

**Submission to the Australian Competition and
Consumer Commission
on the ACCC's draft determination dated 10 July
2013 regarding the application for re-
authorisation of an alliance between Virgin
Australia and Air New Zealand**

Key Wellington Stakeholders

24 July 2013

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EXECUTIVE SUMMARY

Introduction

1 This submission in response to the ACCC's draft determination dated 10 July 2013 is presented by Key Wellington Stakeholders, a group of business, local government and tourism organisations from the Wellington region. Key Wellington Stakeholders include the following organisations (in alphabetical order):

- Greater Wellington Regional Council
- Grow Wellington
- Positively Wellington Tourism
- Wellington Employers' Chamber of Commerce
- Wellington City Council
- Wellington International Airport Limited

2 Collectively, we represent the region's local government, businesses and tourism industry of Wellington and the surrounding region.

Summary of our position

3 We support the ACCC's draft determination to re-authorise the Alliance with continued capacity conditions for the Wellington-Brisbane route and for a further term of three years only. However, we remain of the view that re-authorisation of the Alliance should also be conditional on the continuation of appropriate capacity conditions for the Wellington-Sydney and Wellington-Melbourne routes.

4 We remain concerned that re-authorisation of the Alliance without appropriate capacity conditions on the Wellington-Sydney and Wellington-Melbourne routes will have the effect of substantially lessening competition in the trans-Tasman air passenger services market between Wellington and Australia, without providing sufficient countervailing public benefits.

5 The Applicants' argument that such conditions impose significant costs and inefficiencies is unconvincing. If (as the Applicants say) the rationale of the Alliance is to increase passenger numbers, there can be no real complaint from them about conditions that require capacity growth on those routes with limited competition, such as the Wellington trans-Tasman routes. While the Applicants claim that imposing these conditions gives rise to significant costs and inefficiencies, the Applicants have not put any substantial evidence to that effect into the public arena for interested parties to test. In our submission, their assertions to this effect should not be accepted.

WE SUPPORT THE DECISION TO CONTINUE CAPACITY CONDITIONS ON THE WELLINGTON-BRISBANE ROUTE

- 6 As part of its draft determination, the ACCC considers that it is appropriate to continue capacity conditions on the Wellington-Brisbane route so that, subject to a growth factor, a base level of capacity on this route is at least maintained.¹
- 7 We support this aspect of the ACCC's draft determination. Our previous submission dated 26 April 2013 addressed (at paragraphs 75 to 85) in some detail the position regarding the Wellington-Brisbane route. We repeat (do not set out again) in this submission what we previously said about the Wellington-Brisbane route. We agree with the ACCC's assessment in the draft determination that the Alliance is likely to enhance the Applicants' abilities and incentives to reduce service or raise price on the Wellington-Brisbane route.²
- 8 In our submission, the ACCC is right in its draft determination to recognise that the Alliance is likely to result in public detriments by giving the airlines an increased ability and incentive to unilaterally reduce or limit capacity (in order to raise airfares) on the Wellington-Brisbane route.³ The capacity conditions proposed for this route should be imposed as a condition of re-authorisation of the Alliance. We agree, too, that, absent the Alliance, it is likely that Virgin Australia would continue to operate on the Wellington-Brisbane route, given its hub at Brisbane airport and its existing presence on the route.⁴

WE SUPPORT THE DECISION TO RE-AUTHORISE THE ALLIANCE FOR THREE YEARS ONLY

- 9 As part of its draft determination, the ACCC considers that it should re-authorise the Alliance for a limited term of three years only, and not the five years sought by the Applicants.⁵ Again, we support this aspect of the ACCC's draft determination.
- 10 With respect, the ACCC is right to describe the aviation industry as "dynamic" and to point to the developing nature of the public benefits and the significant role of the conditions of authorisation in the ACCC's decision as good reasons for favouring a three-year authorisation period.⁶ In our submission, these factors militate heavily in favour of a three-year (rather than a five-year) period for the re-authorisation.

BUT CAPACITY CONDITIONS SHOULD REMAIN ON THE OTHER WELLINGTON TRANS-TASMAN ROUTES

Introduction

- 11 We do not support that part of the ACCC's draft determination in which the ACCC considers that re-authorisation of the Alliance should be permitted without continuing the existing (or similar) capacity conditions on the Wellington-Sydney and

¹ The ACCC's draft determination dated 10 July 2013, at [595].

² The ACCC's draft determination dated 10 July 2013, at [469].

³ The ACCC's draft determination dated 10 July 2013, at [549].

⁴ The ACCC's draft determination dated 10 July 2013, at [468].

⁵ The ACCC's draft determination dated 10 July 2013, at [604].

⁶ The ACCC's draft determination dated 10 July 2013, at page v.

Wellington-Melbourne routes. In our submission, capacity conditions on these routes should be maintained.

The ACCC's reasoning

12 The ACCC notes in its draft determination that, since the 2010 authorisation, there have been a number of changes to the trans-Tasman market which have impacted the routes on which the ACCC considers detriments are likely to arise going forward.⁷ Most of the factors identified by the ACCC have no bearing on the Wellington trans-Tasman routes. There is only one change in the market identified by the ACCC that could affect the Wellington trans-Tasman routes: that factor is Virgin Australia's implementation of its game-change strategy.

13 As we understand it, the ACCC's reason for considering that conditions on the Wellington-Melbourne and Wellington-Sydney routes have relevantly changed since 2010 is essentially based on the ACCC's assessment that, absent the Alliance, Virgin would be unlikely to compete against Air New Zealand and Qantas on those routes. That assessment differs from the conclusion that the ACCC reached in 2010. The reason for the changed assessment appears to be Virgin's decision since May 2010 to implement its game-change strategy and a view that, by reason of the game-change strategy, Virgin would not now be likely to fly or put forward a competitive offering on the Wellington-Melbourne and Wellington-Sydney duopoly routes.

Why capacity conditions on these duopoly routes should remain

14 In our submission, the capacity conditions on these routes should remain. We do not agree that Virgin's competitive offering would most likely be limited or non-existent on these routes, absent the Alliance.⁸ In any event, the likely benefits of maintaining the capacity conditions greatly outweigh the likely cost of those conditions.

—Virgin's likely conduct absent the Alliance

15 The ACCC has assessed that, absent the Alliance, Virgin would be unlikely to enter the Wellington-Melbourne route⁹ and its competitive offering would be likely to be limited, if any, on the Wellington-Sydney route.¹⁰ We disagree. In our view, it is most likely that, absent the Alliance, Virgin would seek to re-enter the Wellington-Sydney route and that its majority-owned subsidiary, Tiger, would enter the Wellington-Melbourne route.

16 The ACCC's assessment appears to be based on Virgin's assertions about how it would be likely to proceed in the future without the Alliance. We have reviewed the public register version of Virgin's counterfactual. In that document, Virgin says that, absent the Alliance, it "will not grow capacity on the Tasman and will be required to withdraw capacity and services on some routes in accordance with commercial business performance".¹¹ But nothing specific (at least in the public version) is claimed in Virgin's counterfactual about what Virgin would or would not do in respect of the various Wellington trans-Tasman routes, absent the Alliance. We note, too,

⁷ The ACCC's draft determination dated 10 July 2013, at [572].

⁸ The ACCC's draft determination dated 10 July 2013, at [467], [471] and [475].

⁹ The ACCC's draft determination dated 10 July 2013, at [467].

¹⁰ The ACCC's draft determination dated 10 July 2013, at [471].

¹¹ Virgin Australia's counterfactual dated 25 June 2013, at page 1.

that the draft determination says that there is “conflicting information about the likely behaviour of Virgin Australia absent the Alliance, and whether it would be reasonable to expect it to behave as it did prior to the 2010 alliance on the trans-Tasman”.¹²

- 17 We would expect that, absent the Alliance, Virgin (and indeed all airlines flying the Tasman) would wish to review operations on the various trans-Tasman routes in light of the commercial development that non-reauthorisation of the Alliance would represent. But we do not consider that it is appropriate to infer that, absent the Alliance, Virgin would be likely to reduce its pre-Alliance Wellington-Sydney offering and would not seek to enter the Wellington-Melbourne market. Indeed, we consider it likely that Virgin would re-enter the Wellington-Sydney route and that its majority-owned subsidiary, Tiger, would enter the Wellington-Melbourne route.
- 18 Virgin currently serves the Wellington-Brisbane route by way of an aircraft based at Wellington airport. That aircraft shuttles between Wellington and Brisbane, completing four sectors each day. The first sector leaves Wellington around 6 am local time. The fourth sector arrives back into Wellington around midnight. In the 18 hours or so in between, there is sufficient time to allow the aircraft to complete four sectors – two return trips across the Tasman.
- 19 This four-sector daily “shuttle” approach is the most efficient way to service the Wellington trans-Tasman routes, given (a) the time difference between New Zealand and the Australian East Coast, (b) night curfews at the airports that prevent flights during the early hours of the morning, and (c) passenger preferences as to flight times. It would not make sense for Virgin to base its plane in Brisbane for servicing the Brisbane-Wellington route because, by the time the plane left Australia early in the morning, there would be time to complete only one return trip between Australia and Wellington, given the factors just identified.
- 20 In our experience, it is usual for airlines operating services on the Wellington trans-Tasman routes to adopt this four-sector daily “shuttle” with planes based in Wellington.
- 21 This approach to aircraft deployment does not seem to have been factored into the ACCC’s assessment of the likely counterfactual on the Wellington trans-Tasman routes if the Alliance is not re-authorised. If the Alliance is not re-authorised, we expect (as the ACCC has found) that Virgin would continue to operate services on the Wellington-Brisbane route.¹³ We also expect (as the ACCC has also found) that Air New Zealand will seek to re-enter this route.¹⁴ But that is not the end of the analysis.
- 22 Air New Zealand’s Brisbane entry is likely to come from a redeployment of capacity away from Sydney and Melbourne, which happened in reverse when the Alliance schedule commenced in November 2011. In response to Air New Zealand’s entry onto this route, we expect that, given capacity and demand considerations, Virgin

¹² The ACCC’s draft determination dated 10 July 2013, at [468].

¹³ The ACCC’s draft determination dated 10 July 2013, at [468].

¹⁴ The ACCC’s draft determination dated 10 July 2013, at [468].

will withdraw some of its services in each direction between Wellington-Brisbane so that it would operate at a similar frequency to Air New Zealand.

- 23 The likely counterfactual without the Alliance on the Wellington-Brisbane route is therefore that each of Air New Zealand and Virgin will operate a similar frequency, including some "wingtip" services. That is the situation that existed before the Alliance was authorised.¹⁵
- 24 There are flow-on effects for the other Wellington trans-Tasman routes given the changes that would occur on the Wellington-Brisbane route. Virgin's reduction of capacity on the Wellington-Brisbane route is likely to mean that it will redeploy that capacity on the other Wellington trans-Tasman routes, given that they are the most capacity constrained, provide the biggest yield opportunity, and Air New Zealand would have removed capacity to serve Brisbane. For the reasons already explained, it is most efficient for Virgin to have a plane based at Wellington. Reducing its capacity on the Wellington-Brisbane route means that a Virgin aircraft is now free to be deployed on other routes during the hours when it was previously flying between Wellington and Brisbane.
- 25 Our expectation is that Virgin would be likely to deploy this plane on whichever of the Wellington-Sydney and Wellington-Melbourne routes offered Virgin the best opportunity for competing on the trans-Tasman. There is no prospect of any competition on these routes in the medium term from Emirates or other FFCs, so breaking into the Air New Zealand/Qantas duopoly on these routes would be commercially attractive to Virgin. In this way, Virgin would keep one aircraft fully occupied during the day, completing four sectors each way across the Tasman.
- 26 Given the relatively similar flying distances between Wellington and each of the three East Coast Australian gateways, there is no reason why a particular plane has to shuttle between the same Australian city and Wellington each day. The same plane could, for example, complete a Wellington-Brisbane-Wellington-Sydney-Wellington service during a single day.
- 27 We consider that this outcome (Virgin entering other trans-Tasman routes) is likely in the counterfactual for three reasons. First, Virgin is unlikely to want to keep the plane idle while it is not flying the Wellington-Brisbane route. Redeploying it onto other Wellington trans-Tasman routes seems the most logical alternative.
- 28 Second, Virgin serviced the Wellington-Sydney route before the Alliance.¹⁶ So it could well service this route again and, in our submission, that outcome is distinctly more likely than Virgin not re-entering this route.
- 29 Third, the ACCC notes in its draft determination that the Wellington-Sydney and Wellington-Melbourne routes share, as characteristics, strong demand from government and corporate passengers.¹⁷ Given Virgin's game-change strategy and

¹⁵ See, for example, the Applicants' submission to the ACCC dated 4 May 2010, at page 37. The table set out on that page shows the trans-Tasman direct weekly return services by carrier and route for April 2010. On the Brisbane-Wellington route, each of the Applicants flew seven services per week.

¹⁶ See, for example, the Applicants' submission to the ACCC dated 4 May 2010, at page 37. The table set out on that page shows the trans-Tasman direct weekly return services by carrier and route for April 2010. On the Sydney-Wellington route, Virgin flew four services per week.

¹⁷ The ACCC's draft determination dated 10 July 2013, at [467].

its increased targeting of corporate custom, we expect that Virgin would be incentivised to enter the Wellington-Sydney and Wellington-Melbourne routes, absent the Alliance. Virgin has re-aligned its product offering to appeal more to corporate travellers and it is competing aggressively against Qantas in the Australian domestic market. We expect that Virgin would be incentivised to, and would, behave similarly on the trans-Tasman routes, in the future without the Alliance.

- 30 Moreover, its past participation in the Alliance would put it in a stronger position to compete with Air New Zealand in particular given Virgin's improved understanding of Air New Zealand's business as a result of the Alliance.
- 31 Our expectation is that Virgin is most likely to fly three to four services weekly on the Wellington-Sydney route. It is also possible that Virgin would, on the days it is not flying that route, introduce services on the Wellington-Melbourne route which could coincide with the days throughout the year when Air New Zealand or Qantas do not fly on the route. Certainly, if Virgin reduced capacity on the Wellington-Brisbane route by reducing services, it would immediately have the potential to redeploy that capacity on other Wellington trans-Tasman routes. Even the threat of doing so would operate as some competitive constraint on the existing operators on these routes.
- 32 The position of Tiger, a majority-owned subsidiary of Virgin, should also be considered. Virgin now owns 60% of TigerAir, a low cost carrier operating A320 aircraft (currently 11 aircraft with orders for a further 8) domestically in Australia. In our expectation, Virgin/Tiger will look to operate domestically in Australia in a similar way to the Qantas/Jetstar group, with one airline targeting the corporate market (Virgin and Qantas) and one targeting the leisure market (Tiger and Jetstar). If the Alliance is not re-authorized, we consider it likely that Virgin will look to have Tiger compete on some of trans-Tasman routes.
- 33 Virgin's 60% stake in Tiger provides Tiger with the rights to operate services on the trans-Tasman under the relevant air services agreements. Given the current alliance with Air NZ, it is unlikely that Virgin would let Tiger operate in the trans-Tasman at the risk of cannibalising the Alliance's share of that market. However, under the counterfactual situation, Virgin would have a strong incentive for Tiger to begin trans-Tasman operations (in the same way that Qantas and Jetstar operate on the Tasman), particularly on sectors where Virgin was not operating (and particularly Wellington-Melbourne). This course would allow the Virgin/Tiger group to gain market share over Air New Zealand and the Qantas/Jetstar/Emirates alliance.
- 34 If (as we think likely) Tiger began trans-Tasman services in the event that the Alliance was not re-authorized, Wellington-Melbourne is likely to be the first sector of operation for Tiger, given that Melbourne is the base for Tiger, the sector has no LCC airline to compete with, and the route is capacity constrained. The competitive constraint that Virgin can provide with Tiger on the trans-Tasman routes in the counterfactual is not something that appears to have received attention from the ACCC in its draft determination.

35 As the ACCC notes, the nature of the aviation industry is “dynamic”.¹⁸ Regard should be had not only to what the counterfactual position is likely to be immediately after any refusal of re-authorisation but also to what the counterfactual position is likely to be in the medium term. In respect of the Wellington trans-Tasman markets, Virgin has a very similar share when compared with each of the Qantas/Jetstar group and Air New Zealand (Qantas group 37%, Air New Zealand 36%, Virgin 27%). It may well be the case that, in the medium term, Virgin could again play a “maverick” role on at least some of the trans-Tasman routes, particularly with Tiger working in tandem with it. Virgin’s size on these routes and the other factors we have mentioned give it the potential to shake up the Wellington market, absent the Alliance.

36 In our submission, there is insufficient material available to draw the conclusion that, in the specific case of the Wellington trans-Tasman routes, Virgin would be unable, absent the Alliance, to exercise some significant competitive constraint on Air New Zealand and the Qantas/Jetstar group. To the contrary, it is likely that, absent the Alliance, Virgin (and especially if it acted in tandem with Tiger) would provide a significant competitive constraint on the Wellington trans-Tasman. The Alliance removes that competitive constraint.

—No excess capacity on the trans-Tasman

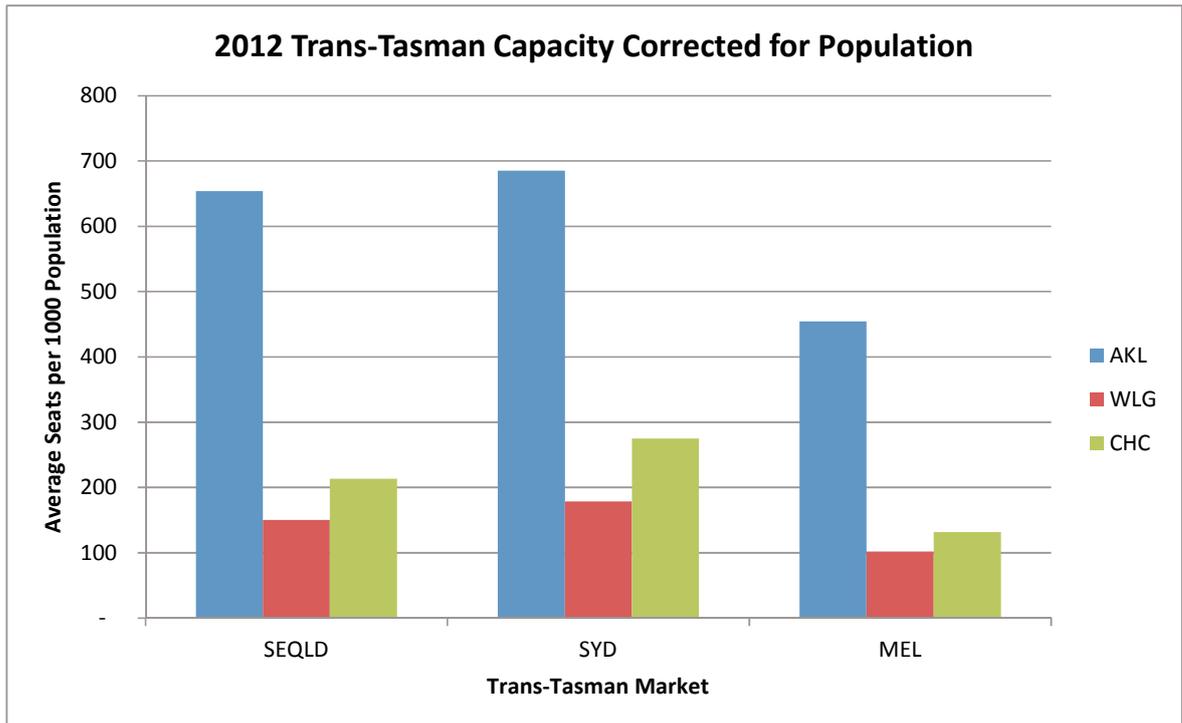
37 The ACCC has asked the Applicants and third parties whether there is excess capacity on the relevant routes between Australia and New Zealand.¹⁹ We do not consider that there is excess capacity on the Wellington trans-Tasman routes, which reinforces the proposition that Virgin is likely to be incentivised, absent the Alliance, to enter the Wellington trans-Tasman routes it does not currently fly.

38 We have prepared a graph below showing the 2012 trans-Tasman capacity for each of Auckland, Wellington and Christchurch in respect of each of the south-east Queensland,²⁰ Sydney and Melbourne routes, corrected for population so that an average seat per 1,000 inhabitants is provided for Auckland, Wellington and Christchurch.

¹⁸ The ACCC’s draft determination dated 10 July 2013, at page v.

¹⁹ The ACCC’s draft determination dated 10 July 2013, at [600].

²⁰ The South-East Queensland routes include routes to and from Brisbane and Coolangatta but not the Sunshine Coast.



39 As can be seen, the average number of seats on each route is much lower for Wellington than it is for Auckland and Christchurch. That is despite the depression of Christchurch capacity following the Canterbury earthquakes as well as the reallocation of South Island trans-Tasman capacity away from Christchurch to Queenstown.

40 The lower capacity on the Wellington trans-Tasman routes has resulted in higher fares than on Auckland and Christchurch trans-Tasman routes, which is unsurprising given the absence of Emirates or Jetstar as competitors on the Wellington routes. It is unlikely that the absence of other competitors on these routes will change going into the future, particularly given Jetstar's position with the Qantas group.

41 It is also telling that Air New Zealand and Qantas continue to operate a roughly 50:50 capacity split on the Wellington-Sydney and Wellington-Melbourne routes and have done so for the last many years. In our view, this steady and even split is a telling sign of a duopolistic market and further suggests that there would be a commercial incentive for Virgin, absent the Alliance, to enter these routes.

–The likely benefits of conditions greatly outweigh their likely cost

42 The ACCC's draft determination has recognised that the nature of the benefits and detriments arising out the Alliance is "finely balanced".²¹ That was the ACCC's assessment in 2010, and we consider that that assessment remains a fair characterisation of the position now.

43 But with benefits and detriments finely balanced, we consider that continued capacity conditions on the Wellington-Sydney and Wellington-Melbourne routes remain critical to ensuring that the public benefits that the Alliance could potentially

²¹ The ACCC's draft determination dated 10 July 2013, at page v.

bring on these routes are in fact realised and that the public detriments that may otherwise result are prevented.

- 44 The Applicants claim that various benefits have arisen from the Alliance. We repeat the point made in our earlier submission that, while there have certainly been some benefits since the Alliance began operation, it is unclear whether the market growth witnessed over the initial term of the Alliance has been driven by the “benefits” pointed to by the Applicants, by the imposition of the capacity conditions themselves, or by other market dynamics affecting the various routes.²² That uncertainty justifies, in our view, the adoption of a precautionary approach towards any relaxing of the existing capacity conditions.
- 45 Nor should too much weight be placed on the Applicants’ assertions regarding the likely costs and potential inefficiencies that the conditions might give rise to. While the Applicants assert that such conditions are “distortive”, we note that the Applicants accept that it is “difficult to calculate precisely the loss of revenue and costs arising from the inefficiencies created by the operation of the capacity conditions”.²³
- 46 The Applicants also claim to have carried out “detailed work” of the alleged cost of the conditions in relation to Wellington routes. Having not seen this work, we are not in a position to comment in detail on these claims. But we note that, while the Applicants say they are happy to share these estimates with the ACCC, they are apparently unwilling to expose those estimates to detailed public scrutiny.
- 47 The ACCC notes in its draft determination that there has been little if any material change to the Alliance’s average airfare prices across the trans-Tasman since the implementation of the Alliance. So it does not appear that the Applicants have had to reduce fares substantially as a result of the capacity conditions imposed by the ACCC. Had the capacity conditions not been imposed, we consider it likely that airfares would in fact have increased.
- 48 It is worth repeating that it was the Applicants who proposed conditions in order to obtain authorisation of their Alliance in 2010. It is reasonable to presume that any cost or inefficiency that the conditions might generate is more than outweighed by the benefits that the Applicants derive from the Alliance. Otherwise, they would not choose to give effect to the Alliance and revert to competing separately.
- 49 In our submission, continuation of the capacity conditions in respect of the Wellington-Sydney and Wellington-Melbourne routes is essential. The ACCC rightly identifies additional frequencies flown as a public benefit.²⁴ However, much of the frequency increases on the Wellington trans-Tasman routes are likely to have been the result of the conditions imposed rather than the Alliance itself. If the conditions are removed, those benefits are at risk on the Wellington routes.

²² Key Wellington Stakeholders’ submission to the ACCC dated 24 April 2013 at [60].

²³ The Applicants’ submissions in response to third parties’ submissions dated 20 June 2013, at p 11.

²⁴ The ACCC’s draft determination dated 10 July 2013 at [202].

Conclusion

- 50 Given the risks of public detriment on the Wellington-Sydney and Wellington-Melbourne routes if the Alliance were re-authorised without conditions, we submit that the ACCC should adopt a precautionary approach and retain the capacity conditions on these routes. In our view, the likely cost of these conditions is minimal compared with the obvious detriment to the public that would otherwise flow from the reduced competitive dynamics inherent in any alliance of this nature.
- 51 We remain of the view that it is imperative that any re-authorisation of the Alliance is made subject to continued and appropriate conditions requiring the Applicants to maintain and grow capacity. Otherwise, there is a very real incentive on the Applicants (and certainly no disincentive) to reduce capacity and to increase fares.

WE SUPPORT THE PROPOSED REPORTING OBLIGATIONS

- 52 Especially if the ACCC is not persuaded that capacity conditions should continue on the Wellington-Sydney and Wellington-Melbourne routes, but in any event, we firmly support the ACCC's proposed reporting obligation conditions requiring the Applicants to keep and provide information to the ACCC on capacity, passenger numbers and the like on each of the trans-Tasman routes. That information will prove very useful in considering any future application by the Applicants for re-authorisation.
- 53 Thank you for the opportunity to make this submission. We are happy to elaborate further on any issue raised with the ACCC. To that end, please feel free to contact Fran Wilde, Chair, Greater Wellington Regional Council at fran.wilde@gw.govt.nz.