McGinness, Clare

From:	Channing, Darrell
Sent:	Wednesday, 17 November 2010 6:30 PM
To:	'Luke Woodward'; 'Louise Klamka'
Cc:	Orr, Jennifer; Woodbridge, Graeme; Smith, Prudence; McGinness, Clare; Chadwick, Richard
Subject:	A91227 & A91228 - Virgin Blue Airlines Pty Ltd & Ors - ACCC to applicant re proposed condition - 17.11.2010 [SEC=UNCLASSIFIED]
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Luke and Louise

As discussed today, here is a list of issues that ACCC staff would like to discuss with the applicants in relation to the proposed condition.

I emphasise that these questions should not be taken as indicative of the ACCC having reached any final position on the applications for authorisation at this stage. Rather, the questions are intended to assist the ACCC in its understanding of the proposed condition and its potential operation.

I will call you tomorrow to arrange a time to discuss.

Regards
Darrell

A91227 & A91228 -
Virgin Blue ...

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Background

In its draft determination, the ACCC expressed concern that the Alliance would allow the Alliance partners to unilaterally raise prices (average fares) on 5 trans-Tasman routes — namely, Brisbane-Auckland, Sydney-Wellington, Brisbane-Wellington, Brisbane-Dunedin and Sydney-Queenstown — and may remove a potentially significant competitive threat on another route (Melbourne-Wellington).

Outline of proposed condition

In response to the ACCC's concerns, the Applicants have proposed to commit to a set of conditions to maintain and increase capacity over time on the 6 routes identified by the ACCC as likely to be subject to unilateral anticompetitive effects. To summarise, the Applicants are willing to commit to the following:

- Maintenance of base year capacity across the Tasman for the term of authorisation.

- For each of the 6 identified routes, the Applicants will make available the same level of capacity as applied in the base year, adjusted for changes to Air New Zealand seat configuration and a proposed change in Virgin Blue capacity.

- For the set of 6 identified routes, the Applicants will increase capacity by 10% after 3 years and by 15% after 5 years. These growth targets are based on expected real GDP growth of 3% per annum over the authorisation period.

- The Applicants propose that these growth rate targets be reduced in the event that industry capacity across the set of 6 identified routes increases by more than 10% at the end of year 3 and/or by more than 15% at the end of year 5. The Applicants propose that for each percentage point of industry capacity above the nominated growth target (i.e. 10% after 3 years, 15% after 5 years), there would be an equi-proportionate reduction in the Alliance capacity growth target. For example, if industry capacity increases by 15% across the set of 6 routes after 3 years, the Alliance would be obligated to increase its capacity (relative to the base year) by 5%, rather than 10%, after 3 years.

The conditions also provide that the Applicants may seek the approval of the ACCC to vary compliance with the conditions in exceptional circumstances or where there is a material change in market condition or material adverse financial performance on the nominated sectors or on the trans-Tasman as a whole.

Key issues

1. The Applicants have submitted that the optimal load factor is 80%. When flights move into the low 80% load factor range, spill rates increase (i.e. there is an increase in the number of customers that are unable to obtain a seat on the flight at the prevailing price).

2. There appears to be some scope under the Alliance for the Applicants to raise average fares on flights with an expected load factor in excess of 80% while maintaining 2010 capacity levels.

3. The Applicants have indicated a willingness to commit to 2 capacity growth targets applied to the set of 6 identified routes (not individual routes). It appears that the Applicants could potentially satisfy the proposed growth targets through capacity growth on the BNE-AKL route alone, which would allow the Applicants latitude to raise prices on other identified routes over the term of the Alliance.

4. Depending on how demand grows on particular routes, the nominated growth targets appear to allow considerable scope for the Applicants to unilaterally raise prices on flights with an expected load factor greater than 80%. For example, the Applicants could raise price (rather than increase capacity) on any flight with an expected 80%+ load factor on any of the 6 routes as long as they are able to introduce sufficient 'catch up' capacity in future periods to meet their 3 and 5 year capacity obligations. Indeed, the Applicants need not catch-up capacity at all on some routes, as long as they are able to meet growth obligation with capacity on one or more other routes.

5. The proposed 3 and 5 year growth targets appear to have been devised by the Applicants on the basis of (i) an assumption that trans Tasman passenger demand will grow exactly in line with real GDP, and (ii) an expectation that real GDP in Australia and New Zealand will grow at a rate of 3% per annum over the next 5 years.
    - In relation to (i), the ACCC notes that demand for trans-Tasman air passenger services historically has not grown exactly in line with real GDP and the rate of growth has varied across routes. To the extent that demand has exceeded growth in real GDP on certain trans-Tasman routes, the constant 3% annual growth factor used by the Applicants will tend to understate actual growth on such routes.
    - In relation to (ii), the ACCC notes that over the next 5 years real annual GDP is forecast to increase by at least 3% in both Australia and New Zealand and in 2012 is forecast to increase by 3.75% in Australia and 3.2% in New Zealand. Thus, even if demand did grow exactly in line with real GDP, the 3 year and 5 year growth targets proposed by the Applicants are likely to understate actual demand on the identified routes.

6. Even if the Applicants had set growth targets to apply annually or seasonally (biannually) rather than at the 3 and 5 year markets and applied growth targets to each route, there remains a considerable temporal disconnect between the period in which the Applicants set prices and the period in which they are accountable for capacity growth.

7. The Applicants have expressed concern that competitors who will be aware of the Applicants' capacity obligations will "dump" capacity onto the identified routes. The problem with the way that the current conditions have been formulated to deal with this concern is that any error in the measurement of actual demand (e.g. due to the use of a very blunt and fixed annual growth factor) that results in

underestimation of actual demand has the effect of reducing the Applicants' capacity growth obligations.

8. The ACCC is concerned that it would be difficult and costly for the ACCC to establish whether any non-compliance with proposed conditions was the result of change in market circumstances (as the Applicants might claim) or whether it reflected conduct of the type that the instrument was intended to constrain.