Australian Government

Department of Infrastructure, Transport,
Regional Development and Local Government

File Reference: 10/7423

Mr Darrell Channing
Director
Adjudication Branch
Australian Competition and Consumer Commission
GPO Box 3131
CANBERRA ACT 2601

Dear Mr Channing

Virgin Blue Airlines Pty Ltd and Air New Zealand Limited applications for authorisation A91127 & A91128

Thank you for your letter of 12 May 2010. The Department of Infrastructure, Transport, Regional Development and Local Government (the Department) welcomes the opportunity to provide a submission to the ACCC on the proposed joint venture between Virgin Blue Airlines Pty Ltd, Pacific Blue Airlines (Australia) Pty Ltd, Pacific Blue Airlines (NZ) Limited (together Virgin Blue) and Air New Zealand Limited (Air New Zealand).

The Department recognises that it is a matter for the ACCC to determine the relative merits of arguments presented by the applicants on the public benefits and the effect on competition of the proposed alliance. However, to assist the ACCC in coming to a determination, this submission will provide contextual information on the relevant aviation market, the air service arrangements which underpin it and the Australian Government's aviation policy.

Regulatory framework and Australian Government policy

The regulatory framework governing international air services is complex. While most sectors of international trade operate on the assumption that markets are open unless governments intervene to restrict access, international aviation cannot occur unless governments act to open the market. This action occurs in the form of at least two governments negotiating and signing an air services agreement, specifying that international air travel can occur between their respective territories. Air services are contrary to most other internationally traded products, as without the cooperation of at least two governments, the product cannot be traded and the market would not exist.

As you would be aware, the Department is responsible for negotiating air services agreements with foreign governments. These bilateral agreements typically set out the number of flights that airlines of the two countries can operate, cities they can serve in the other country and rights to operate via or beyond to third countries. The agreements typically also include provisions related to such matters as airline ownership and control, competition law, safety and security.

The International Air Services Commission is responsible for allocating the available capacity negotiated under air services agreements to the Australian airlines that apply to operate internationally.

The Australian Government released the National Aviation Policy White Paper (the White Paper) on 16 December 2009. In the White Paper, the Government outlined its commitment to pursuing the liberalisation of international aviation to benefit consumers, broader Australian industry and provide Australia's airlines with the opportunity to compete effectively with their global rivals. The White Paper also stresses the importance of ensuring a strong Australian-based aviation industry.

Current state of international aviation

In terms of international markets served from Australia for 2009, New Zealand was Australia's largest origin/destination market with a total of 4.3 million passenger movements, an increase of 5.8 per cent from the previous year. Other markets in the top five were the United Kingdom, USA, China and Indonesia.

According to the International Air Transport Association's (IATA) January 2010 airline industry financial forecast, the aviation industry lost an estimated US$49.1 billion between 2000 and 2009. 2009 recorded the post-war worst decline in history, with passenger demand falling 3.5 per cent, freight demand falling 10.1 per cent and industry-wide losses of US$11 billion.

While airlines in most regions posted losses in 2009, the Asia-Pacific region posted the most substantial at US$3.4 billion. Passenger demand fell 5.6 per cent over the same period. IATA estimates a profit of US$2.2 billion in 2010 for airlines in the Asia-Pacific.

Air services arrangements between Australia and New Zealand

The Australia/New Zealand air services market is one of the most open in the world. The *Agreement between the Government of Australia and the Government of New Zealand relating to Air Services*, done at Auckland on 8 August 2002, [2003] ATS 18 (the Agreement) has no restrictions on capacity, frequency or routes that airlines of either country can operate to, within or beyond the two countries.

The Agreement provides for eligible airlines to be authorised as Single Aviation Market (SAM) airlines. A SAM airline is defined in Article 2 (4) as being at least 50 per cent owned and effectively controlled by either Australian or New Zealand nationals or both; at least two-thirds of the board are Australian or New Zealand nationals, including the Chairperson; and its head office and operational base are in either Australia or New Zealand. Pacific Blue (NZ) for example, is a wholly-owned subsidiary of Virgin Blue Holdings Limited, an Australian company. However, Pacific Blue (NZ) meets the SAM ownership and control requirements as it is substantially owned and effectively controlled by nationals of Australia and/or New Zealand.

Australian and New Zealand airlines can also continue to be designated under the Agreement using the incorporation and principal place of business criteria, consistent with more common air services arrangements.

In conjunction with SAM arrangements the mutual recognition of safety and operational regulatory approvals streamlines airlines' flying within the SAM.

Article 13 of the Agreement provides for eighth-freedom rights to airlines that are authorised as SAM airlines, allowing them to operate both international services between, and domestic services within either country.

Article 2 (3) specifies that there is no limit on the number of SAM airlines of either country that can operate services linking any city pair combinations within and directly between the two countries. Airlines are able to operate passenger and/or freight services as they decide.

The Agreement is relevant only to New Zealand and Australian carriers. It does not provide automatic access to the Australia-New Zealand market for any third-country airline that operates to either Australia or New Zealand. This would depend on the air services agreements between each of Australia and NZ and the relevant third-country.

Article 12 of the Agreement sets out the commercial opportunities available to airlines under the agreement, including the scope for code-sharing. Airlines carrying on services by way of code-sharing must adhere to any rules, regulations or procedures established by the relevant authorities regarding disclosure of code-shared services. The SAM agreement envisages co-operation between airlines, subject to competition concerns.

The proposed alliance between Virgin Blue and Air New Zealand is therefore consistent with the opportunities granted to airlines under Article 12, subject to compliance with the respective competition laws applying in each country. In Australia's context this means the competition framework administered by the ACCC.

Status of the market

The deregulated nature of the SAM means there are no economic regulatory barriers for new market entrants from either Australia or New Zealand. There are similarly no barriers for existing market participants to add or change services; airlines can make air services decisions based solely on commercial considerations. The SAM has also provided New Zealand airlines with the ability to operate services in the Australian domestic market, subject to safety considerations.

In addition to the access afforded to New Zealand carriers, the airlines of over 30 countries currently have rights to commence direct Australia-New Zealand services under bilateral air services arrangements between Australia and the respective country; albeit with the restriction that the flight must originate from its home country. Their entitlements under agreements with New Zealand may impact on these countries' ability to exercise these rights.

Details of third-country access to the Australia-New Zealand market have been provided in a confidential document at Attachment A.

These separate air services agreements with third countries have, over the years, seen multiple entrants into the Australia-New Zealand market. Currently three third-country airlines operate in the market: Emirates, LAN Airlines and Aerolineas Argentinas.

The applicants' submission refers to the domestic Australian market, in particular to Tiger Airways. We consider it would be useful to provide some background and context to this discussion.

Changes to domestic law in 1999 removed industry-specific foreign ownership restrictions on domestic airlines, subject to meeting Foreign Investment Review Board national interest guidelines. This saw Virgin Blue initially enter the market as a majority foreign-owned domestic airline and more recently in 2007, Tiger Airways Australia Pty Ltd.

Tiger Airways Australia, as a 100 per cent foreign owned company, does not meet Australian requirements for the issue of an International Airline Licence which would permit it to operate scheduled international air services. The *Air Navigation Act 1920* effectively provides for foreign ownership of up to 49 per cent of Australian international airlines.

Tiger Airways Singapore Pte Ltd is a Singaporean designated international airline that currently operates to Australia. It would be able to operate from Singapore via any intermediate points (except points in the United States) to any points in Australia and beyond Australia to points in New Zealand. Tiger Airways Singapore does not have seventh freedom rights to operate stand-alone services between Australia and New Zealand. Obviously, it is a commercial decision for any particular carrier to determine whether or not it will introduce services into the market, and for the government of Singapore to allocate Singaporean aviation capacity to that carrier.

In negotiating air services capacity with foreign governments, the Australian Government considers the four gateway destinations (Sydney, Melbourne, Brisbane and Perth) separately from the other Australian destinations. The gateway destinations are considered the more commercially attractive and are treated accordingly. Unrestricted capacity to the other Australian destinations is generally offered on a reciprocal basis under the Regional Package.

In discussing specific routes, the applicants' submission considers Brisbane and the Gold Coast as one destination. The Australian Government considers Brisbane as one of the four major gateway destinations, separate to the Gold Coast, which is considered a regional airport for the purposes of negotiating air services capacity.

Market share

For the sake of clarity, we consider it worthwhile to set out the major competitors on the Australia-New Zealand route (not including code-share arrangements):

<u>Qantas Group</u>

- Qantas (including services operated by New Zealand-based Jetconnect)
- Jetstar

<u>Virgin Blue Group</u>

- Pacific Blue (NZ)
- Pacific Blue (Australia) [operated by Pacific Blue (NZ)]

<u>Air New Zealand</u>

- Air New Zealand

Table 1 at Attachment B provides a five year overview of the market share for traffic in the Australia-New Zealand market. The table includes traffic between Australia and New Zealand and third countries.

Five airlines accounted for almost 98 per cent of air travel between Australia and New Zealand in 2009. Air New Zealand and the Qantas Group are the dominant long-standing operators on the Australia and New Zealand, while the Virgin Blue Group is a growing and significant competitor. Air New Zealand[1] remained the most active airline, with market share at around the mid 40s, with a drop to around 40 per cent in 2009. The Qantas Group was second most active, with a combined 32 per cent market share.

The growth of Pacific Blue can be contrasted with the declining market share of Qantas. Pacific Blue has built a larger market share every year, from 6.8 per cent in 2005 to 16 per cent in 2009. Qantas's market share has fallen every year, from 33.9 per cent in 2005 to 22 per cent in 2009. Jetstar increased its market share from 7.2 per cent in 2006 to 10.2 per cent in 2009, taking up most of Qantas's diminishing market share[2].

Emirates maintained market share consistently between nine and 11 per cent, registering 10 per cent in 2009. All other airlines combined for about a 2-3.5 per cent share over the period.

Table 2 at Attachment B provides a five-year overview of market share accounting for both the proposed alliance and for Jetstar being part of the Qantas Group.

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[1] Figures include Freedom Air International, a wholly owned subsidiary of Air New Zealand until ceasing operations in March 2008.

[2] Jetstar's first flight between Australia and New Zealand occurred on 1 December 2005, making 2005 market share data unreliable for measuring growth.

The table, noting the Qantas Group and the proposed alliance, shows a more even market share being maintained. The two groups maintain a similar market share over the last five years, with Qantas-Jetstar around 32-34.5 per cent and Virgin Blue-Air New Zealand between 53-55.6 per cent.

Proposed alliance

It has been the nature of the aviation industry for airlines to enter into co-operative alliances or arrangements. Many major airlines around the world have joined one of the three major alliances: Oneworld, Star Alliance and Sky Team. Taken together, the three dominate world air traffic. Depending on the relevant agreements, alliances allow the partner airlines to co-operate in matters such as marketing, code sharing arrangements, reciprocal frequent flyer programs and airlines lounges. It is worth noting that Air New Zealand is the only member of the Star Alliance which operates its own aircraft in the Australia-New Zealand market; Virgin Blue is not a member of an alliance.

The level of co-operation between carriers around the world ranges from simple interline agreements, through code share arrangements to greater levels of co-operation such as co-ordination of routes and prices.

Code sharing allows carriers to operate joint services to destinations without the need to operate an aircraft on that particular route. Beyond the gateways, these code sharing arrangements can also allow a foreign airline to access domestic routes. The code sharing arrangements Qantas has with carriers in the US allow, for example, a Qantas passenger to purchase a ticket from Boise, ID, to Canberra on Qantas code shared flights. In this case the Los Angeles to Boise sector is operated by Horizon Air for Alaska Airlines, and sold under a Qantas code.

Thank you again for inviting the Department to provide a submission. I can be contacted on 02 6274 7739 should you wish to discuss this matter further or require any additional information.

Yours sincerely

Stephen Borthwick

Stephen Borthwick
General Manager
Aviation Industry Policy
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19 July 2010

Attachment A

EXCLUDED FROM PUBLIC REGISTER

Attachment B

TABLE 1: MARKET SHARE OF AUSTRALIA-NEW ZEALAND UPLIFT / DISCHARGE TRAFFIC

Airline	2005	%	2006	%	2007	%	2008	%	2009	%
Air New Zealand	1,805,962	37.0%	1,925,480	39.2%	2,034,983	39.5%	2,207,060	43.0%	2,092,938	39.5%
Qantas Airways	1,655,493	33.9%	1,341,361	27.3%	1,296,147	25.1%	1,243,511	24.2%	1,162,188	22.0%
Pacific Blue	332,763	6.8%	370,654	7.5%	426,223	8.3%	558,701	10.9%	847,719	16.0%
Jetstar	29,467	0.6%	355,937	7.2%	386,859	7.5%	376,705	7.3%	538,004	10.2%
Emirates	437,389	9.0%	442,469	9.0%	546,964	10.6%	552,468	10.8%	530,036	10.0%
LAN Airlines	32,387	0.7%	43,013	0.9%	52,561	1.0%	53,732	1.0%	61,161	1.2%
Royal Brunei Airlines	37,741	0.8%	32,558	0.7%	28,405	0.6%	28,254	0.6%	32,644	0.6%
Aerolineas Argentinas	25,496	0.5%	25,989	0.5%	33,503	0.6%	32,226	0.6%	28,811	0.5%
Freedom Air Intl.	451,252	9.2%	361,369	7.4%	348,853	6.8%	80,666	1.6%	0	0.0%
Thai Airways Intl	62,001	1.3%	0	0.0%	0	0.0%	0	0.0%	0	0.0%
Garuda Indonesia	15,617	0.3%	16,256	0.3%	0	0.0%	0	0.0%	0	0.0%
Total	4,885,568		4,915,086		5,154,498		5,133,323		5,293,501	

* Freedom Air International was a subsidiary wholly owned by Air New Zealand; they ceased operating in March 2008.
+ Jetstar began flying internationally on 1 December 2005; their first flight was to Christchurch.

TABLE 2: ALLIANCE MARKET SHARE OF AUSTRALIA-NEW ZEALAND UPLIFT / DISCHARGE TRAFFIC

Airline	2005	%	2006	%	2007	%	2008	%	2009	%
Air NZ/Pacific Blue/Freedom Air*	2,589,977	53.0%	2,657,503	54.1%	2,810,059	54.5%	2,846,427	55.4%	2,940,657	55.6%
Qantas/Jetstar+	1,684,960	34.5%	1,697,298	34.5%	1,683,006	32.7%	1,620,216	31.6%	1,700,192	32.1%
Emirates	437,389	9.0%	442,469	9.0%	546,964	10.6%	552,468	10.8%	530,036	10.0%
Other	173,242	3.5%	117,816	2.4%	114,469	2.2%	114,212	2.2%	122,616	2.3%
Total	4,885,568		4,915,086		5,154,498		5,133,323		5,293,501	

* Freedom Air International was a subsidiary wholly owned by Air New Zealand; they ceased operating in March 2008.

\+ Jetstar began flying internationally on 1 December 2005; their first flight was to Christchurch