africa);
- United Airlines;
- Scandinavian Airline System;
- Lufthansa;
- Cathay Pacific Airlines; and
- HMY Airways;

to the following aviation industry organisations:

- The International Air Transport Association;

- SITA Inc.;[19] and
- The Canadian Airports Council;

to airports, among which are:

- Auckland International Airport Corporation;
- Wellington International Airport Ltd;
- Comox Valley Airport Commission;
- Drewitz Airport (Germany);
- Gander International Airport Authority;
- Government of the Northwest Territories;
- Hamilton International Airport (TradePort International);
- Lamezia Terme International Airport (Italy);
- Moncton Airport Authority;
- North Peace Airport Society;
- Regina Airport Authority;
- Vancouver International Airport Authority;
- Winnipeg International Airport Authority; and
- Spokane International Airport;

And to the following tourism organisations:

- Council of Tourism Associations of British Columbia;
- Tourism British Columbia;
- Tourism Nova Scotia;
- Tourism Saskatchewan;

[19] Société Internationale de Télécomunications Aéronautiques, which now does business simply as SITA.

- Puerto Rico Department of Tourism; and
- The Council of Ministers Responsible for Tourism (Canada);

and to others.

3.3.12 Among others, I have provided expert witness statements on behalf of:

- the (Canadian) Competition Bureau before the (Canadian) Competition Tribunal and the National Transportation Agency;
- Qantas and British Airways before the Australian Trade Practices Commission;
- Qantas before the New Zealand Commerce Commission;
- Qantas and Air New Zealand before the New Zealand Commerce Commission;
- Lufthansa, SAS and United before the Commission of the European Union;
- Comair before the South African Air Services Licensing Board;
- T1T2LP (Terminal 1 – Terminal 2 Limited Partnership) before the Federal Court of Canada;
- The International Air Transport Association before the Australian Competition and Consumer Commission;
- the Association of American Railroads before the Interstate Commerce Commission;
- Rocky Mountaineer Rail Tours Ltd. before the Canada Transportation Act Review Panel;
- the British Columbia Tourism Coalition for Improved Air Services before Canada Transportation Act Review Panel; and
- the Canadian Airports Council before the Canadian House of Commons Standing Committee on Finance.
- Hallcon Transportation Services before the British Columbia Motor Carrier Commission;
- Canadian National to the Competition Bureau (Canada); and
- AUT Technologies before the Federal Court in the United States.

3.3.13 I have provided expert witness statements in several labour arbitrations, including for:

- The Canadian Auto Workers representing the pilots of Morningstar Airlines;
- The Canadian Auto Workers representing airline customer service agents;
- The Canadian Air Line Pilots Association, in several arbitrations;
- The Air Line Pilots Association, in several arbitrations; and
- The Canadian Union of Public Employees representing flight attendants.

3.3.14 My qualifications to comment on issues regarding airlines and/or airports have never been rejected.

3.4 Statement of interest

3.4.1 I am a shareholder in IVM Investments Inc. This company purchased YVR-VISTAS (subsequently renamed Inter*VISTAS* Consulting Inc.). IVM Investments Inc. is the sole owner of Inter*VISTAS* Consulting Inc. I am also a shareholder in (and President of) IVM International Investments Inc., which owns InterVISTAS-USA, Inc. (of which I am also President), which in turn is the sole owner of InterVISTAS-ga[2] Consulting, Inc., of Washington D.C.

3.4.2 I do not own any shares in any airline or airline service business (other than consulting services provided by the InterVISTAS Group, nor in any airport operating company, nor any other type of aviation service business other than IVM Investments Inc.

4.0 Appendix B: Curriculum Vitae of Dr. Michael W. Tretheway

ANNEXURE C: CAPACITY TRENDS ON VIRGIN BLUE ROUTES

[RESTRICTION OF PUBLICATION CLAIMED]

ANNEXURE D: AIR NZ TACTICAL FARE ACTIVITY, OCTOBER 2004 – JUNE 2006

[RESTRICTION OF PUBLICATION CLAIMED]

ANNEXURE E: AIR NZ TACTICAL FARES STRATEGY

[RESTRICTION OF PUBLICATION CLAIMED]