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LAWYERS

**30 January 2012**

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Copies to: David Jones / Clare McGinness / Imogen Hartcher-O'Brien

Dear David,

**Authorisation A91227 & A91228: Alliance between Virgin Australia and Air New Zealand  
Supplementary compliance audit report**

We refer to your letter of 22 December 2012 and to subsequent communications with Imogen Hartcher-O'Brien.

We enclose a supplementary audit report prepared by Pitcher Partners which responds to the issues raised in your letter.

If you require any further information, please contact us to discuss.

Yours sincerely  
**Gilbert + Tobin**

Two handwritten signatures in black ink. The signature on the left is 'L Woodward' and the signature on the right is 'Louise Klamka'.

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## INDEPENDENT ASSURANCE PRACTITIONER'S SUPPLEMENTARY COMPLIANCE AUDIT REPORT

To Virgin Australia and Air New Zealand

**Supplementary Report on compliance with conditions 1(a) and 1(b) of Australian Competition & Consumer Commission (ACCC) authorisations A91227 & A91228 for the period 1 April 2011 to 31 October 2011.**

### *Background*

The Australian Competition and Consumer Commission has issued a determination granting conditional authorisation for an alliance between Virgin Australia and Air New Zealand (the applicants) in respect of Trans-Tasman passenger services. The conditions of authorisation require the applicants to meet certain seat capacity requirements, and for the compliance with those conditions to be subject to a compliance audit.

We audited the applicants' compliance with the conditions of authorisation contained in Attachment A to ACCC authorisations A91227 & A91228 as measured by the achievement of minimum seat capacity requirements for the period from 1 April 2011 to 31 October 2011 in accordance with the varied compliance conditions dated 4 August 2011 and issued an audit report on our findings dated 1 December 2011. In that report we concluded that the applicants have complied, in all material respects, with the ACCC conditions of authorisation for the period from 1 April 2011 to 31 October 2011.

Our audit report was provided to the ACCC on 5 December 2011. On 22 December 2011, the ACCC requested that we provide a supplementary report that provides further explanation and information in regard to our assessment of the applicants' compliance with ACCC conditions of authorisation, and in particular addresses the following:

- an outline of the scope of the audit;
- how the data used to measure compliance was gathered;
- the method used by each airline to measure compliance with its seat capacity obligations;
- the auditor's analysis of this data and the measure used by the auditor in concluding that seat capacity requirements were met by the airlines; and
- any other material that is relevant to the auditor's analysis of compliance.

*Use of Report*

This supplementary report has been prepared for Virgin Australia and Air New Zealand at the request of the ACCC and addresses the issues raised by the ACCC in relation to our audit for the period 1 April 2011 to 31 October 2011. We disclaim any assumption of responsibility for any reliance on this report to any persons or users other than the Australian Competition & Consumer Commission, or for any purpose other than that for which it was prepared.

PITCHER PARTNERS



Carl Millington  
Partner

Sydney, 30 January 2012

## SUPPLEMENTARY INFORMATION AND REASONS FOR AUDIT CONCLUSION

### 1. *Executive Summary*

On 6 May 2010, the applicants sought authorisation for an alliance between the airlines involving coordination and agreement in respect of trans-Tasman passenger services (the Alliance). On 16 December 2010, the ACCC issued a determination granting conditional authorisation to the Alliance for three years. The conditions of authorisation require the applicants to meet certain seat capacity requirements such conditions being outlined in Attachment A of the ACCC's Determination. These conditions require the applicants to:

- at least maintain capacity on each route of concern irrespective of the rate of economic growth or trans-Tasman passenger demand growth over the term of authorisation; and
- grow capacity seasonally on each of the routes of concern in line with most recent economic growth or growth in trans-Tasman passenger demand (whichever is greater) for the term of the authorisation.

On 27 July 2011, the ACCC decided to vary the requirement on the applicants to comply fully with condition 1(b) of authorisations A91227 & A91228 for the Northern Summer 2011 and Northern Winter 2011 scheduling seasons as a result of the Christchurch earthquake.

On 4 August 2011, the ACCC decided to vary the requirement on the applicants to comply fully with conditions 1(a) and 1(b) of authorisations A91227 & A91228 for the Northern Summer 2011 scheduling season as a result of the June 2011 Chilean volcanic ash cloud activity over Australia and New Zealand.

The applicants' compliance with the revised Alliance Seat Capacity for Northern Summer 2011 is subject to compliance audits in accordance with clause 3.5 of the conditions of authorisations A91227 & A91228.

As a result of our audit of the applicants' compliance with the conditions of authorisation for the period 1 April 2011 to 31 October 2011 we concluded that Virgin Australia and Air New Zealand have complied, in all material respects, with the ACCC conditions of authorisation as measured by their achievement of the minimum seat capacity conditions.

### 2. *Audit Objective*

The objective of the compliance audit is to enable the auditor to express an opinion as to whether, in all material respects, the applicants have complied with the conditions of authorisation contained in Attachment A to ACCC authorisations A91227 and A91228 for the period from 1 April 2011 to 31 October 2011 as varied on 27 July 2011 and 4 August 2011.

### 3. *Audit scope*

The scope of the audit encompassed the following:

- Reviewing the ACCC determination dated 16 December 2010, ACCC variation dated 27 July 2011, and ACCC variation dated 4 August 2011 to gain understanding of conditions of authorisation and audit reporting requirements.

- Obtaining confirmation from the ACCC on the interpretation of requirements, specifically each airline's methodology for measurement of seat capacity, and interpretation and application of the "Capacity Growth Factor" definition included in the conditions of authorisation. (Confirmation was received from the ACCC by email on 7 October 2011 and by telephone on 14 October 2011).
- Making a site visit to Air New Zealand's Auckland office to gain an understanding of the controls processes and activities conducted on behalf of the applicants.
- Interviews and discussions with relevant Virgin Australia and Air New Zealand staff to gain an understanding of process controls, systems and procedures.
- Testing of the systems, processes and controls performed through a combination of discussions with relevant key personnel, document reviews, walkthroughs and sample testing. The following staff were involved in the audit process:
  - Virgin Australia:
    - **Restriction of publication claimed** - Corporate & Statistics Cost Accountant
    - **Restriction of publication claimed** - Cost Accounting Leader
    - **Restriction of publication claimed** - Business Analyst, International / Research Analyst
    - **Restriction of publication claimed** - Manager, Network Planning International
  - Air New Zealand:
    - **Restriction of publication claimed** - Tasman Network Planning Manager
    - **Restriction of publication claimed** - Network Planning Analyst
    - **Restriction of publication claimed** - Senior Systems Analyst
- Reviewing explanatory documents, raw data and detailed spreadsheets controlling and monitoring compliance with conditions of authorisation obtained from Virgin Australia and Air New Zealand.
- Comparing explanatory documents, raw data and detailed spreadsheets controlling and monitoring compliance with conditions of authorisation obtained from Virgin Australia and Air New Zealand against third party capacity data sources including the Diio Mi aviation planning data software product and seat guru ([www.seatguru.com](http://www.seatguru.com)).
- Ensuring that calculations of minimum seat capacity were in accordance with the definitions and calculations in the conditions of authorisation and as per specific confirmation provided by the ACCC.
- Increased focus in areas where there the number of seats flown by the alliance was close to the capacity requirements. For example, on the Brisbane – Dunedin and Brisbane – Wellington routes.
- Testing the integrity and structure of the Alliance Master Spreadsheet (the key financial and data model utilised to forecast scheduled seat capacity, capture actual seat capacity, and compare actual seat capacity with ACCC requirements). Testing included a detailed review of the Alliance Master Spreadsheet ensuring that all relevant cell formulae were valid and consistently applied, raw data import was accurate and complete, and resulting reports were accurate and based on the information contained in the spreadsheet.
- Raw data extracted from the Sabre (Virgin Australia) and PC Airflite (Air New Zealand) systems was tested to ensure that it agreed with the data utilised in the Alliance Master Spreadsheet.

- Formulas and data used to calculate capacity growth factors were tested to ensure that they agreed with the requirements of the conditions of authorisation and data sourced from the Australian Bureau of Statistics and BITRE.
- Reporting of findings to Virgin Australia and Air New Zealand.

#### **4. Audit Methodology**

Our audit has been conducted in accordance with ASAE 3100 "Compliance Engagements" and accordingly included such tests and procedures as we considered necessary in the circumstances. These audit procedures have been undertaken to form an opinion whether, in all material respects, Virgin Australia and Air New Zealand have complied with the ACCC conditions of authorisation.

The responsibility for the applicants' compliance with ACCC requirements rests with Virgin Australia and Air New Zealand. Our audit, conducted in accordance with clause 3.5 of ACCC conditions, does not relieve the applicants of their obligations to ensure compliance with ACCC compliance requirements, measured by achievement of the minimum seat capacity conditions detailed in those conditions of authorisation for the period from 1 April 2011 to 31 October 2011.

#### **5. Audit Period**

The time period covered by the audit is from 1 April 2011 to 31 October 2011. This is the first audit of the applicants' compliance with ACCC conditions of authorisation. The next audit will cover the reporting period from 1 November 2011 to 31 March 2012.

The time period over which the audit was conducted was from June to December 2011. This includes planning, field work, reporting and discussion of results with the applicants' representatives. This supplementary report was prepared in January 2012.

#### **6. Method used by airlines to measure compliance with seat capacity obligations.**

##### **6.1. Measuring seat capacity**

The ACCC conditions of authorisation determined the minimum seat capacity conditions as follows:-

##### **1. Minimum Seat Capacity Conditions**

- In respect of each Nominated Route, the Applicants must fly in each Scheduling Season, not less than 100% of the Scheduling Season Alliance Seat Capacity for that Route (as varied).*
- In respect of the Trans-Tasman, the Applicants must fly in respect of each Scheduling Season, not less than 100% of the Trans-Tasman Base Year Alliance Seat Capacity (as varied).*

In the airline industry seat capacity can be measured in several ways. In calculating their seat capacity for the purposes of the capacity conditions, Virgin Australia (Virgin Blue) used "Physical Capacity" and Air New Zealand used "Saleable Capacity" to measure seats. Physical Capacity is the actual number of seats on the aircraft. Saleable Capacity is the physical number of seats on the aircraft, less the

seats that cannot be used because of payload restrictions (eg. weather, aircraft range).

During the planning phase of the initial audit, lengthy discussions were had with Air New Zealand representatives relating to their interpretation of the definition of seat capacity. As a result, confirmation was sought from the ACCC regarding the definition of seat capacity as it related to the applicants and their compliance with the conditions of authorisation. The ACCC confirmed that the applicants were expected to apply an approach to measuring seat capacity that was consistent with that used to derive the Scheduling Season Alliance Seat Capacity and Trans-Tasman Base Year Alliance Seat Capacity as set out in Attachment A of the ACCC's determination.

Configurations and seating plans for the various aircraft operated by each airline were confirmed by discussions with representatives from the airlines, information sourced from the respective airline's website, and independent sources such as [www.seatguru.com](http://www.seatguru.com).

Our discussions with the applicants and subsequent audit testing indicated that each airline had measured actual seat capacity provided to the market during the period 1 April 2011 to 31 October 2011 in accordance with the methodology used for the derivation of the Scheduling Season Alliance Seat Capacity and Trans-Tasman Base Year Alliance Seat Capacity as set out in Attachment A of the ACCC's determination (ie Virgin Australia applied 'physical capacity' based on the actual configuration of the aircraft used, and Air New Zealand applied 'saleable capacity' based on physical capacity reduced by the seats not available due to relevant payload restrictions).

## *6.2. Key Documentation and Processes - Alliance Master Spreadsheet.*

The alliance between Virgin Australia and Air New Zealand involves detailed planning for Tasman routes, including planning to comply with the conditions of authorisation. To achieve this, the applicants have created and maintained a master spreadsheet (maintained by Air New Zealand on behalf of both airlines) which serves as a single record for the two airlines.

The master spreadsheet serves as both a capacity calculator and measurement tool and derives data from the airlines' respective scheduling systems. For scheduling purposes, Virgin Australia utilises Sabre Air Vision Schedules Manager and Air New Zealand utilises PC Airflite.

The master spreadsheet also contains actual operated capacity data for comparison against planned schedules and seat capacities, which is used to monitor progress through the season including the number of seats operated over and above the ACCC capacity commitment.

Virgin Australia utilises the Sabre Air Operations System where actual operated capacity data is automatically updated from the aircraft via the Aircraft Communications and Reporting System (ACARS). For aircraft not having automated ACARS functionality data is loaded manually into the Sabre Air Operations System by the Technical records team from flight log reports prepared by the flight crew. A

monthly extract run on the Sabre Air Operations System provides data for preliminary reporting on the third day of every month. A final version of the Sabre Air Operations System data is prepared by the fifteenth day of each month and then updated into the Alliance Master Spreadsheet.

Air New Zealand utilises the PC Airflite system for scheduling, then Air Ops system and Departure Control system (DCS) for monitoring aircraft movements. Air Ops is populated with information from PC Airflite seven days prior to the day of departure. On the day of operations Air Ops receives information from the Aircraft Communications and Reporting System (ACARS) on board the aircraft and movement messages generated from the airports which automatically updates the system with flight leg data. Data is extracted from both Air Ops and DCS and captured in the Group Data Base (GDB), Air New Zealand's central data warehouse. A Microsoft Access query is used to extract relevant data for the Alliance Master Spreadsheet from the GDB.

Both airlines conduct stringent controls and data testing each month to ensure that no cancelled, returned, or non-revenue flights are included as operated flights for the purposes of the conditions and review diverted flights to ensure that they are accounted for correctly.

The master spreadsheet is used as a measurement and reporting tool for the Network Planning and Scheduling Teams of both Virgin Australia and Air New Zealand. The master spreadsheet enables planned capacity to be measured against ACCC capacity commitments.

Each month the Alliance Master Spreadsheet is updated with actual data derived from both airlines as described above and circulated twice a month for review by relevant managers. From August to October 2011, Pitcher Partners was included on the twice monthly circulation for audit purposes.

### *6.3. Capacity Growth Factor.*

The ACCC conditions of authorisation define Capacity Growth Factor for any Scheduling Season as the greater of:

- (a) the sum of quarterly changes in Australia's Trend Chain Volume GDP, as published by the Australian Bureau of Statistics in Catalogue No 5206.0, data series A2298668K over the period from:
  - i. December quarter 2009 to the most recent December quarter for the NS Scheduling Season or
  - ii. June quarter 2010 to the most recent June quarter for the NW Scheduling Season; or
- (b) the sum of the annual percentage changes in Total Industry Seat Capacity across the Trans-Tasman over the period from 2 months prior to the end of the relevant Scheduling Season in 2010 to 2 months prior to the end of the most recent Scheduling Season. Total Industry Seat Capacity across the Trans-Tasman is to be sourced from International Airline Activity data collection published by the Australian Bureau of Infrastructure, Transport and Regional Economics (BITRE).

Based on statistics sourced from the Australian Bureau of Statistics and BITRE, the sum of quarterly changes in Australia's Trend Chain Volume GDP exceeded the growth in total industry seat capacity, resulting in the GDP figures being the applicable measure for the Capacity Growth Factor for the period under review.

<b>Variations in GDP</b> (ABS Cat. 5206.0, series A2298668K)		<b>Total Industry Seat Capacity – BITRE<sup>2</sup></b>	
<b>Quarters</b>	<b>GDP<sup>1</sup></b>		
March 2010	0.8	Year to August 2010	7,835,560
June 2010	0.8	Year to January 2011	7,851,186
September 2010	0.5	Variance	15,626
December 2010	0.1		
	<b>2.2%</b>		<b>0.2%</b>

- (1) Data derived from ABS Catalogue No 5206.0, data series A2298668K released March 2011. Each ABS quarter release updates previously released data. The March 2011 release was used in the calculation of the Capacity Growth Factor because it was the most recent release available prior to the start of relevant scheduling season and therefore contained the most up to date GDP figures.
- (2) These numbers reflect Competitor seat capacity sourced from BITRE for the relevant period, plus actual seat capacity operated by the applicants (as per the Alliance Master spreadsheet) for the relevant period (to calculate a Total Industry Seat Capacity number). Actual seat capacity in the Alliance Master Spreadsheet differs slightly from BITRE data held for Virgin Australia and Air New Zealand due to the variance between the airlines in measuring seat capacity as outlined in 6.1 above and the exclusion of Norfolk Island (NLK) services from the count of Total Industry Seat Capacity, as per the ACCC's determination of 16 December 2010.

Audit testing of the calculation and application of the growth factors proved satisfactory and confirmed that the applicants had complied with the capacity growth factor requirements of the conditions of authorisation with each sector and the Trans-Tasman total exceeding the required growth factor as detailed in the following table:-

<b>Route</b>	<b>Base Year Seat Capacity<sup>1</sup></b>	<b>Scheduling Season Alliance Seat Capacity NS11<sup>2</sup></b>	<b>Actual Alliance Seat Capacity NS11<sup>3</sup></b>	<b>Variance between required and actual Alliance Seat Capacity<sup>4</sup></b>	<b>% Variance<sup>5</sup></b>
<b>Auckland - Brisbane</b>	320,212	327,257	334,891	7,634	2.3%
<b>Brisbane - Dunedin</b>	47,038	48,073	48,608	535	1.1%
<b>Brisbane - Wellington</b>	141,722	144,840	146,592	1,752	1.2%
<b>Melbourne - Wellington</b>	55,555	56,777	62,328	5,551	9.8%
<b>Sydney - Wellington</b>	107,871	110,244	132,984	22,740	20.6%
<b>Sydney - Queenstown</b>	45,613	46,616	47,544	928	2.0%
<b>Nominated Sector Total</b>	718,011	733,807	772,947	39,140	5.3%
<b>Trans-Tasman Total</b>	2,261,728	2,261,728	2,325,479	63,751	2.8%

- 1 *Base Year Seat Capacity* - as per varied ACCC determination dated 4 August 2011.
- 2 *Scheduling Season Alliance Seat Capacity NS11* – calculated by applying a Capacity Growth Factor of 2.2% derived from variations in GDP to the Base Year Seat Capacity.
- 3 *Actual Alliance Seat Capacity NS11*– from the Alliance Master Spreadsheet maintained by Air New Zealand.

- 4 *Variance between required and actual Alliance Seat Capacity* – difference between Scheduling Season Alliance Seat Capacity NS11 and Actual Alliance Seat Capacity NS11.
- 5 *% Variance* – the percentage by which Actual Alliance Seat Capacity NS11 exceeded Scheduling Season Alliance Seat Capacity NS11.

## **7. Auditor's analysis: Findings and Observations**

### **7.1. General Observations.**

- Representatives from both Virgin Australia and Air New Zealand were readily available for meetings and discussions and provided all information requested in a timely manner.
- The relevant data required to monitor and report on the applicants' compliance with the conditions of authorisation is collated and analysed in an Excel spreadsheet maintained on behalf of the applicants by Air New Zealand (the Alliance Master Spreadsheet).
- Both Virgin Australia and Air New Zealand have prepared and provided for audit purposes detailed explanations of the processes used to ensure compliance with the conditions of authorisation. Appendix A, prepared by Air New Zealand, is a summary of the monthly process adopted to capture data in the Alliance Master Spreadsheet and ensure ongoing compliance with the ACCC conditions of authorisation.

### **7.2. Audit Findings.**

- Compliance with the capacity requirements of the conditions of authorisation is closely monitored by the applicants on a monthly basis through the Alliance Master Spreadsheet and regular management review.
- Measurement of seat capacity was in accordance with the ACCC requirements (ie. Virgin Australia applied 'physical capacity' based on the actual configuration of the aircraft used and Air New Zealand applied 'saleable capacity' based on physical capacity reduced by the seats not available due to relevant payload restrictions).
- Based on statistics sourced from the Australian Bureau of Statistics and BITRE, the sum of quarterly changes in Australia's Trend Chain Volume GDP exceeded the growth in total industry seat capacity, resulting in the GDP figures being the applicable measure for the Capacity Growth Factor for the period under review.
- The formulae used to calculate capacity growth requirements in the Alliance Master Spreadsheet are in accordance with the requirements of the ACCC.
- The calculation of Scheduling Season Alliance Seat Capacity for NS11 was in accordance with the ACCC conditions of authorisation.
- For each Nominated Route, Actual Alliance Seat Capacity in NS11 exceeded the Scheduling Season Alliance Seat Capacity for NS11, as varied by the ACCC on 27 July 2011 and 4 August 2011.
- In respect of the Trans-Tasman as a whole, Actual Alliance Seat Capacity in NS11 exceeded the Trans-Tasman Base Year Alliance Seat Capacity, as varied by the ACCC on 27 July 2011 and 4 August 2011.

- Our discussions with the applicants and audit testing indicated that the Alliance Master Spreadsheet was an appropriate and reliable record for determining compliance with the conditions of authorisation.

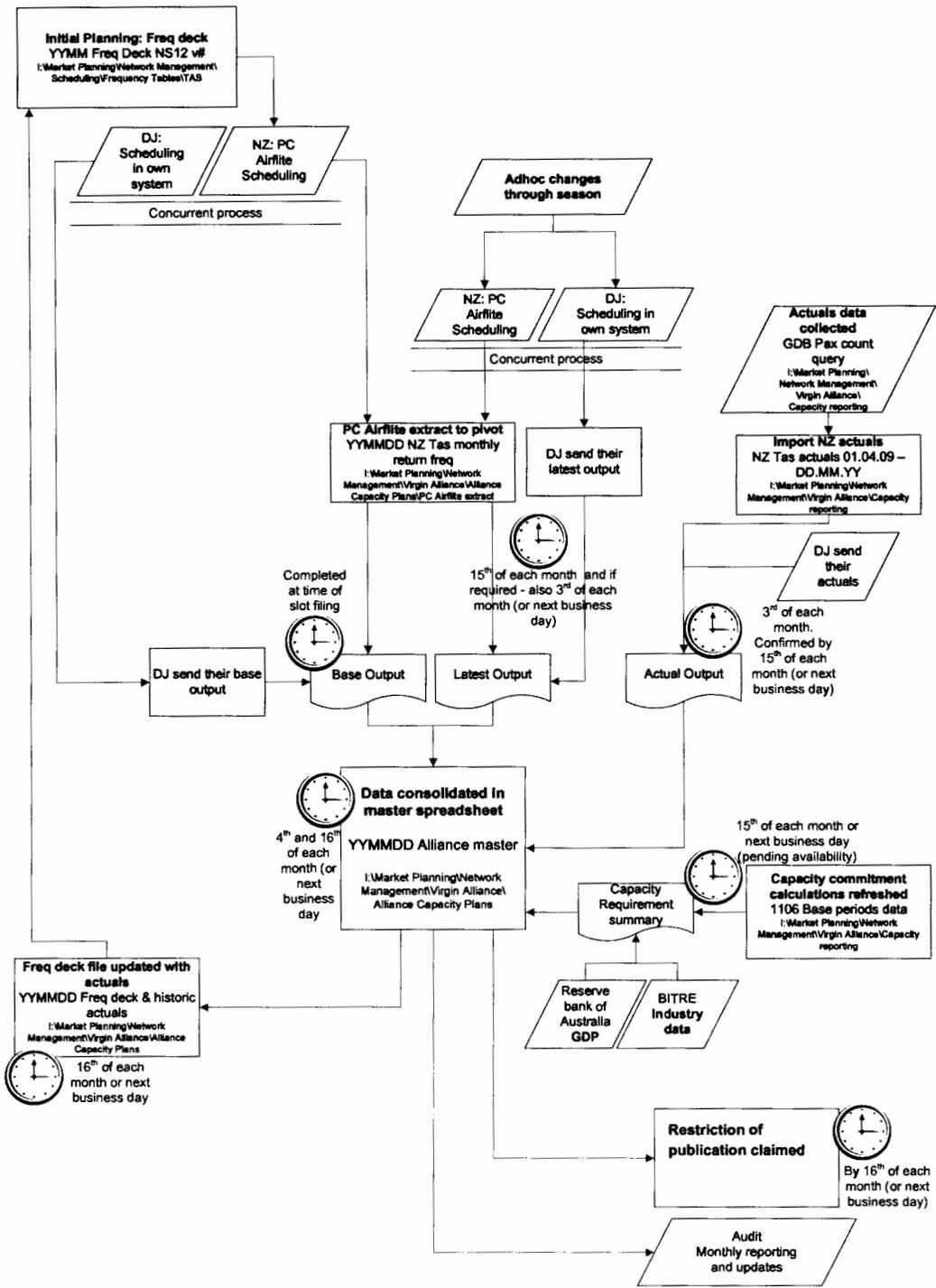
#### **8. Other relevant material**

We examined the following information sources in reaching the conclusions in our audit report:

- ACCC Determination and Authorisations A91227 and A91228 dated 16 December 2010.
- ACCC Variation to Authorisations A91227 and A91228 dated 27 July 2011.
- ACCC Variation to Authorisations A91227 and A91228 dated 4 August 2011.
- Documentation prepared and provided by applicants to explain relevant systems and procedures:-
  - Trans Tasman Alliance capacity and frequency reporting (Air New Zealand);
  - Air New Zealand/Virgin Alliance Network planning & Scheduling key files (Air New Zealand);
  - Alliance Spreadsheet Data Input process Documentation (Virgin);
  - Capacity commitment definitions, interpretations and comments;
  - Base output data provided by Air New Zealand and Virgin Australia; and
  - Flowchart showing Alliance Master Spreadsheet update process and report outputs (Attached as Appendix A).
- Alliance Master Spreadsheet – Excel files for each month August 2011 to October 2011.
- Relevant capacity data extracted from the Diio Mi aviation planning data software product and seat guru ([www.seatguru.com](http://www.seatguru.com)).
- Data extracted from Australian Bureau of Statistics and BITRE websites.

### Appendix A:

Flow chart showing Alliance Master Spreadsheet update process and report outputs



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**Key of symbols**

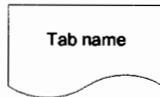
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**Primary process step in a key MS Excel file**



**Process step in non MS Excel programme (secondary process steps)**



**Name of tab in spreadsheet where data inputted**



**Time frame for completion of process step**

Task  
completed  
by