Partner Luke Woodward
Contact Alastair Corrigall
T +61 2 9263 4170
acorrigall@gtlaw.com.au
Our ref LXW:AXC:1006827
Your ref C2009/1316

GILBERT + TOBIN

LAWYERS

Gilbert + Tobin

2 Park Street
Sydney NSW 2000
Australia

GPO Box 3810
Sydney NSW 2001

T +61 2 9263 4000
F +61 2 9263 4111

DX 10348 SSE

www.gtlaw.com.au

16 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

Thank you for the opportunity to meet with you in relation to the authorisation applications listed above.

There were certain issues raised in the meeting on 9 October 2009 (and in a subsequent information request from the Commission dated 13 October 2009) which we respond to in this letter.

Delta and Virgin Blue (the Applicants) would also like to briefly reiterate the key elements of the authorisation case.

- Firstly, the Joint Venture will not result in any lessening of competition in trans-Pacific aviation markets (passenger or freight). The Joint Venture between the number 3 and 4 carriers in the market will not in any way lessen competition, but rather will strengthen the competitive offering of the Applicants. The Joint Venture provides the capacity to enhance services on existing trans-Pacific routes (particularly Brisbane and Melbourne), to enter onto other trans-Pacific routes in competition with Qantas and United Airlines and to develop new trans-Pacific services.

  The Joint Venture results in direct public benefits through cost savings available through the Joint Venture. Robust competition in the direct trans-Pacific markets under the Australian/US Open Skies policy and the Applicants' lack of market power ensure that cost reductions will be passed through for the benefit of customers.

- More fundamentally, by facilitating enhanced cooperation between the Applicants and integration of the Applicants' domestic networks with the Joint Venture's trans-Pacific routes, the Joint Venture will increase overall passenger levels (and improve the fare mix) on the Applicants' flights. This strong and consistent conclusion is based on commercial experience from other airline alliances. This result is also supported by the consistent empirical and regulatory findings that airline alliances lead to improved services and lower fares in competitive markets. It is the increase in passenger levels (and improved fare mix) that will enable the Applicants to extend services on existing trans-Pacific routes (particularly Brisbane and Melbourne) and to introduce new trans-Pacific services. It is the enhanced services that will be possible under the Joint Venture that are the core public benefit of the Joint Venture.

- Access to a strong US domestic network and distribution capability is critical to V Australia's success, because at least 60% of trans-Pacific traffic is beyond/behind LA. Currently, V Australia captures only a small proportion of beyond/behind LA traffic. This impacts both its loads and its fare mix. **[REMOVED]**
- Finally, under an integrated codeshare supported by the Joint Venture, both parties will have an incentive to route passengers via the most direct trans-Pacific routes irrespective of which airline is the operator of the route. As outlined in the meeting, a passenger flying from Los Angeles to Brisbane on Delta under a limited codeshare would be routed through Sydney to maximise Delta's revenue. With the Joint Venture, Delta is incentivised to put the passenger on V Australia's direct service to Brisbane, simultaneously providing a better product for that passenger and improving loads on the BNE-LAX route. The improved load factor facilitated by the Joint Venture will create opportunities for expanding the direct trans-Pacific services offered.

We set out below a response to a number of specific issues arising from the meeting with the Commission and its subsequent information request.

1.1 Costs

[REMOVED]

More importantly, the Joint Venture will have no adverse impact on the cost of operations on the trans-Pacific routes and will in fact result in cost savings. Nor is there any basis to conclude that there would be an adverse effect on fare levels that would arise from a different cost profile between the Joint Venture parties. The Joint Venture parties have an overriding objective to enhance (not undermine) their combined competitive position on the trans-Pacific routes.

1.2 Codesharing

In the email of 13 October 2009, the Commission also asked specific questions concerning the operation of codesharing under the Joint Venture arrangements. These questions and the Applicants' responses are listed below.

(a) *For trans Pacific gateway to gateway ticket sales (with no behind/beyond travel) can Delta and V Australia each sell tickets with their own code designation on each other flights?*

Yes.

(b) *Can V Australia sell a passenger a ticket for travel from Sydney to points beyond Los Angeles where V Australia is the transpacific carrier with the V Australia code on all flight sectors?*

Yes

(c) *Can V Australia sell a passenger a ticket for travel from Sydney to points beyond Los Angeles where Delta is the transpacific carrier with the V Australia code on all flight sectors?*

Yes

(d) *If the V Australia code cannot be used on sectors beyond Los Angeles is it the case that the only ticket that can issued by either airline for travel from Sydney to points beyond Los Angeles with a single airline code on it is a Delta ticket?*

Not applicable, since the V Australia code can be used on sectors beyond Los Angeles

(e) *If the V Australia code can be used on Delta flights beyond Los Angeles what code will appear on flights beyond Los Angeles operated by other carriers under codeshare arrangements with Delta?*

The V Australia code can be used on Delta flights beyond Los Angeles. To codeshare on other carriers, V Australia would need to have a separate codeshare agreement with each carrier (i.e., it is unable to put a VA code on a DL codeshare).

The Applicants note, however, that the Joint Venture routes identified in the Supporting Submission do not require codesharing with other carriers. These routes were :

[REMOVED]

1.3 Fare reductions under integrated airline alliances

In the meeting Mr Woodbridge questioned the conclusion that fare levels are likely to be lower (in competitive markets) under an integrated airline alliance. Please note that this is a consistent conclusion of the academic and regulatory reports we have referred to in submissions and a more recent report[1]. The effect is referred to as the removal of a double marginalisation[2]. Mr Woodbridge questioned whether V Australia marked up fares over the codeshare cost to it. We note that airfares set under a yield management system (by V Australia or any other airline) are not based on the particular cost of a particular ticket or a particular margin applied to a particular ticket. However, the codeshare ticket cost is a cost to V Australia and overall it seeks to obtain a return (i.e., a margin) above its costs. Please also note that the conclusions in the various reports cited do not depend on the application of a specific margin that is added to a particular ticket.

[REMOVED]

1.4 One-way sector airfares

During the meeting, the Commission questioned whether airfares are no longer presented and calculated as return fares, but rather as one-way sector fares (i.e., that a trans-Pacific airfare might more accurately be described as two flights of SYD-LAX and LAX-SYD, rather than SYD-LAX return).

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[1] B Keating, M Israel and R Willig, M Israel, 'Competitive Effects of Airline Antitrust Immunity' (2009) US DOT-OST-2008-0252

[2] The term "double marginalisation" is the term used by Brueckner to describe a general price outcome of noncooperative interline pricing. Brueckner described interline fare determination without an alliance as the airlines setting fares through a process of strategic interaction. In such a model, each airline chooses a 'subfare' for its portion of the trip and the sum of the resulting subfares gives the total fare. From this conclusion, Brueckner noted that:

> *With noncooperative behaviour, each carrier would ignore the negative impact on the other airline's profit from raising its own subfare. By contrast, when the carriers are alliance partners operating under antitrust immunity, they would set the overall fare in cooperative fashion, focusing on joint profit. In effect, the carriers would internalize the negative externalities from the two subfare decisions, taking into account the impact on one another's profits. The result is a lower fare and higher traffic in the relevant city-pair market. An alliance thus eliminates a particular form of 'double marginalization…*

Although search engines such as Webjet present one-way sector fares for international flights, this is a function of the search engine's display mechanism[3]. A passenger may not be able to get the same fare for a forward or the return journey when only purchasing a ticket on a standalone one way basis.

This issue was raised in the context of the ability of customers to construct their flight itinerary using sectors from a number of different carriers. The overwhelming commercial experience is that customers prefer the convenience and security of single-ticket service. This is particularly true for long-haul or interconnecting flights, where using multiple carriers is markedly inconvenient. The number of travellers building their own itinerary using multiple carriers for trans-Pacific travel is not commercially significant.

1.5 Webjet price comparison

We note that the Commission undertook a price comparison based on Webjet prices to test whether V Australia is the price leader on the trans-Pacific route. We reiterate the concern that no such conclusion can be drawn from the Webjet analysis. We also note that even if this conclusion were substantiated, it is not possible to draw a conclusion that V Australia will cease to be the price leader on the trans-Pacific route under the Joint Venture, or to draw any conclusion that the Joint Venture may result in higher fares.

The only plausible conclusion as to the impact of the Joint Venture on future fares is that it will lead to lower fares as there will be enhanced capacity on the route. Further, we note that V Australia is expected to be responsible for pricing and marketing Joint Venture services out of Australia and hence will continue to provide competitive pricing on the route. There is also no basis to suggest that either V Australia or Delta, as the most recent and smallest operators on the trans-Pacific route, have individually or combined through the Joint Venture any pricing power.

We also note that the results obtained by the ACCC from its one day review of fares on the trans-Pacific route are not necessarily replicated at other times. We enclose as Annexure 2 a more recent Webjet fare comparison.

1.6 Confidentiality

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.

If the ACCC would like any further information or clarification on any of the issues raised in this letter, please feel free to contact us.

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[3] This is made clear by an '*' next to international fares, which notes that the price is a return fare that has been halved for display purposes. Selecting an outgoing flight brings up a message explaining that both flights must be from the same airline.

GILBERT + TOBIN

LAWYERS

Yours sincerely

Luke Woodward
Partner
T +61 2 9263 4014
lwoodward@gtlaw.com.au

Alastair Corrigall
Graduate
T +61 2 9263 4170
acorrigall@gtlaw.com.au

Annexure 1: [REMOVED]

Annexure 2: Webjet price comparison

The Applicants continue to believe that searching Webjet using randomly-selected dates and averaging the results is not an appropriate mechanism for determining the prices available in the marketplace. Because of the sophisticated yield management mechanisms used by modern air carriers, such searches do not demonstrate wider pricing strategies or behaviours. Instead, they return incomplete results that elide the considerable range of factors that influence and inform the dynamic pricing behaviour of air carriers.

As a direct illustration of the Applicant's contention that yield management produces potentially misleading responses from averaging Webjet search results, the Applicants have re-examined the price comparison provided by the Commission in its letter of 30 September 2009. The Commission provided the following table of economy class fares:

Table 1: Lowest SYD/LAX economy class air fares over 6 months, at 23 September 2009

Lowest return fare available from Webjet on 23 September 2009 for travel on the 23rd of the month indicated with return 8 days later					
Departure month	**V Australia**	**Delta**	**United**	**Qantas**	**Cheapest other**
Oct 2009	$ 1,236	$ 1,118	$ 1,382	$ 1,680	$ 1,382
Nov 2009	$ 1,136	$ 1,692	$ 2,528	$ 1,680	$ 1,382
Dec 2009	$ 1,770	$ 2,622	$ 2,622	$ 2,656	$ 2,408
Jan 2010	$ 1,222	$ 1,264	$ 2,116	$ 1,608	$ 1,382
Feb 2010	$ 1,290	$ 2,454	$ 1,488	$ 1,456	$ 1,382
Mar 2010	$ 1,364	$ 2,266	$ 2,266	$ 2,300	$ 1,382
Average	**$ 1,336**	**$ 1,903**	**$ 2,067**	**$ 1,897**	**$ 1,553**

The interpretation of this data was:

> *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.*

However, this conclusion cannot be sustained by averaging prospective Webjet bookings. Using the same inputs (lowest return fare available from Webjet for travel on the 23rd of the month indicated with return 8 days later) at a later date returns an entirely different result, as illustrated in the table below:

Table 2: Lowest SYD/LAX economy class air fares over 6 months, at 12 October 2009

Lowest return fare available from Webjet on 12 October 2009 for travel on the 23rd of the month indicated with return 8 days later					
Departure month	**V Australia**	**Delta**	**United**	**Qantas**	**Cheapest other**
Oct 2009	$ 1,640	$ 2,050	$ 1,124	$ 1,680	$ 1,490
Nov 2009	$ 1,398	*Not displayed*	$ 1,248	$ 1,498	$ 2,016
Dec 2009	$ 1,896	$ 2,622	$ 2,622	$ 2,656	$ 2,408
Jan 2010	$ 1,140	$ 1,222	$ 1,278	$ 1,756	$ 1,490
Feb 2010	$ 1,270	*Not displayed*	$ 1,122	$ 1,664	$ 1,490
Mar 2010	$ 1,388	$ 2,266	$ 1,122	$ 2,300	$ 1,582
Average	**$ 1,455**	**$ 1,632**	**$ 1,419**	**$ 1,926**	**$ 1,746**

If the Commission had checked on this date instead of 23 September 2009, it would have arrived at an entirely different conclusion on pricing behaviour. United now has the lowest average price, with Qantas pricing significant higher than all other carriers.

It is inappropriate to use either set of results to draw wider conclusions about pricing behaviour, however.

The difference between the two tables demonstrates the significant effect of yield management, which alters the displayed pricing through a complex functional relationship between present load factors, flight scheduling and historical knowledge of load projections. Webjet does not present a reliable aggregation of available fares, but rather illustrates pinpoint price availability and is therefore highly unlikely to present a complete or accurate overall picture.

The impact of yield management over this brief 3 week period is summarised on the table below.

Table 3: Dollar change in Webjet fares for each date, between 23 September and 12 October

Dollar difference between fares available from Webjet on 23 September 2009 and fares available from Webjet on 12 October 2009 for specified travel (23rd of the month indicated, return 8 days later)					
Departure month	**V Australia**	**Delta**	**United**	**Qantas**	**Cheapest other**
Oct 2009	+$404	+$932	-$258	+$0	+$108
Nov 2009	+$262	N/A	-$1,280	-$182	+$634
Dec 2009	+$126	+$0	+0	+$0	+$0
Jan 2010	-$82	-$42	-$838	+$148	+$108
Feb 2010	-$20	N/A	-$366	+$208	+$108
Mar 2010	+$24	+$0	-$1,144	+$0	+$200

This change over time represents yield management. It does not demonstrate that United, Qantas or Delta) have lowered their prices in response to the continuing availability of V Australia's cheap fares Nor does it demonstrate which (if any) carrier is the price leader. This point can be illustrated by repeating the exercise with different travel dates, which produces a broad range of results that could be construed to support various different hypotheses regarding pricing behaviour.

For example, repeating the Commission's Webjet sampling exercise using the 19th of each month as the starting travel date produced the following dataset as at 12 October 2009:

Table 4: Lowest SYD/LAX economy class air fares over 6 months, at 12 October 2009

Lowest return fare available from Webjet on 12 October 2009 for travel on the 19th of the month indicated with return 8 days later				
Departure month	**V Australia**	**Delta**	**United**	**Qantas**
Oct 2009	$ 1,890	$ 1,118	$ 1,124	$ 1,680
Nov 2009	$ 1,236	$ 1,818	$ 1,248	$ 1,494
Dec 2009	$ 2,134	$ 3,130	$ 2,622	$ 2,868
Jan 2010	$ 1,764	$ 1,886	$ 1,128	$ 1,606
Feb 2010	$ 1,140	*Not displayed*	$ 1,122	$ 1,456
Mar 2010	$ 1,388	$ 2,266	$ 1,122	$ 2,300
Average	**$ 1,592**	**$ 2,044**	**$ 1,394**	**$ 1,901**

This result appears to represent an entirely different pricing dynamic amongst the direct carriers. United has the lowest prices on these dates, with Delta and Qantas being substantially more expensive. The difference between the results in the various scenarios presented above, based on searches for arbitrary travel dates, illustrates the Applicants' argument that drawing wider conclusions from Webjet sampling is unsound.

The examples above demonstrate that Webjet searches produce outputs that hide the complexities of yield management and promotional offerings. They are therefore unable to produce accurate and representative evidence in respect of trans-Pacific pricing by air carriers.

To the extent that the Commission wishes to draw conclusions about pricing from the Webjet sampling data, it should conclude that V Australia is an effective competitor and will continue to be so if the Joint Venture is authorised. The Joint Venture will enable the Applicants to compete across a wider range of city-pairs and strengthen their ability both to compete on existing trans-Pacific trunk routes and to introduce additional direct trans-Pacific services.

To the extent that price comparison is necessary, however, the Applicants continue to believe that the most accurate measure of pricing behaviour is the lowest published fares as outlined in the Applicants' letter of 7 October 2009.