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7 October 2009

By email

Dr Richard Chadwick
General Manager
Adjudication Branch
Australian Competition & Consumer Commission

Email richard.chadwick@accc.gov.au

[RESTRICTION OF PUBLICATION OF PART CLAIMED]

Dear Dr Chadwick

Virgin Blue Airlines Pty Ltd & Ors - applications for authorisation A91151-A91152 and A91172-A91173

We refer to your letter dated 30 September 2009 regarding applications for authorisation A91151-A91152 and A91172-A91173 (**Authorisation Application**). Your letter seeks clarification from the Applicants on several specific issues (**Information Request**) in relation to the proposed Joint Venture between Virgin Blue and Delta.

We attach the Applicant's responses to the questions asked in the Information Request.

Confidential information has been redacted in this version of the response. This version may therefore be placed the Commission's public register.

In respect of the information that is redacted throughout the document, the Applicants request that this information be excluded on the that basis that it is commercially confidential to the Applicants. The disclosure of this information would unreasonably and adversely affect the Applicants in respect of their lawful business, commercial and financial affairs.

Yours sincerely

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[REMOVED]

6 **[REMOVED]**

(b) Given the strong competition on the [LAX-SYD] route what opportunities are there to improve yields?

[REMOVED]

LAX-SYD is a dense, highly travelled and highly competitive route. However, Northwest's experience with KLM illustrates that carriers can develop successful Joint Venture networks even in extremely thin hub-to-hub markets. For example, Northwest currently operates four A330 wide body flights a day, offering 1,192 seats per day in the Detroit-Amsterdam market. **[REMOVED]** The overwhelming majority of passengers are travelling from points behind Detroit, to points beyond Amsterdam. If Northwest and KLM can operate 4 daily flights in the small Detroit-Amsterdam market, then Delta and V Australia can certainly operate two viable daily flights in the much larger LAX-SYD local market, notwithstanding strong competition on the local segment. The key to achieving this success is to jointly manage the network towards a common purpose to attract and benefit customers.

[REMOVED]

8 The Applicants noted at page 17 of their submission dated 9 July 2009, that redeployment of long range aircraft is particularly difficult for new carriers such as V Australia that do not have any established long-haul operation in other markets. Accordingly is it likely that an airline the size of Delta has greater opportunities than Virgin to redeploy aircraft currently deployed on the trans-Pacific route?

It is likely that Delta has greater opportunities than Virgin Blue to redeploy aircraft currently deployed on the trans-Pacific route. Due to its larger size and broader existing network, Delta would find it easier than V Australia to reallocate aircraft to other long-haul routes. Lacking existing alternative international routes, V Australia would need to incur additional start-up costs on additional new routes. Additionally, there are relatively few alternative long-haul routes available compared to the many in the US given its geographic position and population size.

Delta has deployed its newest flagship aircraft – the B777-200LR – to the LAX-SYD market. This aircraft is equipped with Delta's latest product improvements, including lie-flat seats, which are only beginning to appear elsewhere in its fleet. There are numerous other routes where these high value aircraft could be deployed elsewhere in Delta's system. Delta fully expects to maintain and realise the value of this investment in developing service to Australia, and approval of the Joint Venture is a key component to Delta's strategy for developing and maintaining the South Pacific service.

9 What is the extent of domestic network benefits accruing to Virgin Blue from V Australia's trans-Pacific operations?

Virgin Blue benefits from both inbound and outbound feed traffic between the Virgin Blue domestic network and V Australia trans-Pacific city-pairs. The additional volume provides a base of traffic for Virgin Blue on its domestic routes, supporting the frequency and capacity of its domestic network.

[REMOVED]

13 *Tables 1 and 2 below show that V Australia is a price leader in business and economy classes for direct flights to the mainland USA by a substantial margin in economy class and a reasonable margin in business class.*

In economy class, V Australia is the primary source of price competition with prices approximately a third lower than other direct carriers. Delta pricing by comparison is broadly consistent with the other legacy carriers on the route.

With the proposed Joint Venture providing for coordination of prices between Delta and V Australia is it more likely that agreed prices will move up towards the current Delta level or down towards the V Australia level? The Applicants' submission provides that the proposed Joint Venture would facilitate lower fares. What fare levels are the parties anticipating in the event the proposed Joint Venture is implemented?

It is inaccurate and potentially misleading to seek to identify one price leader in the market. The pattern of aggressive competition on these routes is such that where any one of the airlines operating on the route seeks, for its own commercial reasons, to reposition fare levels it is likely to be matched by the other airlines almost immediately.

Further, the approach taken in Tables 1 and 2 does not accurately reflect the pricing behaviour of air carriers on the trans-Pacific routes. By measuring the price offered on specific dates and averaging the result, the ACCC is measuring the lowest available fare at that moment in time rather than the lowest offered by each airline. This sampling methodology ignores the process of yield management and it is therefore inappropriate to conclude from this data that V Australia is a price leader in the trans-Pacific market.

Qantas, United, Delta and V Australia each offer broadly comparable pricing. On a given day Qantas fares may be higher than other carriers, which is a function of the higher demand for its service, resulting in its low fare and promotional seats selling out more quickly than V Australia. It is also a reflection of V Australia's position as a new entrant on the route, offering more promotional fares.

This contention is supported by Table 3, which shows substantially higher load factors on Qantas and United over the US-Australia routes. Where the cheapest fares available from Qantas and United are taken up, Webjet will thereafter show a higher minimum fare price. However, this does not mean that V Australia (with its lower load factor and corresponding larger level of unsold seats at the lower price points) is necessarily the price leader. Importantly, the ACCC's sample of Webjet fares does not indicate that there would be any adverse change to competitive pricing by V Australia and Delta under the Joint Venture.

Although all the fares are economy class, they represent a range of distinct types of fare (e.g. promotional vs. fully flexible) with different terms, conditions and limitations. Webjet does not display the type of fare until the completion of the booking process, so among the problems with the Webjet comparison is that it compares different types of fare without identifying their different fare conditions and restrictions. Comparing different types of fares results in the average price being distorted.

Please note that the data also does not fully support a conclusion that V Australia is the sole price leader. For example, Table 1 itself shows that Delta's coach fares in October are lower than V Australia's by more than A$100, and V Australia's and Delta's fares in January are virtually identical. Delta's and V Australia's published business fares are comparable.

Presented in the table below is a more appropriate indicator of pricing behaviour, being the minimum published promotional fares for each month. This produces very different results for the travel contemplated in the ACCC's pricing exercise. For example, Delta's minimum price for the travel specified in February 2010 was A$1,222 (slightly cheaper than V Australia). Using the Webjet sampling, Delta's February result is A$2,454 (which is A$1,164 more expensive than the V Australia result). This price differential represents yield management and prior bookings on the specific travel dates rather than broader pricing behaviour in the market.

The following tables present the lowest published promotional fares on the SYD-LAX route for the months detailed in the ACCC's sampling exercise.

Table A: Lowest published economy class air fares on SYD-LAX route for next 6 months

Lowest published economy class return fare for travel in each month				
Departure month	**V Australia**	**Delta**	**United**	**Qantas**
Oct 2009	A$1,122	A$1,117	A$1,117	A$1,282
Nov 2009	A$1,122	A$1,117	A$1,117	A$1,282
Dec 2009	A$1,276	A$1,117	A$1,117	A$1,282
Jan 2010	A$1,126	A$1,222	A$1,222	A$1,432
Feb 2010	A$1,276	A$1,222	A$1,222	A$1,432
Average[1]	**A$1,184**	**A$1,159**	**A$1,159**	**A$1,342**

Source: GDS/Virgin Blue

Table B: Lowest published business class air fares on SYD-LAX route for next 6 months

Lowest published return fare for travel in each month[2]			
Departure month	**V Australia**	**Delta**	**United**
Oct 2009	$6,326	$6,321	$6,321
Nov 2009	$6,326	$6,321	$6,321
Dec 2009	$6,590	$6,321	$6,321
Jan 2010	$6,590	$6,585	$6,585
Feb 2010	$6,590	$6,585	$6,585
Mar 2010	$6,590	$6,585	$6,585
Average	**$6,502**[3]	**$6,453**	**$6,453**

Source: GDS/Virgin Blue

[1] Figures for March 2010 have not been provided because Delta, United and Qantas have not yet released published promotional fares for dates beyond February 2010.

[2] It is not feasible to replicate this pricing exercise with Qantas business fares, because Qantas does not provide published promotional fares through the GDS in the same way that it does for economy class fares.

[3] V Australia notes that these minimum published fares are above those offered by Webjet. This apparently reflects Webjet's independent decision to cut into its commission in order to sell V Australia seats.

These figures indicate that V Australia, Delta and United have comparable pricing strategies rather than V Australia being a price leader as suggested by the ACCC.

Furthermore, a substantial portion of business fares are sold on the basis of corporate contracts **[REMOVED]** which are not captured or reflected in the WebJet retail snapshot. Intense competition exists and will continue to exist in all segments of the market.

V Australia and Delta are both new entrants and have offered deeply discounted promotional fares in order to attract new business. These discounts have been exacerbated by economic conditions. As acknowledged by the ACCC, it is unrealistic to expect either carrier to price and operate services at levels that are not self-sustaining indefinitely.

By joining their networks together, Delta and V Australia will be competing against other networks in thousands of additional online city-pairs. This provides the opportunity to attract additional customers, increase load factors, and attract greater numbers of premium passengers – all of which will contribute materially to the Joint Venture's bottom line.

There is no basis for a conclusion that V Australia will offer higher prices under the Joint Venture than it would otherwise. The fundamental driver of fare levels, under yield management systems, is capacity and demand. Under the Joint Venture, the joint venture parties are likely to maintain higher overall capacity on trans-Pacific routes, and bring on more capacity, new routes and new schedules earlier than under any counterfactual.

[REMOVED]

The parties do not propose to discuss future pricing strategies at this time in the absence of immunity from US and Australian antitrust laws. However, it would be unrealistic to assume the deeply discounted start-up and promotional fares under recessionary conditions as the baseline for comparison. The US-Australia marketplace is highly competitive and the open-entry provisions of the open skies agreement ensure that there is no potential for the Applicants to raise fares above competitive levels. The success of the Joint Venture lies in creating new revenue streams through a better and more attractive joint network, not in raising fares on the trans-Pacific routes.

[REMOVED]

15 *In their submission of 9 July 2009, the Applicants have stated that alliances such as theirs enable carriers to offer lower fares overall as a result of the absence of double marginalisation incentives. In support they cite a study by J K Bruckner which shows that the elimination of double marginalisation has led to fare decreases of approximately 16%.*

The Bruckner study was restricted to examining the benefits of code sharing over normal interlining on sequential routes, i.e. where the code share parties did not operate flights in parallel in competition with each other. The study did not extend to parallel code shares. However it did note that where alliance partners provide overlapping services cooperation may result in collusive behaviour and higher rather than lower fares.

Importantly the Bruckner study suggests that V Australia and Delta would incur substantial savings from their Limited Code Share proposal over normal interlining arrangements.

Why would code-sharing under the integrated alliance lead to the capture of a higher share of beyond passengers than under the Limited Code Share?

An integrated alliance will lead to substantially greater capture of beyond/behind passengers for three reasons.

First, the Applicants will be incentivised to develop broad, full-network codesharing. **[REMOVED]** The greater range of points will capture a greater number of passengers.

Second, and more importantly, is the way the Applicants will manage the network. Under a Joint Venture arrangement, Delta will treat V Australia's network as its own – optimising the full range of available fares, inventory, and schedules to create the most attractive product offering for consumers. Again, the experience of Northwest/KLM is illustrative. The carriers initially tried cooperating under an arms-length blocked space agreement. Because each partner was competing against the other, KLM guarded high value inventory and connections beyond Amsterdam for its own advantage, and Northwest did the same at its US hubs. It was only through the Joint Venture and establishment of a common bottom line that the carriers were able to create a single, comprehensive and effective network. The explosive growth of Northwest/KLM hub-to-hub flying and increased capacity relative to non-Joint Venture, arms-length codeshares is testimony to this.

Third, customers purchasing a ticket on an integrated Joint Venture carrier have an enhanced expectation and understanding that they are purchasing an equivalent product. Customers have come to know "Northwest/KLM" as a common brand. A customer purchasing a less-integrated arms-length codeshare partner might have some doubts as to the level of integration, convenience of check in, common terminals, and luggage transfer (e.g., an American Airlines customer purchasing a ticket on China Eastern).

16 To what extent do LCCs in the USA such as Southwest compete for beyond traffic?

Given international passengers strong preference for online service, the strongest competition for beyond traffic in the United States is from the existing alliances on the route – United/Air New Zealand and Qantas/American Airlines.

While LCCs such as Southwest and JetBlue do provide services for beyond traffic in the US market, many LCCs, including Southwest, lack interline capability. Using LCCs separately for beyond travel is therefore inconvenient and requires more effort for travellers than online service (e.g., due to the need to claim and recheck baggage). In addition, using separate carriers exposes passengers to risk in the event of delay on one leg leading to missed connections.

Although the LCCs operating in the US offer passengers the ability to purchase their beyond journey separately, the inconvenience and risk attached to this method will tend to discourage passengers who are not highly price-conscious.

For business or premium travellers, where FFPs, total flight-time, lounge access and convenient scheduling are more important, LCCs are unlikely to be a suitable alternative. Business or premium travellers are also more likely to make arrangements through a travel agent.

[REMOVED]