Australian Government

International Air Services Commission

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Dear Dr Chadwick

VIRGIN BLUE GROUP AND DELTA AIRLINES – APPLICATIONS FOR AUTHORISATION A91151 AND A91152

Thank you for your letter of 16 July 2009 inviting comments on the application for authorisation from Virgin Blue and Delta Airlines concerning the co-ordination and agreement between the two carriers in respect of Trans-Pacific routes. The International Air Services Commission (IASC) welcomes the invitation to comment. Before turning to the specifics of the application, I thought it would be useful to outline the IASC's own processes in the event of any subsequent application from the Virgin Blue Group to the IASC to enter into joint services arrangements with Delta.

As you may know, Australian carriers cannot use capacity allocated by the IASC in joint services without approval from the IASC. The IASC considers joint services applications in accordance with the *International Air Services Commission Act 1992* and the public benefit criteria set out in the Minister's Policy Statement. The latest Policy Statement, issued in May 2004, includes the Minister's expectation that the IASC would generally approve applications to code share consistent with opportunities available under the relevant air services arrangements. However, where the IASC has serious concerns that a code share or other joint service proposal may not be of benefit to the public, it may subject the proposal to detailed evaluation and must consult with the ACCC before doing so. The relevant assessment criteria also require the IASC to take account of any relevant determinations or decisions made by the ACCC.

The IASC would therefore take careful account of the ACCC's assessment of the arrangements sought by Virgin Blue and Delta Airlines in considering any application to the IASC to use allocated capacity in joint services. The IASC has done so in previous cases in similar circumstances. In those cases, the IASC has approved airline applications on terms consistent with those of ACCC authorisations and the IASC approval has been contingent on continuing ACCC authorisation. Nevertheless, the requirement for the IASC to consider applications in terms of the public benefit criteria contained within its Act mean that the IASC's conclusions in those previous cases involving ACCC authorisations cannot be taken to infer a particular outcome in respect of any future application by the Virgin Group to operate joint services on the Trans-Pacific route.

The IASC does not anticipate receiving an application from the Virgin Blue Group for joint services approval until after the ACCC has made a decision about the airlines' current applications to the ACCC. I will contact you in the event such an application is made.

Turning to the applications currently before the ACCC, the IASC's approach in submissions to previous ACCC cases involving aviation authorisation applications has been to not comment on the merits of authorisation of particular proposals. In this case, the IASC again does not propose to argue in support of or against authorisation. However, it wishes to convey some observations about the proposed arrangements which the ACCC might like to take account of in its deliberations.

As you would be aware, the aviation industry has been operating in some of the most difficult economic circumstances for many decades. Demand for air services has fallen and airline yields are also down. In June 2009, the International Air Transport Association (IATA) revised its financial forecast for airline losses worldwide to US$9 billion. This nearly doubled IATA's forecast of losses from its March 2009 assessment. Revenues were forecast to decline by 15 per cent. In more recent months, the Influenza A(H1N1) virus outbreak has contributed to continued weak demand for air services, and oil costs are beginning to rise, adding to airline costs.[1] A number of airlines around the world have failed throughout the economic downturn, including some smaller Australian carriers.

V Australia entered the United States route, its first, in February 2009 in the midst of this protracted economic downturn. These were and are difficult circumstances for a new entrant carrier with well-established incumbent carriers on the route. The IASC notes that estimated trading losses for V Australia to 30 June 2009, reported by Virgin Blue Holdings Limited to the Australian Stock Exchange, were $30-35 million. This was in addition to pre-operational and foreign exchange costs of $60-65 million.[2]

V Australia's entry appears to have stimulated very competitive air fares on the United States route, as well as bringing consumers a welcome additional choice of carrier. However, both V Australia and the incumbent carriers have presumably been responding not only to the more competitive environment associated with V Australia's entry, but also in part to the weaker demand for air services generally as a result of the protracted economic downturn. Delta's recent entry to the route has further intensified competitive pressures in difficult economic circumstances.

While it appears that there are substantial gains from the additional competition so far, these gains are likely to be sustained only so long as the new entrants maintain a presence in the market. As you would know, the United States route is the only one which V Australia currently serves. While that carrier has a capacity allocation from the IASC to service the South Africa route, it has not commenced services. Operations only on the United States route mean that V Australia is unable, at this stage at least, to spread fixed costs across a broader network, and to perhaps achieve better margins from other routes than might currently be the case on the United States route. Should V Australia be unable

[1] "Loss forecast increases to US$9 billion". IATA Press Releases and Briefs. No. 24 of 8 June 2009. http://www.iata.org/pressroom/pr/2009-06-08-01.htm

[2] "Equity raising and trading update". Virgin Blue ASX/Media release. 27 July 2009. http://www.asx.com.au/asxpdf/20090727/pdf/31jqvyqwsg4x1x.pdf

to develop or even sustain operations on the United States route because of the weak economic environment, there could be a loss of future public benefits compared with its continued presence. For Australia, public benefit losses could extend beyond the United States route, if V Australia is unable to enter new routes or has to defer planned entry to new routes because of poor financial results on the United States route. As you know, V Australia is the first new long-haul Australian carrier since the collapse of Ansett in 2001, leaving aside Jetstar, the Qantas wholly-owned subsidiary.

By contrast, for Delta, a large United States carrier, the Australia – United States route is only one small part of its extensive global operations. Should Delta not continue on the route or maintain a limited presence, there could be a loss of public benefits, but this may not have such broad implications for public benefits to Australia.

The IASC notes that the incumbent carriers, Qantas and United, are well established, with Qantas in particular operating the major share of capacity on the route. This provides it with substantial competitive power with a large frequency advantage, supported by strong behind gateway services through its extensive Australian domestic network and arrangements with American Airlines in the United States.

The Commissioners note the extensive behind-gateway networks which V Australia and Delta would gain access to as part of the proposed arrangements. These would be important to achieving competitive access to traffic originating from or destined for behind-gateway points. However, the Commission notes that this access could be achieved independently of other aspect of the arrangements planned by the applicants.

The arrangements proposed in the application to the ACCC are far reaching and involve extensive co-operation including price and revenue management. On the face of it, the arrangements seem to have potential to result in some weakening of competition compared with the current situation on the route, although the IASC notes the applicants argue the arrangements will strengthen their competitive presence and public benefits will be generated such as through the ability to co-ordinate scheduling and develop new sectors which might not otherwise be possible operating independently. The assessment of the likely counterfactual scenarios over a period of time will clearly be of great importance in the evaluation process. These are of course matters for the ACCC to assess.

Should you have any queries, my email address is michael.bird@infrastructure.gov.au. My phone number is 02 6267 1107.

Yours sincerely

Michael Bird

Michael Bird
Executive Director

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