Applicants' response to further submissions– Tasman Networks Agreement

30 October 2006

Introduction

1 Qantas Airways Limited (**Qantas**) and Air New Zealand Limited (**Air NZ**) (together, the **Applicants**) have previously filed responses to third party submissions to the Commission in relation to the Tasman Networks Agreement (the **TNA**) on 4 July 2006 and 21 August 2006 (the **First** and **Second Responses**).

2 On each occasion, the Applicants addressed successive submissions made by Wellington International Airport Limited (**WIAL**). Annexed to the Applicants' Second Response was a paper prepared by Dr Michael W Tretheway commenting upon a report prepared by LECG on behalf of WIAL.

3 On 23 August 2006, Air NZ filed with the Commission the *"Report of Dr Michael W Tretheway: Evidence on the Impact of market Structure on Average Air Fares in the trans-Tasman Market, 1999-2006"*.

4 WIAL has since made a third submission to the Commission, which was made public on 6 October 2006 (the **WIAL Submission**)and consists of:

- A letter dated 25 September 2006 from Chapman Tripp.
- Two reports prepared by LECG: "*Response to review by Dr Tretheway of LECG Report*" prepared by Kieran Murray, and "*Review: Report of Dr Michael Tretheway*" prepared by Dr Tim Maloney.
- A letter from the New Zealand Ministry of Transport to Mr Sam Cooper of Chapman Tripp regarding New Zealand's air services agreement (**ASA**) with the United Arab Emirates (**UAE**) (the **Bradbury Letter**).

5 Professor Tim Hazledine has also submitted a response to Dr Tretheway's report filed by Air NZ (the **Hazledine Submission**).

6 In this response, the Applicants address both these submissions. In addition, the Applicants use this opportunity to provide the Commission with an update to their previous submissions regarding business travellers on the Tasman.

Hazeldine Submission

7 Please find attached as **Annexure 1** a response to the Hazledine Submission prepared by Dr Tretheway.

8 In addition, the Applicants disagree with Professor Hazledine's suggestion that because Qantas and Air NZ have adjusted their operations in response to the competitive presence of Virgin Blue and Emirates this means the TNA will result in undesirable effects on competition and price. As the Applicants have submitted repeatedly, the key competitive constraints they continue to face on the Tasman, with or without the TNA, are:

- the presence of Emirates and Virgin Blue (as well as the other fifth freedom carriers), who have the ability and incentive to set the market price and represent serious sources of commercial rivalry for Qantas and Air NZ; and
- the absence of barriers to entry or expansion of Emirates, Virgin Blue or other carriers.

WIAL Submission

9 Set out below is the Applicants' response to the two arguments raised by the WIAL Submission, namely that:

- the existence of the Bradbury Letter suggests that Emirates is not a competitive constraint on the Tasman; and
- Dr Tretheway's reports are not reliable.

Constraint imposed by Emirates

10 WIAL submits that:

- The Bradbury Letter shows that Emirates has regulatory restrictions upon its operation and expansion on the Tasman and that these restrictions have not yet been considered in the context of the Applications.
- The existence of the Bradbury Letter undermines the reliability of the Applicants' submissions to date regarding the competitive constraint provided by Emirates on the Tasman.
- The Bradbury Letter undermines the usefulness of Dr Tretheway's analysis.

11 Any inference that the New Zealand Ministry of Transport is currently reviewing Emirates' Tasman rights and that such a review will diminish the competition provided by Emirates on the Tasman is without foundation.

12 Indeed, answers recently provided by the Hon Annette King, New Zealand Minister for Transport, regarding the ASA during parliamentary question time on 26 September 2006 show that these submissions are unsubstantiated. The Hansard of these questions and answers is provided at **Annexure 2.** In those answers, the Minister made it clear that:

- Articles 9 and 10 are standard provisions common in many air services agreements around the world.
- As a matter of general practice, New Zealand does not exercise the rights contained in such Articles.
- The Ministry has no intention of exercising those rights in relation to Emirates.

13 WIAL's contention that Emirates will be compelled by the New Zealand Government to maintain its capacity at the maximum level required to transport passengers travelling between New Zealand and the Middle East only is not supported by current practice. Emirates currently operates in excess of a million seats a year on the Tasman and into Dubai, capacity levels far in excess of what is required to transport the 54,000 New Zealand/UAE origin and destination passengers. This is not expected to change.

14 Based on the matters raised above, the Commission should not give any weight to WIAL's submission that the New Zealand and UAE ASA constrains Emirates' ability to compete on the Tasman. Emirates is a strong competitive force and will continue to constrain Qantas and Air NZ in the foreseeable future. The Bradbury Letter does not undermine the Applicants' submissions to date in this regard, nor does it undermine Dr Tretheway's analysis or findings in either of his reports.

Dr Tretheway's analysis

15 As part of the WIAL Submission, LECG raises a number of criticisms regarding the two reports prepared by Dr Tretheway and filed with the Commission by the Applicants and Air NZ respectively. Dr Tretheway's response to these issues is at **Annexure 3**.

16 The Applicants submit the WIAL assertion that Dr Tretheway's language indicates he is acting in a partisan manner is without foundation. Dr Tretheway is an independent expert. He is well recognised as an expert in airline economics and has been acknowledged as an independent and reliable witness. The Australian Competition Tribunal (the **Tribunal**) has noted:

> *"Dr Tretheway was an impressive and credible witness. He alone of the overseas experts made some attempt to become familiar with the trans-Tasman market scene and to collect data and estimate the impact of structural changes in Australia's airline market following the collapse of the Ansett group of companies in September 2001 and the entry of Virgin Blue. He also commissioned new econometric evidence from the Unites States on the impact of LCCs, compared with FSAs, in affecting average fare levels. We found him to be cogent, persuasive and balanced in his testimony."*[1]

17 Furthermore, Dr Tretheway is the only expert to have conducted a contemporary and Tasman specific empirical review in the context of the current TNA applications. The analysis of Dr Tretheway should be preferred.

18 Finally, both the WIAL and Hazeldine Submissions criticise Dr Tretheway's report entitled the *"Report of Dr Michael W Tretheway: Evidence on the Impact of market Structure on Average Air Fares in the trans-Tasman Market, 1999-2006"* on the basis that the tables of regression results are not disclosed in the public register version. The decision not to publicly disclose the regression results was made by the Applicants given considerations of commercial confidentiality. However, so that third party economists can properly analyse Dr Tretheway's findings, the Applicants will provide any named economists with access to these results, subject to the signing of a confidentiality undertaking.

Business travellers on the Tasman

19 The Applicants wish to assist the Commission by drawing together and updating the Applicants' previous arguments and evidence regarding the impact of the TNA on the time sensitive or business traveller.

20 The Applicants submit that:

- There is no separate business passenger market on the Tasman.
- There will be no detriment to business passengers under the TNA.

No separate market

21 There is no relevant distinction between business and leisure passengers in respect of the Tasman market. This is largely because of the short-haul nature of the Tasman routes. This was accepted by the Commission and the Tribunal in relation to the previous proposed alliance.[2]

22 Price sensitivity is the key feature of the Tasman market. Even passengers who travel for business purposes are, to a greater or lesser degree, price sensitive. This is clearly

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[1] Qantas/Air NZ Decision, at 409.

[2] See: *Applications for Authorisation: Submission to ACCC in support of Applications for Authorisation*, 13 April 2006, at par7.4.

demonstrated by the proportion of tickets sold in business and fully flexible fare categories, relative to the proportion of passengers who travel for business purposes. According to DIMIA data, the proportion of passengers who selected “business” as their purpose of travel on their passenger cards substantially exceeds the proportion of passengers who purchase a business or fully flexible fare as set out in the fare mix tables provided by the Applicants in their First Response.[3]

23 More recent data confirms the continuing trend for business travellers to purchase tickets in lower fare classes. The increasing tendency for some business passengers to choose price over flexibility and service on the Tasman is reflected in the numbers of corporate customers who are choosing to purchase cheaper fares. This corporate buying behaviour is evidenced for Qantas and Air NZ in **Annexure 4**.

No detriment to business passengers

24 Qantas and Air NZ currently face competition in relation to Tasman business passengers from Virgin Blue (through Pacific Blue) and Emirates, which will continue if the TNA is implemented.

25 The fact that business passengers on the Tasman are increasingly price sensitive and budget conscious (as illustrated above) means that airlines like Virgin Blue are increasingly attractive to business travellers on the Tasman. The innovations being introduced by Virgin Blue serve to further increase its appeal. In this regard we refer the Commission to the Applicants’ previous submissions, which have addressed these initiatives in some detail.[4]

26 The Applicants note that Virgin Blue’s marketing emphasis on business passengers extends to its Pacific Blue product. With the exception of the Lounge, the business passenger initiatives which have been launched in domestic Australia have all been introduced on the Tasman.[5] This includes the “Business Friendly Corporate Plus Fares”, the Velocity frequent flyer program, and the “Corporate Deals” service available for companies that spend in excess of $100,000 on travel a year. Information regarding these products is attached at **Annexure 5**.

27 Attached in **Annexure 6** is a press release from Virgin Blue which highlights its new initiatives in relation to attracting business passengers and foreshadows the extension of its business offering. In addition, we attach at **Annexure 7** a recent article from the *WA Business News* which discusses the appeal of Virgin Blue as a “new world carrier” whose initiatives make it attractive to business and leisure passengers alike, whilst retaining all the features of a low cost carrier or LCC.

28 Given the price sensitivity of many business passengers on the Tasman and the enhanced competitive offerings provided by Pacific Blue and Emirates, under the TNA the Applicants will be constrained by the real prospect of losing these price sensitive business passengers to their competitors if they contemplate increasing fares above the current competitive level. This competitive constraint has an effect beyond the fares offered to these passengers, as the Tribunal articulated:

> "… *Further, because airlines cannot easily discriminate between passengers at the margin and committed passengers, the low fares offered by Virgin Blue and Emirates*

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[3] *ACCC Questions for Qantas & Air New Zealand (tranche 1*), 13 June 2006, Question 6, p. 5, compared with the Applicants’ First Response, paragraph 13.

[4] Applicants’ Second Response, paragraphs 13 & 14.

[5] Virgin Blue launched its Lounge product in Adelaide in August 2006, increasing the geographical reach of its product.

in their attempt to gain market share at the expense of the Alliance will flow through to all the passengers in the market who wish to take advantage of them."

29 The difficulties associated with ex ante discrimination between passengers is yet again highlighted in Annexure 4, which demonstrates that business passengers trade off price and ticket attributes throughout the cabin.

Annexure 1 – Response of Dr M W Tretheway to Hazeldine

Annexure 2 – Debates Hansard – Transport , 26 September 2006

Source: http://www.parliament.govt.nz/en-NZ/Search/Results.htm?search=-672518652

Order Paper, Debates (Hansard), Questions, Daily Progress, Journals

Questions for Written Answer

House of Representatives

26 September 2006

13460 (2006). Heather Roy to the **Minister of Transport** (28 Sep 2006): Has the Minister been advised of any conditions imposed on Emirates in 2003 by Australia when Australia allowed Emirates to exercise across the Tasman the rights agreed by New Zealand in the UAE - New Zealand Air Services Agreement of I March 1998; if so, what protection do they provide against Australian curtailment of Emirates' trans Tasman services if Australia decides that such action would be in the interests of Qantas?"

Hon Annette King (Minister of Transport) replied: Reply due: 06 Oct 2006

13375 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): Has Air New Zealand or Qantas provided any evidence to the Ministry that Emirates has been "dumping capacity and dropping ticket prices "so low that they would reduce any accountants ..to tears" as Air New Zealand's Chief Executive is reported to have said (Herald 11 Feb 2006;} if not; has the Minister investigated any such claims?

Hon Annette King (Minister of Transport) replied: Hon Pete Hodgson for Annette King (Minister of Transport) replied: Air New Zealand's views on Emirates capacity and pricing behaviour are public and well known. Air New Zealand and Qantas have presented their views in their application to the Ministry of Transport for approval of the Tasman Networks Agreement submitted in April, and in response to questions by the Ministry on that proposal. The Ministry does not actively monitor tariff levels but does routinely monitor capacity.

13378 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): Has the Minister enquired of the Australian authorities regarding their attitude to Emirates trans-Tasman services, and what assurances, if any, has New Zealand received that Emirates' competition to Air New Zealand and Qantas will not be curtailed by Australian action?

Hon Annette King (Minister of Transport) replied: Hon Annette King (Minister of Transport) replied: No enquiries have been made of Australian authorities, and no assurances have been sought or received.

13377 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): Does the Minister agree with the reported statement of the Chief Executive of Air New Zealand that New Zealand is "one of the few countries that are prepared to give [Emirates] unconstrained access" (Herald 11 Feb 2006) if not, what are the constraints on Emirates' access?

Hon Annette King (Minister of Transport) replied: Hon Annette King (Minister of Transport) replied: I do not have details of the United Arab Emirates's Air Services Agreements with other countries. I am only aware of it having one "open skies" agreement, and that is with the United States. There are no predetermined capacity constraints in New Zealand's Air Service Agreements with the United Arab Emirates but there are principles in the treaty applying to the airline's carriage of traffic, as has been the case with virtually all air services agreements throughout the world except those of a purely "open skies" nature.

13373 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): Would the Minister consider withdrawing approval for any of Emirates' Trans Tasman tariffs under the power conferred by Article 10 (5) , if she concludes that they are lower than "reasonable levels, due regard being paid to all relevant factors, including the cost of operation, the interests of users, reasonable profit, class of service and, when it is deemed appropriate, the tariffs of other airlines operating over" the Tasman"; if not, why not?

Hon Annette King (Minister of Transport) replied: Hon Annette King (Minister of Transport) replied: As a matter of general policy, since the early 1990s New Zealand has not required airlines to file tariffs for approval. This policy applies equally to Emirates.

13374 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): Have Qantas or Air New Zealand this year asked or pressed the Minister to restrict Emirates' Trans Tasman services by reference to the UAE - New Zealand Air Services Agreement; if so on what occasions, giving dates and references to letters and documents?

Hon Annette King (Minister of Transport) replied: Hon Pete Hodgson for Hon Annette King (Minister of Transport) replied: No.

13370 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): If the Minister concludes that Emirates' Trans Tasman services do not have as their "primary objective the provision, at a reasonable load factor, of capacity adequate for ... passengers, cargo and mail originating from or destined for [Dubai]" (from Article 9 (3) of the UAE - New Zealand Air Services Agreement) will she consider restricting Emirates' capacity or tariffs; if not, why not?

Hon Annette King (Minister of Transport) replied: Hon Annette King (Minister of Transport) replied: Should such a conclusion be of sufficient concern, the appropriate course of action would be to call for consultations with the United Arab Emirates.

13371 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): How does the Ministry monitor compliance with obligations such as that under Article 9 (3) of the UAE - New Zealand Air Services Agreement, for Emirates' trans Tasman services to have as their "primary objective the provision, at a reasonable load factor, of capacity adequate for ... passengers, cargo and mail originating from or destined for [Dubai]"; what conclusions has it drawn from its monitoring

Hon Annette King (Minister of Transport) replied: Hon Annette King (Minister of Transport) replied: The Ministry uses statistical information derived from the entry and departure cards completed by passengers. The conclusion drawn is that a very small proportion of the traffic carried by Emirates is coming from or destined for the United Arab Emirates, or indeed the Middle East.

13372 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): What estimates does the Ministry have of the capacity Emirates should have in Trans Tasman services for "the provision, at a reasonable load factor, of capacity adequate for ... passengers, cargo and mail originating from or destined for [Dubai]" (from Article 9 (3) of the UAE - New Zealand Air Services Agreement); if it has none, why?

Hon Annette King (Minister of Transport) replied: Hon Annette King (Minister of Transport) replied: Emirates four services per day provide 459,900 seats per year into New Zealand. In the year ended June 2006, on all airlines serving New Zealand, there were 4,518 United Arab Emirates resident arrivals and 3,697 New Zealand residents departed for the United Arab Emirates as their principal destination (statistics are not available on the number of New Zealanders returning from the United Arab Emirtes, but this is taken to equal the numbers departing).

13367 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): "Why does Article 10 (5) of the UAE - New Zealand Air Services Agreement reserve to the Minister the right to prevent Emirates' (on 15 days notice), from pricing below Air New Zealand; how could the exercise of that right be in the interests of New Zealand consumers and businesses dependant on trans Tasman travel?

Hon Annette King (Minister of Transport) replied: Hon Annette King (Minister of Transport) replied: Article 10 is a standard provision common in many air services agreements around the world. As a matter of general practice, New Zealand does not exercise the rights contained in such Articles.

13368 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): Does the Minister think it appropriate that Article 9 (2) of the UAE - New Zealand Air Services Agreement requires Emirates to take into account the interests of Air New Zealand, and how does that restriction on competition serve the interests of the travelling public, rather than the profit interests of Air New Zealand and its shareholding Minister?

Hon Annette King (Minister of Transport) replied: Hon Annette King (Minister of Transport) replied: Article 9 is a standard provision common in many air services agreements around the world, having been part of an international model used by virtually all countries for some 50 years. The Air Services Agreement with the United Arab Emirates was negotiated in 1997 and exchanged rights with the overall and determining objective of maximising economic benefits to New Zealand, including trade and tourism, which would result from improved air services linkages with the Middle East.

13369 (2006). Heather Roy to the **Minister of Transport** (26 Sep 2006): Does the Minister think that Emirates has provided services at unreasonably low prices in breach of Article 10 (1) of the UAE - New Zealand Air Services Agreement?

Hon Annette King (Minister of Transport) replied: Hon Annette King (Minister of Transport) replied: Neither I nor the Ministry of Transport review airline tariffs.

Annexure 3 – Response of Dr M W Tretheway to LECG

Annexure 4 –Corporate buying behaviour

Air New Zealand

[RESTRICTION OF PUBLICATION CLAIMED]

Qantas Airways Limited

[RESTRICTION OF PUBLICATION CLAIMED]

Annexure 5 – Virgin Blue and business products

5 Simple Reasons

5 simple reasons to get into business with Virgin Blue

1. Velocity

Virgin Blue's award winning loyalty program that allows you to earn 6 points for every $1 AUD spent on Virgin Blue flights. You can redeem points for any available Virgin Blue seat, any flight, any time.

Join Now Free Online

2. Business Friendly Corporate Plus Fares.

Change your date, time or even the person travelling, with refundable fares or up to 12 months credit, plus access to The Lounge and extra baggage limits!

Find out more here

3. Self Check-in.

Online or at the airport Kiosks, Self Check-in is the perfect way to avoid the queues and pick your own seat.

View the demonstration here

4. The Lounge.

At Melbourne, Sydney, Brisbane and soon to come Adelaide domestic airports now boast the perfect business destination. Relax, eat, drink, work or play.

Experience The Lounge Here

5. On Time Performance

Compare us to the competition and you will find we are one of the best on time performers in the world. In the meantime, we will continue to do our best to ensure you arrive on time, every time.

See our performance record

Where to now

- Contact our corporate deals team
- Hear what Brett Godfrey has to say about all of this

Corporate Plus

Virgin Blue, Pacific Blue and Polynesian Blue are delighted to introduce the new corporate plus fare, the new addition to our flexible fare family.

Corporate Plus has been designed with the business traveller in mind, delivering complete flexibility for those high frequency Corporate and Government Guests that require greater flexibility when needing to adhere to a pre-trip approval process.

For the first time at Virgin Blue, guests who book a Corporate Plus fare and who can no longer travel for any reason, will have the option of obtaining either a full refund or credit. Refunds will attract a small administration fee of $30 per guest per cancellation, however a credit retains the full value of the fare paid and can be used within 12 months from the original booking date. Check out the Corporate Plus fare rules for full details.

In addition to this, all Corporate Plus fare holders will also be able to take advantage of the following:

- The use of Priority check-in counters at all Australian Domestic ports
- Free entry to The Lounge*, the new destination to do business
- A generous 32kg of baggage that may be checked into the aircraft hold
- Cancellations or flight changes can be made within 24 hours after the scheduled flight departure

If you book via the Virgin Blue Guest Contact Centre or through a travel agent you'll have the ability to book and hold your fare for up to 48 hours. This is the first time this service has been offered by Virgin Blue Airlines and it is to benefit your changing needs.

So the next time you fly, enjoy the service of Virgin Blue and the extra benefits of Corporate Plus.

* in Brisbane, Sydney and Melbourne, subject to The Lounge terms and conditions of entry.

Source: http://www.virginblue.com.au/products/corporateplus/

How to Register for a Corporate Account

Thank you for your interest in Virgin Blue and allowing us the opportunity to present our corporate product to you.

With our rapid expansion into the Australian, New Zealand & South Pacific Market & the introduction of new routes and destinations, we are able to extend even further our commitment to Corporate clients in `Keeping the Air Fair'. This means looking after your bottom line, by providing low fares and fair deals on a regular basis.

Virgin Blue & Pacific Blue understand that it is not always possible in your dynamic environment to plan your travel schedules weeks in advance and we believe you shouldn't be penalised for this. When you make a booking with Virgin Blue, even if it's a last minute booking, you can be sure that you're making significant savings on the everyday published full economy fares of other airlines. (In some instances this saving can be more than half the published price).

Virgin Blue offers competitive discount alternatives for Corporate clients who spend a minimum of $100k/annum on Virgin Blue and Pacific Blue flights.
**Domestic Air Travel Agreement required & Corporate Clients outside Australia would be required to have an Australian Bank account to receive rebate payments)*

To register for a Corporate Account, you simply need to decide on a preferred payment method:

1 **Credit Card Account** – This gives you the convenience of using our Corporate Website, www.virginblue.com.au/corporates, to make bookings. Alternatively, you can call our corporate priority number and speak to one of our Award winning Guest Contact Centre staff. Payment by credit card is required at time of booking.

2 **Corporate Credit Facility Account** – This gives you the convenience of using our corporate website, www.virginblue.com.au/corporates, to make bookings. Alternatively, you can call our corporate priority number and speak to one of our Award winning Guest Contact Centre staff. A credit facility account gives you the opportunity to charge flights back to your Virgin Blue Corporate Account. On a monthly basis our Virgin Blue Accounts team send you a detailed statement outlining the flights booked and the dollar value, with the money being direct debited from your nominated bank account.
(Virgin Blue Credit Facility Accounts are only available to Australian & New Zealand Corporate Clients)

If you would like to proceed with setting up a Corporate Account, please click the appropriate link below.

Alternatively, if you would like further information on Corporate Accounts with Virgin Blue Airlines, please contact your State Sales Office:

Kind Regards

Vanessa Young

Manager Corporate Sales

Source: http://www.virginblue.com.au/skylights_forms/Corp/index.php

Annexure 6: Virgin Blue press release

02 August 2006

New Corporate Plus Fare Delivers Significant Cost Savings To Corporate And Government Customers

Get Into Business With Virgin Blue

Virgin Blue has stepped up its tenacious campaign to attract more corporate and Government travellers with the overhaul of its business friendly Blue Plus fare to offer a number of new benefits including a book and hold capability.

The enhanced "Corporate Plus" fare comes as a result of feedback from Virgin Blue's existing corporate and Government clients who have been limited in their ability to use Virgin Blue due to the instant purchase requirement.

Corporate Plus fares come with a host of benefits for business travellers. These include:

- Complimentary access to The Lounge, an oasis for the weary business traveller, now with wireless broadband facilities and complimentary food and beverages.
- Priority check-in to express Corporate Plus Guests through the process.
- Generous baggage allowance of up to 32 kg.
- If flights are booked through the Virgin Blue Guest Contact Centre or a preferred Travel Management Company, the instant purchase requirement is removed, allowing the benefit of booking and holding for up to 48 hours.

The new fare is also available on Virgin Blue's international airlines, Pacific Blue and Polynesian Blue.

Mathias Friess, Virgin Blue's newly appointed General Manager, Sales, said, "Corporate Plus is critical in our strategy to attract a fair share of the Government travel market and the main beneficiaries of the redesigned fare product will be corporate Australia and Government agencies."

He added, "Virgin Blue's instant ticket purchase system satisfies the needs of small business travellers. On top of these Guests, there is a significant market segment of business travellers from larger corporations and Government agencies that need a higher level of flexibility in their travel planning. By enhancing our fully flexible fare type, we will be able to extend the significant cost saving opportunities to the larger corporate and Government agency accounts."

Virgin Blue has a number of new business focused innovations that will be rolled out in the second half of 2006.

Source:http://www.virginblue.com.au/about_us/news/index.php?co=vb&artdate=082006#news020806

Annexure 7: “Virgin Blue gets down to business”

Virgin Blue gets down to business
Geoffrey Thomas
21 September 2006
WA Business News
A profit in the airline industry these days is rare, but when you increase profit and every other significant parameter – against soaring fuel prices and a new robust competitor – that is certainly something to celebrate.

But **Virgin Blue** is not in a celebratory mood. Like its latest advertising campaign of ‘Getting into Business’, the airline’s management is getting on with business – attracting more traffic from the business end of town.

That push started in earnest 12 months ago and has delivered the airline a 12 per cent lift in net profit to $84.5 million for the nine months ending June 30.

Revenue was up 8.5 per cent to $1.39 billion, earnings per share up 12.5 per cent, available seat kilometres (ASK, the number of seats times the distance flown) up 3.9 per cent while costs per ASK excluding fuel were down 3.4 per cent.

CEO Brett Godfrey attributes some of the result to Virgin’s focus on the corporate market but suggests that the best is yet to come.

“It takes time for the full impact to be felt – so far it has been trickling through,” he told WA Business News.
But that trickle is gaining momentum, with yield up 2.6 per cent and load factor up 1.9 points to 77.9 per cent, resulting in an increase of revenue per seat kilometres of 3.4 per cent, to $0.802 cents.

Virgin Blue has essentially morphed into what Mr Godfrey likes to call a “new-world carrier”, since it was launched on August 3 2000 with two 737s offering seven return flights a day between Brisbane and Sydney.

The airline now has 51 737-800s dubbed NGs for “New Generation” operating over 300 flights a day to 22 destinations in Australia and the Pacific region under the Pacific Blue brand. In June, it ordered nine more 737-800s, exercising price rights placed in 2003, but these are to replace leased aircraft – not expansion.

The push into the business end of flying encompasses both adding product to match Qantas and innovative concepts – at least for Australia – to better the competitor.

In 2005, **Virgin Blue** introduced web check-in ahead of Qantas, which is yet to roll-out that capability, along with a frequent flyer program – Velocity – which matched Qantas but also upped the ante by offering members the opportunity of redeeming points on any flight.

“Any seat, every flight, every route, every day with no blackout period,” Mr Godfrey said.
The program was also launched with some clout, thanks to its partners NAB, American Express, Emirates, Virgin Atlantic and Europcar.

“Velocity has become one of Australia’s most popular customer loyalty programs with our ‘any seat redemption on **Virgin Blue**’ policy proving hugely appealing to Australian travellers,” Mr Godfrey said.

Also appealing has been a restructure of **Virgin Blue**’s timetable around frequency – particularly at peak business travel periods.

This year, **Virgin Blue** opened lounges at major airports and also introduced a casual user fee of $30. The take-up has been bullish, according to Mr Godfrey, with the “casual budget” for the year exceeded in just six weeks.

Virgin Blue has also introduced ‘corporate plus’ fares with easier booking restrictions. The fares give passengers complimentary access to the lounge, priority check-in and increased baggage allowance to 32 kilograms.

In August, the airline took delivery of its first aircraft equipped for live TV at every seat. After a 30-day shake-down trial, the airline will launch into a complete nose-to-tail refit, to be completed in 10 months.

Virgin Blue will be only the third airline – and the first in Australia – to introduce live television in connection with cable provider Foxtel.

Mr Godfrey said it would be the biggest thing since the airline intro-duced year-round low fares in 2000.
The live TV will replace DigEplayers, which are offered on longer haul flights and can be hired for $15 with unlimited access to 10 pre-loaded feature length movies, 10 sitcoms and short programs, up to 20 music videos and about 100 songs across several music categories.

Another plus for **Virgin Blue**, Mr Godfrey said, was its on-time performance.
But one corporate frill that will never find its way onto **Virgin Blue** flights is mobile phones, “except maybe in the loo down the back”.

Federal government travel contracts are also on **Virgin Blue**’s radar.
In Queensland, **Virgin Blue**’s home state, the airline gets 40 per cent of the travel, but for the rest of the country the figure is more like 1 per cent of the annual $250 million spend, according to Mr Godfrey.

So far, the results of the corporate push are certainly on the board – despite a 35 per cent hike in fuel costs of $70 million and $7 million in one-off costs associated with the set-up of Velocity.

Not as clear are the airline’s international plans, and Mr Godfrey is cautious in this regard.
“I am a bit of a contradiction,” he said. “I am a risk-averse entrepreneur – I am encouraged by what I have seen but there are challenges”.

The major challenge is access to the US market to build a viable business model and fleet plan.
Virgin Blue has ‘requests for proposal (RFPs) with Boeing and Airbus for five 777-300ERs or A340-600s but may have to look at Asian destinations if US access is limited.

But that may alter the type of aircraft selected
“If we’re going to do it, we can do it within the two years we have indicated, with first services in 2008,” Mr Godfrey said.

Also on the expansion radar are domestic flights within New Zealand. The airline had aggressively launched flights to NZ in 2004 – under the Pacific Blue brand – but these have not built up at the rate anticipated due to intense competition across the Tasman. These flights were supposed to be the launch pad for NZ domestic flights.

Virgin Blue serves Auckland, Wellington and Christchurch from Brisbane with one flight a day, and only Christchurch from Sydney and Melbourne, again with one flight a day – not sufficient to drive into the domestic market.

The airline has had more success serving the PacificIslands with flights to Vanuatu, Fiji, Tonga, Samoa and the Cook Islands.

Possibly **Virgin Blue**’s greatest success story is its staff, who belong to just three unions as opposed to the 16 unions at Qantas covering 45 enterprise bargaining agreements.

“The culture of the Virgin group is a worldwide phenomenon and our staff is just superb,” Mr Godfrey said.
In Australia, like the rest of the world, the Virgin brand is recognised for value for money, challenging the establishment and a fun work environment.

But Mr Godfrey explains that **Virgin Blue** is a very different airline to Virgin Express or Virgin Atlantic.
“You take some fundamental principles, such as being family and you build your local niche around that,” he said.
“Sir Richard [Branson] said that **Virgin Blue** was more Virgin than Virgin.”

And to get the right staff, flight attendants must go through a rigorous five-stage recruitment process.
Mr Godfrey said **Virgin Blue** spent more money on recruitment than any other company he had been associated with.
But the results are on the table with extremely low turnover.
He says **Virgin Blue**'s ace is its corporate culture. And while there is no doubt that Qantas will make inroads over the next decade in reducing its cost base, it will "never ever replicate our corporate culture," he says.

"Our people believe they're on a crusade and they feel responsible for the fact that our airfares are less than half the price they were when we started – despite inflation."

> **Virgin Blue** now operates four daily non-stops to Melbourne at 6am, 1.35pm, 5.40pm and 11.35pm, while Sydney has three non-stops at 12.25am, 12.45pm and 4.25pm. The airline also offers one daily non-stop to Adelaide with connections to Sydney and Melbourne and a daily Broome flight.

Tretheway Comments on Submission of Professor Tim Hazledine

19 Oct 2006

Professor Hazledine provides undated comments in a statement titled "Submission on the Proposed Tasman Network Agreement by Professor Tim Hazledine, Dept. of Economics, University of Auckland." Professor Hazledine's comments are in response to my statement dated 21 August 2006. Below I comment on the issues raised by Professor Hazledine.

1.0 Issues regarding my statistical analysis

1.1 Fares have tended to increase since 2004

At paragraph 6, Professor Hazledine asserts that it is common ground that fares have increased since 2004.

- I do not think the average fare data provided by the Applicants to the Australian Competition and Consumer Commission (ACCC) (which is the data analysed in my 21 August 2006 Statement) support Dr. Hazledine's statement that fares have tended to increase since 2004.
- First, it is unclear whether Professor Hazledine is referring to some specific fares in the range of fares offered for sale by the carriers, or whether he is referring to average fares paid by consumers on trans-Tasman routes.
- Second, the evidence indicates that some individual fares have increased, and the average fares on some routes for some carriers have increased, but for other routes or for other carriers average fares have either remained constant or have decreased since 2004.[1]
- As an example, attached to this document (Confidential Annexure B) is a plot of average fares for Qantas (QF) and Air New Zealand (NZ) on the Sydney (SYD) – Auckland (AKL) route. This shows that **[RESTRICTION OF PUBLICATION CLAIMED]**.

[1] It should be noted that if some individual fares have increased, average fares paid by consumers may decrease, either because the mix of fares paid by consumers have changed to a greater share of purchases in the lower fare categories, or because some individual fares have increased while other individual fare categories have decreased.

In item 10, Professor Hazledine lists notable changes in the trans-Tasman market.

- Professor Hazledine excludes from his list of changes to the market the significant increase in fuel prices.

- I attach a plot at the end of this document (Annexure A) that contains the Australian crude oil price. As can be seen, crude oil prices increased by roughly 100% from 2004 to 2006.

- To the extent that average fares have increased on any trans-Tasman route since 2004, the roughly 100% increase in fuel prices (fuel typically represents between 15 and 20% of most passenger air carriers' costs) may have been a major contributor.[2] Professor Hazledine seems to ignore the potential impact of the dramatic increase in oil prices on average airline fares since 2004.

Beginning at paragraph 28, Professor Hazledine describes some results using internet data for the period from 2004, and claims that this data reveals current market behaviour.

- When considering what has happened to average fares since 2004, it should be borne in mind that this period of analysis includes the 100% increase in oil prices. In the presence of a major increase in fuel cost (a 100% increase in the price of fuel is equivalent to a 15% increase in unit cost, ceteris paribus, if fuel costs are 15% of total cost, initially, depending on the degree and successfulness of hedging). Constant or even slightly increasing nominal average fares represent decreases in real fares.

1.2 Spurious HHI regression result

At point 13, Dr. Hazledine comments on my claim that a simple regression of average fares on a Herfindhal-Hershman index (HHI) produces a spurious result. He seems to argue that the result is not spurious, and it does not matter what the reason is for the high HHI coefficient in the simple regression.

- It is well known in econometric theory that a regression with one or more relevant variables excluded from the analysis will lead to biased coefficient estimates for the included variable(s).

- It is in this light that I made my comment that the HHI coefficient from a simple regression of average fares on only HHI (and a constant) is spurious, or biased.

- The literature review I conducted revealed that the (largely U.S. based) literature found that the size and significance of the HHI coefficient in a regression on average fares is

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[2] The increase in a given airline's actual fuel costs in 2004-2006 will depend in part on whether the carrier engaged in hedging of fuel costs, the portion of the carrier's fuel costs that were hedged, and whether or not the hedging strategy was successful. The net impact of fuel prices must also be considered in the context of other cost categories.

reduced when other relevant variables are excluded from the regression. Of special importance is the presence or lack of presence of a low cost carrier in the market.[3] The U.S. results provided guidance to me as to how to specify the regression equation for analysis of trans-Tasman data. Using the trans-Tasman data requested from the Applicants by the ACCC , I found similar results. The inclusion of the indicator/dummy variables for Pacific Blue and/or Emirates reduces the size and significance of the coefficient for the HHI, and the added variables are statistically significant. This indicates that these are relevant variables for the econometric analysis. Excluding these variables produces biased or spurious results for the coefficient on the HHI.

- Professor Hazledine claims that I am ‘forcing down' the effect of the HHI by including the indicator/dummy variables for Pacific Blue and/or Emirates in my analysis. I am not sure that this is the correct phrase. I conducted econometric regression analysis which was based on findings found in the peer reviewed literature, and which had results using actual trans-Tasman data which were statistically significant for the indicator variables for Pacific Blue and Emirates. Perhaps a better phrasing would be that my analysis was revealing a smaller and statistically insignificant effect of the HHI measure on average fares in a regression model which does not exclude key relevant variables.

In Professor Hazledine's point 15, he claims that the concentration variable (the HHI) and the indicators/dummies for the entry of Pacific Blue and/or Emirates are ‘masking' the same thing.

- This is not the case. The HHI data has variation which is separate from the entry of Emirates or Pacific Blue. This is due to a) the growth of Qantas' capacity, as Dr. Hazledine observes, b) changes in some of the other 5th freedom carriers, c) changes in the capacity of NZ as it deployed new aircraft on trans-Tasman routes, and d) subsequent changes in the Pacific Blue and Emirates capacity. It would only be the case that the HHI and the Pacific Blue/Emirates indicators/dummies ‘mask' the same phenomena if there were no other variation in the HHI. But this is not the case. There is other variation in the HHI, and that is captured statistically in my regression analysis.

At his point 16, Professor Hazledine claims that there is multicollinearity of the HHI index and the indicator/dummy variables for Pacific Blue and/or Emirates.

- Again, this is not the case. If there was such multicollinearity, then the correlations between the HHI and the dummy/indicator variables for Pacific Blue and/or Emirates would be either very close to 1.0 or very close to –1.0. I have checked these correlations and now report them:

[3] While the observation of this effect began with examining the impact of Southwest Airlines, as I point out in my *Journal of Air Law and Commerce* paper, summarised in my August 2006 statement, as other low cost carriers (LCCs) entered into markets, the LCC effect seemed to apply to other carriers.

Pairs of variables	Correlation
HHI and Pacific Blue indicator variable	- 0.367
HHI and Emirates indicator variable	- 0.562
Pacific Blue and Emirates indicator variables	0.083
HHI and '9/12' indicator variable	0.171

- These results do not indicate multicollinearity in these variables. To the contrary, these correlation results indicate a reasonable degree of independent variation in the variables.

- Further, the standard errors of the coefficients for the indicator variables are not large, something which would be expected if the variables suffered from multicollinearity.

- I also note that the insignificance of the HHI coefficient in my regressions in my Section 5.8 is not due to a higher standard error of the HHI coefficient. Rather it is due to the reduced value of the coefficient in the preferred regression. In the simple regression I reported at 5.6.5 in my August 2006 statement, the standard error of the HHI was 8.5. This compares with the standard error of 9.3 in the results in my paragraph 5.8.3 in Analysis B, or the standard error of 11.8 in Analysis D. (I rejected Analysis D due to incorrect sign on the traffic variable). The small increase from 8.5 to 9.3 for the standard error of the HHI coefficient is not what would be expected if the variables were multicollinear. If multicollinearity is a problem in the regression, the standard error of the HHI coefficient should have increased quite noticeably.

- Thus, contrary to the claim of Dr. Hazledine, there is no evidence of multicollinearity of the HHI index and the Virgin Blue and/or Emirates indicator/dummy variables. The econometric analysis I undertook for the preferred specification does not suffer from multicollinearity of these variables and produces a legitimate result for the small and statistically insignificant impact of the HHI.

- I also point out that Figure 3 of my 21 August Statement plotted the HHI for the nine trans-Tasman routes where both QF and NZ operated. As can be seen, the HHI is not merely tracing the entry of Pacific Blue and Emirates. As Professor Hazledine points out at his paragraph 10, Emirates entered the trans-Tasman market in August 2003, and Pacific Blue in January 2004. But the HHI for the trans-Tasman fell in January 2001, prior to such entry. It also rose in Winter of 2005. This indicates that Professor Hazledine is incorrect in claiming that the indicator variables are masking the effect of the HHI. The HHI does show variation for other developments in the market.

Professor Hazledine also claims that it is rash for me to assign names to the indicator/dummies for the presence of Pacific Blue and/or Emirates.

- Perhaps I was not clear as to how these variables were constructed. For each data observation (a data point is a monthly observation on average fare for either QF or NZ, for a particular route), the indicator variables are assigned unique to that route. Thus in the indicator variables used at my paragraph 5.5.18, the DJ indicator is unity if Virgin Blue is present on that route for that month, and zero otherwise. These are not general indicator variables for the presence of DJ or EK. In those cases where DJ or EK exited the route, the indicator/dummy was set to zero for those months. Thus the indicator/dummy variables are specific values for a specific route at a specific month. These are not general variables that overlap with other events – they are specific to the presence of DJ or EK.

2.0 Issues regarding Professor Hazledine's argument that it is back to 'normal' rules of competition

2.1 Comparison the introduction of jet service in 1958

At his paragraph 21, Professor Hazledine begins a discussion of what happened in the late 1950s, almost 50 years ago, when jets were introduced in aviation markets. He points out that when the new technology was introduced to the market fares for service in slower turboprop and faster jets ended up being the same.

- Professor Hazledine seems to be unaware that this question has been extensively investigated by economists in the 1960s and 1970s. The phenomenon of equal prices was the result of government regulation which imposed such prices on the industry, rather than allow a market outcome. In fact, works of authors such as Richard E. Cave (Air Transport and it Regulators), Arthur DeVany, William Jordan and Michael Levine severely criticised the regulatory imposition of equal fares for services of very different quality. These criticisms laid the basis for the deregulation of the U.S. airline industry in the 1970s. To paraphrase, the perversity of the regulatory outcome with equal fares for services of such different quality, led to the calls for deregulation of the industry.

- It would be a distortion to draw inferences from a series of nearly fifty year old regulatory decisions that equalised the prices of jet and turboprop services as having any relevance for how the trans-Tasman market will behave with the proposed Tasman Network agreement.

2.2 The legacy carriers are now healthy

Beginning at his paragraph 22, Professor Hazledine suggests that there has been an adjustment of the legacy carriers to the innovative business model of the low cost carriers, but that adjustment is now over, he claims, and the legacy carriers are now healthy.

- I disagree with this statement in general and for the trans-Tasman market in particular.

- Air New Zealand is flying today on the trans-Tasman market because it received significant state aid in 2001.[4] Without the massive state aid provided by the Government of New Zealand, most observers would agree that the carrier would have been required to enter bankruptcy. New Zealand does not have the type of bankruptcy protection provisions that the U.S., Canada and some other nations have.

- In the European Union, the provision of state aid to air carriers is strongly discouraged by the European Commission.

- I also note that Air New Zealand has received state aid on more than one occasion in its history.

- It is difficult to perceive that legacy carriers can be viewed today as fully adjusted and healthy. Delta, Northwest and others are still in bankruptcy protection in the U.S. Alitalia is verging on failure. Swiss had to be rescued by Lufthansa *after it was already restructured following the failure of Swissair*. Brazilian legacy carriers suffering. The current evidence is that the legacy carriers are still undergoing major adjustments to their business models, pricing policies, etc.

- Some carriers have exited bankruptcy protection such as Air Canada, US Airways (a second time) and United. However, none of these has yet weathered a recession in their post bankruptcy environment, and none have yet entered into a post bankruptcy round of major collective agreements with organised labour.

- The real test of the health of the legacy carriers around the world will be how they weather collective bargaining and/or recession. Several legacy carriers emerged from bankruptcy protection or other reorganisation and have reported positive results for a few years only to re-enter bankruptcy or endure other financial stress when the next recession came around. (E.g., Continental, Swissair, TWA, US Airways, Canadian Airlines). Dr. Michael Levine has stated that in his view U.S. legacy carriers will require two rounds of restructuring under bankruptcy protection to adjust to the new environment.

2.3 Concluding Comment

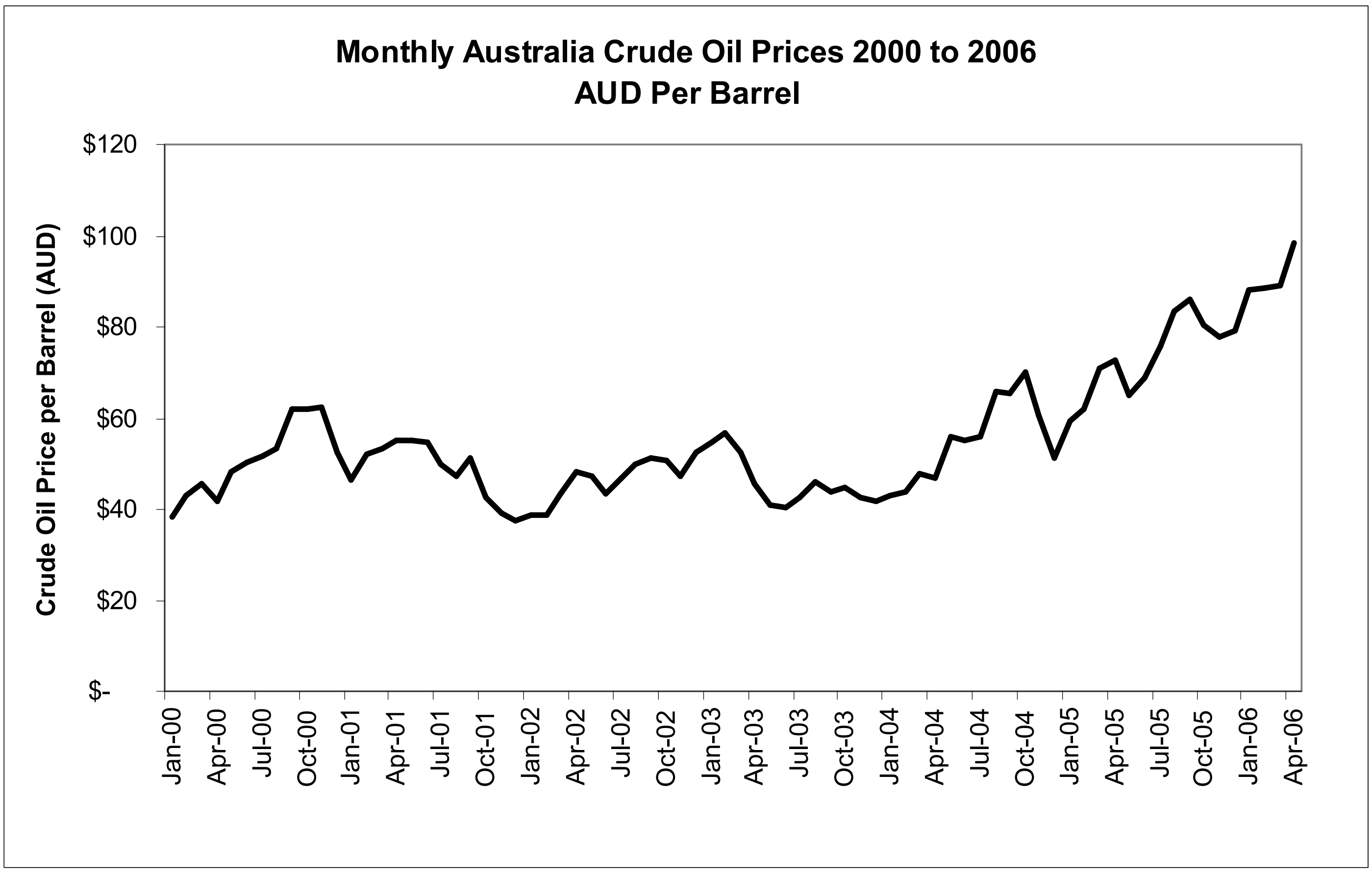
I have carefully considered the criticisms of Professor Hazledine but have not changed my views of the competitive nature of the trans-Tasman market. None of his criticisms have led me to change my view regarding the accuracy or meaning of the statistical regression analysis I have undertaken with trans-Tasman data. Results for a large and significant coefficient of the HHI on average fares depend on excluding relevant variables. This

[4] State aid in this case took the form of a large scale government investment in the shares of Air New Zealand, which allowed it to survive. I am advised that the Government, after a full commercial due diligence and in advice of independent bankers concluded they were the only likely investor in the airline at that time. The Government made it clear they expected the business to produce a commercial return on that investment.

practice is known to produce biased results. I cannot agree with Professor Hazledine's claim that fares have risen on these routes since 2004, as the actual data suggests that a) some carriers on some routes have had declines in average fares, b) the post 2004 period was also accompanied by a roughly 100% increase in oil prices, and c) in light of the latter, even if there were modest increases in average fares on some trans-Tasman routes for some air carriers, it appears both QF and NZ had declining real fares in the post 2004 period.

It continues to be my view that the most significant 'shock' to the trans-Tasman market in the period from 2000 to 2006, including the 2004-2006 period, is the entry and expansion of service by Pacific Blue and Emirates on trans-Tasman routes. The presence of these carriers will act as a constraint on NZ and Qantas if the proposed agreement is permitted.

Annexure A: Fuel Price Trend



Note: Crude oil price is Australia Gippsland Spot Price FOB per Barrel converted to AUD.
Source: U.S. Energy Information Administration (http://tonto.eia.doe.gov/dnav/pet/hist/wepcgippsw.htm)

Confidential Annexure B:
Average fares on SYD-AKL, with fuel prices

[RESTRICTION OF PUBLICATION CLAIMED]

Tretheway Comments on LECG Statements

16 Oct 2006

1.0 Comments of Dr. Tim Maloney

Dr. Maloney's 21 Sep 2006 Statement comments on the Statistical Analysis in Dr. Tretheway's Statement of 21 August 2006.

- Dr. Maloney did not have any of the regression results, only the text. Some of his comments can be attributed to this.

- Dr. Maloney acknowledges that he is not an expert in the airline industry, and thus is only commenting on the statistical methodology.

Below I address each of the concerns he raises. His acknowledged lack of expertise in analysis of the airline industry may have contributed to the errors in his analysis. His pure statistical criticisms of my analysis are also mistaken.

1.1 Definition of a LCC

His first criticism is that my analysis *assumes* that Pacific/Virgin Blue (DJ) and Emirates Airlines (EK) are essentially different than full service airlines, and that I have not put forth any evidence to substantiate this claim.

- The starting point for my analysis is the well established 25-year literature (which I reviewed) which establishes that the effect of LCCs is different from that of legacy carriers.

- As well, the New Zealand Commerce Commission (NZCC), the Australia Competition and Consumer Commission (ACCC), the Australia Competition Tribunal (ACT) and NZ High Court all accepted that these two carriers are different, and thus I found no need to establish that a difference exists.

- In any event, the analysis I undertook is equivalent to what an econometrician would call fixed effects estimation,[1] something which Dr. Maloney later suggests is desirable.

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[1] This is a rather technical issue. Fixed effects estimation using panel data employs indicator/dummy variables to denote specific firms. My analysis with an Air New Zealand (NZ) dummy and dummies for Pacific Blue and Emirates is fixed effects estimation, something widely accepted by econometricians. (Panel data is a cross section of firms tracked through time – the type of data used in my analysis. There is a subtly in that I do not have date for the average fares by month for EK and DJ. What is available is monthly average fare data for each of NZ and Qantas (QF). To deal with the effect of DJ and EK on average fares charged by each of QF and NZ ,I indicate the presence of these carriers on a route by adding the appropriate

The fixed effects estimation reveals a small and insignificant coefficient on concentration, and this should satisfy Dr. Maloney, even if he rejects the assumption that Virgin Blue and Emirates are different. Thus, even if Dr. Maloney does not accept that DJ and EK are different types of carriers than QF and NZ, proper statistical analysis *conditioning on* firm effects reveals a small and insignificant impact of concentration on fares in trans-Tasman markets.

1.2 Lack of Any Regression Output

This matter should be addressed to counsel.

1.3 Step-wise Regression

Dr. Maloney criticises what he perceives is my use of step-wise regression. Step-wise regression is a technique whereby the researcher specifies a set of variables and lets statistical analysis reveal which variables are relevant and should be included, and which should be excluded. Step-wise regression suffers from being dependent, at times, on the sequence in which variables are excluded or included. While statisticians use the technique frequently, many econometricians dislike it, preferring to let economic theory indicate which variables should be included.

- I am not using step-wise regression analysis. I showed a large number of regressions, largely as 'descriptive statistics'; for example to indicate average fares in the market, the general trend in fares, the seasonality pattern, etc.

- In the NZ High Court 'hot tub', I was criticised by Prof. Oum for not having done 'lots of regressions' for my 2004 analysis.

  For the NZ High Court and the ACT, I followed a scientifically rigorous procedure. I reviewed the literature and based on that survey specified one regression to estimate. Further, I did not estimate the regression myself, but used another researcher (Cliff Winston) to do the estimation. This process was intended to remove any potential criticism of 'fishing' for results.

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indicator/dummy variable to the NZ and QF data.) There is another subtlety in how to interpret coefficients from fixed effect estimation. The coefficients show relationships *conditional* on the presence or not of DJ or EK in the market. (I use the term 'market' intentionally here, as my findings indicate that even if neither DJ or EK are present on a trans-Tasman route, their presence in the trans-Tasman market has negative effects on average fares on all routes.) Different econometric questions will use conditional versus unconditional statistical interpretations. For evaluating the effects of market concentration on air fares, it is my opinion that the correct inference for this matter is conditional – that is, it matters whether or not DJ or EK are present on a trans-Tasman route. More explicitly, if neither EK or DJ were present on any trans-Tasman route, then it would likely be my opinion that an alliance of NZ and QF would have a statistically significant and large fare increasing impact on average fares in the trans-Tasman market.

Nevertheless, Oum criticised me for not showing 'lots of regression results'. For my Aug 2006 analysis I followed Oum's advice and showed lots of results.

- I am comfortable following Oum's recommendation with this data set for two reasons. First, by showing lots of regressions, I am able to demonstrate that my key finding (that market concentration has only a small and insignificant impact on average fares) is a robust finding, which is present under variations of the statistical analysis. The result is only overturned when the presence of an LCC or 5th freedom carrier is not controlled for.

- Second, the data set is new and not previously used. Some investigation of the data using descriptive statistics is useful for understanding the properties of the data and revealing anomalies, if any. In contrast the U.S. data on which most of the literature is based, is well understood, often used, and even has filters available from the U.S. government to deal with known anomalies in the data. It is because of the well known characteristics of the U.S. data that in 2004 I felt I could have another researcher conduct the regressions for me for my ACT/NZ High Court statements. With the 2006 untested data sets from NZ and QF, I felt that investigating the data to see whether it had anomalies would be prudent statistical analysis.

- Dr. Maloney points out that I did not include the cost per RPK variable in my final regression, and did not give a reason for this. This is a valid criticism. It was merely an oversight. I attach to this comment the results of a regression for Analysis A adding the variable. As can be seen, the cost variable is of borderline significance, and the results on the other coefficients are little changed.

1.4 Linear Time Trend

Dr. Maloney criticises my work for using a linear time trend, claiming it may obscure the true effects of market concentration on average fares. He recommends using either a cost variable or an index of fares for the world or this region.

- The use of linear time trends is very common in econometric analysis, if not ubiquitous. It is generally interpreted as reflecting the average rate of technical change / managerial learning / productivity, and/or the impact on nominal fares of general price inflation.[2] He is correct that the trend is not explicit in revealing the source of such productivity/technical change, and thus a time trend might be unkindly referred to as a measure of ignorance. However, a large proportion of the empirical econometric analysis using time series data employs time trends.

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[2] It should be noted that the general magnitude of the time trends is such that the average annual increase in fares, after controlling for all other variables in the regression, is similar to but below the general rate of inflation. Inflation in Australia and New Zealand has averaged roughly 2.8-3.0 percent per annum from 2000 to 2006. Inflation of 2.9% per annum, applied to a $238 average fare, would be equivalent to roughly $0.55 per month, compared to monthly time trend coefficients that range from $.20 to $.30.

- The use of the unit cost variable is not a satisfactory alternative to a time trend. The airline cost variable is a cost per unit of capacity, not a cost per unit of output. Thus it will not capture productivity gains from increased capacity utilisation, something which is definitely present in the trans-Tasman data, especially for NZ.

- I am unaware of any index of fares for the world. The cost and time required to develop a meaningful measure of world air fares would be prohibitive.

- I am unaware of any index of fares for 'this particular region'. In any event it is unclear whether he means the Tasman, Australia/NZ, the South Pacifica or Asia Pacific.

- In any event any index of fares will not capture the important effect of productivity on the trans-Tasman on average trans-Tasman fares.

1.5 Definition of Herfindahl-Hirschman Index

Dr. Maloney criticises the use of capacity data to construct the HHI, rather than traffic data.

- Seat capacity data is available by month, by carrier and by route. There is no publicly available traffic data by month, carrier and route. It is common in airline econometric analysis outside of the United States to use a capacity based HHI or other market concentration measure.[3]

Dr. Maloney asks whether Freedom and Jetstar are treated as separate carriers in the construction of the HHI.

- Yes.

1.6 Lack of Importance for LCC capacity

Dr. Maloney criticises my findings on the importance of LCC presence, even with small levels of capacity.

He points out that I find the fare reducing effect is higher with higher capacity.

- His statement is true and I acknowledge this in my statement. However, even at the low capacity levels, the LCC effect is larger than the HHI effect. My point is that LCCs do not have to have large capacity to have a greater impact on average fares than a market concentration measure. This result is also found in the U.S. literature.

- Dr. Maloney is incorrect in claiming that my results find an impact of LCCs at higher capacity that is double the impact at low capacity. My results in the tables in Section 5.8 show that at small capacity, EK/DJ reduce fares by $32 versus $49 at the highest capacity. This is not double.

[3] The U.S. is unique in having a publicly available database of 10% of all airline tickets used in the U.S.

Dr. Maloney claims that EK/DJ are already present and that there would be no further offset to the expected increased concentration with the alliance.

- It is my view that the presence of EK/DJ will constrain the ability of QF/NZ to raise fares. The statistical results on concentration are consistent with no impact of increased concentration on average fares.
- As noted above, Dr. Maloney has pointed out that higher traffic of EK or DJ will have a larger impact on average fares. Thus, if the alliance is permitted, and if EK or DJ expand capacity (which is consistent throughout the world with what has happened following legacy carrier alliances or mergers), then there will be a further downward impact on average fares as a result of that higher LCC capacity. Further, the $17 effect of going from the smallest LCC capacity to the highest (i.e., $32 vs $49) is still larger than the impact of the higher concentration from the alliance (5.8.11 where I indicate the best case for a concentration effect would be $10-$15).

1.7 Inclusion of the traffic volume measure

Dr. Maloney criticises my rejection of results from the regressions with the traffic volume measure, merely because they have the wrong sign.

- It is well established empirically that the industry is subject to strong and highly statistically significant economies of traffic density. That is, higher traffic levels leads to lower unit costs. Thus, aviation economists expect that higher traffic will generally result in lower average fares on a route.
- The above is a supply side argument, based on the underlying cost structure of airlines (something which is well established empirically).
- Demand side economics also expect that at higher quantities, the consumer willingness to pay will fall. Thus, the traffic level coefficient should have a negative sign in the demand equation.
- For both supply and demand theory reasons, the expected impact of traffic on average fares is negative.
- Thus there is no basis for Dr. Maloney's conclusion that my results suggest a plausible finding that concentration is strongly and significantly associated with higher average fares, in a market with an LCC present. Economic theory and airline industry empirical analysis indicate the sign of traffic variable should be negative.

1.8 Indirect evidence of Concentration

Dr. Maloney comments on my citation that Itoh and Lee found that the impact of an LCC in reducing average fares is larger the more concentrated the market. He claims that their work is indirect evidence of an effect that higher concentration raises fares.

- I do not dispute that in markets where there is no LCC present, a major increase in market concentration by legacy carriers will be likely to lead to higher fares.

- I also agree that if an LCC withdrew from a market, leaving no other LCC in the market, and if there are major barriers to entry, then the withdrawal of the last LCC will likely lead to higher average fares.

- I am aware of no market anywhere in the developed world where well established LCCs have withdrawn in entirety. (Note that a market in this matter is *not* defined as a city pair route.) Thus the issue raised by Dr. Maloney is merely hypothetical and not relevant to this case here, where DJ in particular is well financed and profitable.

- Further, as I discussed in my statement, the barriers to entry in this market are extremely low.

- In any event, Dr. Maloney's interpretation of the Itoh and Lee statistical results is unclear.

1.9 Exclusion of Fixed Effects

Dr. Maloney criticises my results for failing to consider fixed effects by allowing indicator/dummy variables for each route.

- I discussed the concept of fixed effects on the first page, above.

- My analysis with the NZ variable is fixed effects analysis.

- Most econometric analysis of average fares considers fixed effects of *carriers*, but not of *routes*. In the extensive literature I reviewed, I am not aware of any fixed effects model indicating routes, rather than carriers.

- Dr. Maloney would have to explain the economic theory as to why fixed effects would be route specific, rather than firm specific as most conditional panel data estimation employs.

- In any event, I have done such analysis, but it was so voluminous, that after preliminary investigations revealed no material differences in results, I abandoned this research line. I undertook a number of statistical analyses using data on single routes (similar in concept to the conditional inference of fixed route effects estimation).

1.10 Applying results to specific sectors

Dr. Maloney criticises the lack of specific regression results and comments on some further investigation.

- As already indicated, the issue of access to the specific regression results is a matter to raise with counsel, the Applicants, the ACCC and the MoT.

He indicates that if the data were available other investigations could be conducted.

- This may be true, but access to the data is an issue for counsel, the Applicants, the ACCC and the MoT to resolve and is not a criticism of my work.

Dr. Maloney indicates that barriers to entry should be factored into the results.

- As I discuss in my statement, I do not find any material entry barriers into the trans-Tasman market.

2.0 Comments of Kieran Murray

Mr. Murray's 22 September 2006 Statement comments on "Dr. Tretheway's Comments of 21 August 2006 on the July 2006 LECG report submitted on behalf of Wellington International Airport."

Below I address each of the concerns he raises. His 22 September statement provides a few useful clarifications, but does not change any of my conclusions.

2.1 LECG claims that the Wellington fare increase will be 19%, not 49%

Mr. Murray asserts clearly in his 22 September Statement that the increase on routes into and out of Wellington would be only 19%. I had suggested that their analysis in July seemed to put forth a 49% fare increase claim.

- This clarification by Mr. Murray is useful.
- The 19% increase is based on hypothetical game theory modelling, not on analysis using actual data for trans-Tasman routes.

2.2 There is at least one piece of evidence that fare increases have been in excess of 19%

Mr. Murray points out that I am incorrect in stating that there is no evidence of fare increases following mergers of 19%.

- My comment was based on the 49% fare increase, which Mr. Murray has now clarified is only 19%.

He cites the Borenstein paper on the Northwest-Republic merger, which found that merger to have had a 23% increase.

- The Borenstein paper was one of the first in a long series of articles on the impact of market structure on air fares. As I indicate in my extensive review, the literature evolved significantly since the early Borenstein paper. The more recent papers show a much smaller impact of concentration on average fares, in part but not exclusively, due to the impact of LCCs.
- Nevertheless, I would generally agree that *absent an LCC* in the market, and with the significant entry barriers present in the Minneapolis market following the Northwest-Republic merger, one might expect a significant increase in price following a merger of two FSAs.
- It is my view that the Northwest-Republic merger findings are largely irrelevant for the trans-Tasman market. A well established and large LCC is present in the trans-

Tasman market, and does provide some service to Wellington. This is a material difference from the NW-RE results analysed by Borenstein more than 15 years ago, when an LCC was not present in the overlapping Northwest – Republic markets.

- Further, the 1986 NW-RE merger took place in a market with significant barriers to entry, especially but not limited to the severe limitations on an entrant's ability to access airport gates, and other resources at Minneapolis International Airport, and the strength at that time of the NW frequent flyer program.

- The trans-Tasman market enjoys the presence of a well established and well funded LCC carrier, including a presence at Wellington. Further, the entry barriers of airport access and an exclusive frequent flyer program are absent on the trans-Tasman, including at Wellington.

Mr. Murray then cites my simple regression (at my 5.6.8) as evidence that fares would increase by 15%.

- He is taking my statement out of context. I present and then reject the type of simplistic regression of average fares on only a measure of concentration.

- My conclusions regarding the effect of market concentration on average fares is found at my paragraphs 5.8.9 and 5.8.10. In 5.8.9 I indicate that the effect may be in the 6% range, ceterus paribus, and that this is small compared to the much larger effect on average fares of the presence of Pacific Blue.

- In contrast to Mr. Murray's claim in the last paragraph on his page 4, I am of the opinion that his price impact estimates are unreasonable. In part this is because his estimates are not based on empirical analysis of actual data, but rather due to the results of a hypothetical game theory model.

- I have addressed the criticisms of Dr. Maloney (to which Mr. Murray refers) in Section 1, above.

Mr. Murray claims that the treaty between NZ and the UAE is more protectionist than I represent.

- Even if the NZ government were to change course and discourage additional flights by EK, the carrier currently has the ability to substitute aircraft and increase capacity on the trans-Tasman. I am not aware of any attempt to prevent EK from substituting aircraft on trans-Tasman routes.

Mr. Murray points out the practical limitations on EK entering the Wellington routes.

- I do not dispute this.

- However, in my Section 5.9, I point out that the presence of EK and DJ in the trans-Tasman market has been observed to reduce average fares on routes they do not directly serve. This is consistent with evidence from the U.S. on the impact of LCCs, but is confirmed with trans-Tasman data. It is also consistent with how the carriers have described their pricing on the trans-Tasman.

- In any event, it is the presence of Pacific Blue in Wellington, the absence of entry barriers at Wellington (and at the spoke ends of Wellington's trans-Tasman routes) and the healthy nature of Virgin Blue which forms the basis of my opinion that it will constrain QF and NZ from being able to sustain a non-transitory increase in price on trans-Tasman routes to/from Wellington.

2.3 Cournot Modelling

Mr. Murray cites my 2003 response to questions from the NZCC regarding my views on Cournot modelling as contradicting my current views on such analysis.

- I acknowledge that my thinking on the use of hypothetical game theory models as evidence of actual market behaviour has evolved since 2003, in large part due to my examination of the modelling more thoroughly in 2004 before the ACT and the NZ High Court.

- I acknowledge that there is no empirical evidence which supports models other than Cournot, for airline markets. However, the evidence which does support it is extremely limited, and upon review, is based on short time periods, not long term adjustments when carriers are able to replace their fleets.

- I am particularly concerned with the inability of game theory models, Cournot or otherwise, to properly analyse markets with a significant degree of price discrimination, especially in the presence of empirically documented and extensive economies of traffic density. This is a critical aspect of airline markets which must be considered when analysing the total surplus or economic efficiency in a market. As is well established, a perfectly price discriminating monopolist is economically efficient. While QF and NZ are neither monopolists nor perfect price discriminators, the degree of price discrimination is such that meaningful numbers of seats are available for purchase at very low prices in the market, suggesting high economic efficiency.

- At the bottom of his page 7, Mr. Murray seems to suggest that it is *necessary* to use game theory to quantify detriments and benefits. I note the comments of Commissioner Stephen King who stated that "Because of its complexity and sensitivity to particular assumptions, merger simulation is generally contentious and, at best, provides 'back up' input for a more complete merger analysis."[4] I recommend a more complete merger analysis than merely relying on a hypothetical game theory model, which is unable to model key economic characteristics in this market.

[4] "The use of empirical methods in merger investigations," 29 September 2005, 2005 Industry Economics Conference, La Trobe University. Available from web site of the ACCC.

2.4 Monopoly and Competitive Supply

Mr. Murray claims I was incorrect in inferring that their statement that the oversupply in the market was evidence that load factors were adequate.

- It is correct that the LECG statement did not use the word 'adequate'.[5]

- In any event, I maintain my opinion that comparison of trans-Tasman load factors to load factors of other carriers on other routes is not revealing. As I stated, the analyst must compare actual load factors of an air carrier to breakeven load factors of that carrier. Simply finding a carrier's load factors are high is not sufficient. If yields are low or units costs are high, 'high' load factors may be uncompensatory.

Mr. Murray claims that I posit that the Alliances' joint trans-Tasman operations will be larger than their separate current operations.

- This is not a correct reflection of what I stated. The total capacity on the route may be less than the sum of their present individual capacities.

- In any event, this is not the relevant issue for how airline seat management techniques will determine the percent of total seats that will, on average, be sold. The size of the joint pool of seats to be managed under the alliance will be larger than either carrier's existing individual capacity. Regardless of whether total alliance capacity is lower or higher than the summed present capacities, there are important gains in seat management from joint seat management. The law of large numbers will allow the alliance to sell a higher portion of the Alliance's jointly managed seats. Thus, even in the event that total capacity is reduced by the alliance, the carriers will sell a higher percentage of their joint capacity.

- This sale of a higher portion of capacity has important benefits. These include the opportunity to reduce capacity deployed without reducing seats sold, resulting in a genuine reduction of costs. There are also important environmental benefits from reducing airline capacity, without reducing seats sold.

- Contrary to Mr. Murray's claim, this is not an argument that competition is wasteful. It is merely a consequence of an ability to better manage a stochastic process. This is a well known phenomena in the airline, hotel, hire car and other sectors.[6] Mr. Murray

[5] Perhaps my comments should have been directed at the 31 July 2006 submission of Wellington International Airport, rather than the LECG statement, where the claim was made that Tasman load factors were adequate.

[6] The airline sector is subject to stochastic demand. Carriers do not know how many seats will be sold on each flight, but they have extensive data on the statistical properties (mean, variance, skewness, kurtosis) of the demand for each flight on each day. As any statistician knows, the variance of expected sales will be reduced as the size of the market increases. A lower variance of demand will drive any airline seat management system to sell a higher percentage of capacity without a deterioration of last minute seat availability.

does not seem to appreciate that what is being discussed is the positive market outcomes of management of stochastic processes of different scale.

- To be explicit, I am NOT saying that competition is wasteful. To the contrary, it is my view that competition is highly desirable. In airline markets today, the most important dimension of competition is whether an LCC is present in the market. As well, it is important that there are low barriers to entry. Both of these are present in the trans-Tasman market.

Mr. Murray states that at 2.4.9 I claim that airlines will use greater market power to make lower prices available.

- I make no such reference to market power in 2.4.9 or anywhere in this passage of my comments.

- Nevertheless, Mr. Murray's claim in nonsensical – he is saying that I claim carriers will use greater market power to sell more seats at lower prices. I do not say this.

- As I pointed out above, what I am saying is that with a larger pool of seats to be managed by a single seat management system, the statistical law of large numbers (or more precisely, the law which results in a lower variance of demand for a given flight as the capacity to be managed increases) will result in selling a higher portion of capacity.

- Perhaps a simpler way of stating this is that seat management of larger blocks of seats is more efficient and leads to sale of a higher percentage of the seats.

- This point is not novel. It is thoroughly understood by airline managers and investors. It has been the subject of extensive analysis, fine tuning and implementation by operations researchers since the early 1970s.

2.5 Incentives to the cartel

Mr. Murray acknowledges that, as I pointed out, he gave unrealistic examples regarding incentives for the Applicants.

Thus any discussion as to whether cost reduction is the only variable available to rectify an unrealistic situation is also irrelevant.

2.6 Threat of new entry

Mr. Murray raises the issue as to whether my analysis is dependent on defining markets as being a city pair rather than the trans-Tasman in total.

- I have not addressed this issue, as my understanding from the 2003/2004 investigations is that the NZCC and QF/NZ agreed that the trans-Tasman geographic market, and not city pairs, were accepted as the relevant market. The NZCC stated that a regional approach to market definition was most appropriate.

- In any event, my empirical results using trans-Tasman data have indicated that the impact of LCC presence on trans-Tasman routes extends, in part, to routes not directly served, a finding consistent with the U.S. literature.

Addendum: Regressions with Unit Cost Variable Added

Following is a table comparing the results as reported in my Statement of 21 August 2006, with results including the unit cost variable. The results for Analysis A are shown. Note that the added variable (unit cost) has the correct sign, but is statistically insignificant. Similar results were obtained for Analysis B to D; i.e., the variable was not statistically significant.

Revised results for 'Analysis A'

	Con-stant	Time Trend	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Analysis A – As reported in Tretheway Statement of 21 August										
Coefficient	**171.384**	**0.219**	**-16.486**	**-19.338**	**-16.975**	**-24.303**	**-34.087**	**-11.391**	**-16.999**	**-11.967**
Standard Error	11.222	0.047	3.617	3.633	3.688	3.785	3.794	3.705	3.704	3.703
T-statistic	15.272	4.617	-4.558	-5.322	-4.603	-6.421	-8.985	-3.074	-4.590	-3.232
Analysis A – with unit cost variable										
Coefficient	**160.848**	**.194**	**-16.838**	**-20.157**	**-14.073**	**-21.830**	**-31.632**	**-8.932**	**-14.541**	**-9.483**
Standard Error	12.018	.051	3.874	3.869	3.880	3.896	3.909	3.817	3.818	3.819
T-statistic	13.384	3.832	-4.346	-5.210	-3.627	-5.603	-8.092	-2.340	-3.809	-2.483

Table cont. next page

	Oct	Nov	Dec	9/12 Year	Distance (one way km)	HHI	EKDJ Capacity 0-12.5%	EKDJ Capacity 12.5% - 25%	EKDJ Capacity 25+%	Unit Cost Cost per RPK (Aust cents)
Table cont.										
Analysis A – As reported in Tretheway Statement of 21 August										
Coefficient	**-13.571**	**-20.540**	**1.747**	**29.805**	**0.034**		**-32.474**	**-37.333**	**-49.454**	
Standard Error	3.678	3.680	3.679	2.256	0.005		3.804	3.039	2.906	
T-statistic	-3.690	-5.582	0.475	13.209	7.436		-8.536	-12.286	-17.019	
										R2 = .42, DW = .43
Analysis A – with unit cost variable										
Coefficient	**-11.113**	**-17.963**	**4.339**	**28.244**	**0.034**		**-32.119**	**-38.260**	**-49.634**	**57.690**
Standard Error	3.797	3.801	3.803	2.339	0.005		3.991	3.162	3.042	24.447
T-statistic	-2.927	-4.725	1.141	12.076	7.459		-8.047	-12.101	-16.318	2.360
										R2 = .44, DW = .45