

## VIRGIN AUSTRALIA'S COUNTERFACTUAL

### 1. Summary

Since the Alliance launched in 2011, Virgin Australia has been able to offer Australian travellers a highly competitive alternative to Qantas (and now Qantas-Jetstar/Emirates). Consumers have benefited from a better choice of services, better flight connections and more capacity. Importantly, they have benefited through lower fares, both directly under the Alliance, but also because those consumers who have switched from Qantas to Alliance services have been able to benefit from lower relative fares.

Absent the Alliance, Virgin Australia's ability to offer consumers a competitive international network will be limited. There will be less effective competition on the Tasman and in the broader Australasian aviation market. Without the Alliance, Virgin Australia will not be able to offer an effective competitive constraint on the Tasman to the dominant position of the Qantas Group which has been enhanced through its Qantas/Emirates alliance due to its weaker product offering, materially reduced schedule frequency and the reduction in the breadth of network and connectivity either side of the Tasman.

Virgin Australia will be forced to review its offering to consumers, absent the Alliance. Virgin Australia 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. As a result, Virgin Australia firmly believes consumers will be worse off absent the Alliance.

### 2. Absent the Alliance Virgin Australia's ability to offer consumers a competitive international network will be limited

Under its "Game Change Program" Virgin Australia is seeking a larger share of business travellers while preserving a strong focus on leisure and Visiting Friends and Relatives travellers. Despite how good Virgin Australia's domestic product is Virgin Australia will always face limitations in attracting corporate accounts and high frequency travellers if it cannot offer a competitive international network with the destinations, frequencies and enhanced product offering (including loyalty program and lounges) all of which attract such passengers.

In theory, there are three ways in which Virgin Australia can offer an international network:

- 1 Pursue an ad-hoc opportunistic point to point international strategy where routes are abandoned if not able to return adequate profitability.
- 2 Purchase additional aircraft requiring high capital outlay to grow network reach and trans-Tasman frequencies.
- 3 Create an integrated international network through alliances.

Option 1 was undertaken prior to the Alliance and under that model Virgin Australia was subject to profit volatility and was constrained in its ability to attract corporate customers and high yield leisure customers due to its limited breadth and depth of schedule on the Tasman. With the changes to Virgin Australia's business model (away from a traditional Low Cost Carrier) Virgin Australia no longer has the cost base to compete effectively with Jetstar on the Tasman under this option particularly when Jetstar is part of the broader Qantas Group and has much greater frequencies and connections.

Option 2 will not deliver the return on capital or be approved by shareholders. Substantial capital expenditure would be required to provide sufficient breadth and depth of schedule and match the frequency offering of Qantas-Jetstar/Emirates without the ability to recoup those costs within a reasonable time. This strategy would involve time lags in terms of deploying the aircraft and

**PUBLIC VERSION**  
**VIRGIN AUSTRALIA COUNTERFACTUAL**

building the traffic for such services without the benefit of feeder traffic from Air New Zealand and it would result in increased operational costs.

Option 3 provides the possibility of a global network including frequent flyer and lounge benefits with a much smaller capital expenditure requirement and a faster rollout. The Alliance has allowed Virgin Australia to offer enhanced services that consumers' value and to better compete with Qantas for passengers travelling on the Tasman, domestic Australia and domestic New Zealand including in relation to competition for corporate customers. This has been shown on the Tasman by the increased passengers and load factors on Alliance services and the switching of passengers from Qantas to Alliance services.

**3. Absent the Alliance there will be less effective competition on the Tasman**

Consumers will be worse off in the counterfactual because without the Alliance there will be less effective competition on the Tasman and in the broader Australasian aviation market.

- Absent the Alliance, both Virgin Australia and Air New Zealand will struggle to compete with the Qantas-Jetstar/Emirates Group.
- Virgin Australia will be severely impacted due to its limited depth and breadth of schedule while Air New Zealand will struggle to compete due to its limited ability to attract Australian-based passengers and access behind gateway points in Australia. This was the case prior to the Alliance and was part of the strategic rationale for implementing the Alliance.

In the Qantas-Jetstar/Emirates alliance Final Determination, the Commission noted that Qantas' international operations have a number of structural advantages relative to other international airlines operating services to/from Australia. The most significant of these is Qantas' substantial domestic network in Australia. Qantas provides in excess of 50% of Australian domestic air passenger services each year. This gives Qantas a significant advantage over foreign carriers when competing for consumers who require an Australian domestic flight in conjunction with their international flight. It has also enabled Qantas to build significant customer loyalty, which is reinforced by Qantas' frequent flyer program and the contracts Qantas has secured with government and business organisations for their domestic and international travel. These structural advantages enable Qantas to achieve a larger scale of operation and higher revenues by charging a 'loyalty premium' in some of its fare classes.<sup>1</sup>

With the combined strength and market penetration of Qantas-Jetstar and Emirates under their alliance it will be even more difficult for competitors to challenge Qantas' existing position, not only for international travel, but for domestic Australian travel and Australian corporate and government travel. Qantas' main competitor for corporate customers who wish to acquire both domestic and international air passenger transport services from a single provider is Virgin Australia and Virgin Australia is able to offer a broad international network of services to corporate customers through its alliances.<sup>2</sup>

Absent the Alliance, consumers will immediately have less choice and be faced with diminished service and product offerings. They will also be likely to pay higher fares overall on the Tasman. A reduction in fares in the Tasman market will no longer occur through the switching of passengers from the higher priced Qantas services to Alliance services. Without the strong competitive service offering available under the Alliance, Qantas-Jetstar/Emirates will be able to charge higher fares largely unconstrained. In the Final Determination authorising the Qantas-Jetstar/Emirates alliance, the Commission considered and approved the authorisation of the Qantas-Jetstar/Emirates alliance in the context of competition from the Virgin Australia and Air New Zealand Alliance (as a single entity – the sum of which is greater than its parts in terms of the competitive offering available to consumers). Even with the Virgin Australia and Air New Zealand Alliance in place on the Tasman, the Commission noted its concern that Qantas and Emirates will

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<sup>1</sup> QF/EK Final Determination, page 39, paragraph 182.

<sup>2</sup> QF/EK Final Determination, page 110, paragraphs 539 and 540.

**PUBLIC VERSION**  
**VIRGIN AUSTRALIA COUNTERFACTUAL**

have the ability and incentive to unilaterally raise airfares. It further noted that in relation to the Tasman, the major competitive constraint on the Qantas/Emirates alliance will, for the foreseeable future, come from the Virgin Australia and Air New Zealand Alliance.<sup>3</sup> Absent the Alliance, this will not be the case.

In the event that the Alliance is not reauthorised, the following position is likely to apply on the Tasman:

**3.1 Unrestrained Qantas-Jetstar/Emirates alliance**

The Qantas-Jetstar Group will immediately regain a large schedule frequency, schedule breadth and network connection advantage over all other operators on the Tasman.

- The Qantas-Jetstar Group will continue to implement a flexible dual product strategy with its Qantas service targeted to the high frequency routes serving higher population and traffic destinations which can attract higher yield passengers and Jetstar principally serving routes that have smaller population and traffic levels and are primarily leisure focused or attract lower yields.
- In some cases, both the Qantas and Jetstar brands are used on the same route with different pricing and service strategies. These routes include both Sydney and Melbourne to Auckland, Sydney to Christchurch and Sydney to Queenstown.
- The Qantas-Jetstar Group's large schedule frequency and breadth will be further entrenched under the authorised Qantas-Jetstar/Emirates alliance, where these carriers will be able to offer an integrated service offering to all customers, including corporate accounts, across the Tasman, domestic and international routes.
- The Qantas-Jetstar/Emirates alliance was authorised on the basis of a competitive assessment assuming the existence of the competitive constraint from the Virgin Australia/Air New Zealand Alliance - a constraint which the Commission noted would be the major competitive constraint on the Qantas-Jetstar/Emirates alliance for the foreseeable future. Without the Alliance this major competitive constraint will no longer be in place. Critically for Australian based customers, including corporate accounts, it is clear that the Qantas-Jetstar/Emirates alliance will not be constrained by Virgin Australia.
- The Qantas-Jetstar/Emirates alliance has approximately 47% capacity share serving twelve Tasman markets. Without the Alliance, based on current operations, Virgin Australia would at most only be able to offer services on eight of these Tasman markets (assuming no withdrawal of capacity or service reduction).
- As noted in the Final Determination for the Qantas-Jetstar/Emirates alliance, on the key Tasman routes which are important for Australian corporate contracts such as AKL-BNE/MEL/SYD, the comparative shares of total capacity of Virgin Australia and Qantas-Jetstar/Emirates for the year ending June 2012 were as follows:<sup>4</sup>

Sector	Virgin Australia	Qantas-Jetstar/Emirates
AKL-BNE	14.4%	42.8%
AKL-MEL	10.5%	57.9%
AKL-SYD	5.2%	51.2%

- The general evidence of the impact of Virgin Australia's enhanced competitive offer against Qantas on fare levels is unequivocal. It can be expected that with a diminished Virgin Australia product offer absent the Alliance Qantas-Jetstar/Emirates will be able to increase fares.

<sup>3</sup> QF/EK Final Determination at page 103, paragraph 501.

<sup>4</sup> QF/EK Final Determination pages 101 and 102.

**PUBLIC VERSION**  
**VIRGIN AUSTRALIA COUNTERFACTUAL**

**3.2 Air New Zealand will be at a material service disadvantage to Qantas/Emirates**

Air New Zealand will of course remain on the Tasman as the Tasman is a substantial part of Air New Zealand's business which feeds its long haul international and domestic networks. However, Air New Zealand will lack Australian domestic connections since Virgin Australia would not offer Air New Zealand a codeshare or Special Prorate Agreement in relation to domestic Australia with the only carriers able to provide these to Air New Zealand being Virgin Australia and the Qantas-Jetstar Group. Air New Zealand would also be at a material schedule disadvantage to Qantas-Jetstar/Emirates absent the Alliance.

Air New Zealand is limited in its ability to attract Australian-based passengers to access behind gateway points in Australia as it has no access to the Australian domestic market beyond possible interline agreements. Without the Alliance, Air New Zealand will not have the network enhancement that it currently gains through access to Virgin Australia's domestic network and therefore, will not have access to Virgin Australia's Australian destinations and feed. Any interline agreements that Air New Zealand manages to negotiate will come at a greater cost to both Air New Zealand and consumers and leave Air New Zealand at a competitive disadvantage to Qantas-Jetstar/Emirates in competing for passengers requiring access to or from points behind the main Australian gateways.

**3.3 Fifth freedom services and utilisation flying don't provide a competitive offer against Qantas/Emirates**

China Airlines and LAN Airlines will continue to opportunistically target the market through fifth freedom services, offering low fares available through utilisation flying and marginal cost pricing. While low fares make the route highly competitive, these carriers are not able to provide a competitive offer against the frequency and breadth and network connection advantage of Qantas-Jetstar/Emirates. The trans-Tasman market will remain open to other fifth freedom carriers such as Thai Airways, Malaysian Airlines, Aerolineas Argentinas and Garuda all of which have operated Tasman services in the past.

**4. Absent the Alliance, Virgin Australia will review its offering to consumers on the Tasman**

**4.1 Virgin Australia will review its trans-Tasman operated routes**

When considering the likely counterfactual, Virgin Australia's current revenue performance on the Tasman would be taken into consideration. Since commencement of the Alliance, Virgin Australia's revenue performance has improved.

The key reasons behind the improvement have been due to the Alliance and include:

- an improved network and schedule enhancing passenger choice through increased access to flights to more city pairs and a better spread of departure and arrival times;
- an increase in sales and distribution through Air New Zealand especially in point of sale New Zealand;
- an improved product;
- a higher number of city pairs on offer for sale (behind main gateways in Australia to beyond main New Zealand gateways);
- an improvement in frequency offered through codeshare on Air New Zealand services – an additional 576 online connection options for Alliance passengers which has increased to 628 since May 2013;
- an increase in domestic feed onto the Tasman on Virgin Australia ticketed sales from having access to the Alliance's higher frequency on the Tasman;

**PUBLIC VERSION  
VIRGIN AUSTRALIA COUNTERFACTUAL**

- the addition of frequent flyer redemption revenue on the Tasman; and
- the improved availability of lounges – Virgin Australia passengers can access Air New Zealand’s six international air-side lounges on the Tasman and 12 domestic New Zealand lounges and Air New Zealand passengers can access Virgin Australia’s eight domestic Australia lounges.

In addition to the direct impact to revenue performance on individual routes, since the commencement of the Alliance a number of other benefits have been recognised. While these do not directly impact financial performance on the trans-Tasman routes, they do positively impact performance on the rest of the Virgin Australia network. These include:

- Connecting passenger feed onto the Virgin Australia Australian domestic network from Air New Zealand.
- Corporate clients won or retained due to the ability to provide a high frequency enhanced offering on the Tasman. Where the majority of spend is on Virgin Australia domestic Australian routes this manifests as better yields on the Virgin Australia network.
- Loyalty benefits such as the high value customer benefits, which manifests as higher yield on the Virgin Australia network.
- Frequent flyer members won and/or retained due to redemption offering on the Air New Zealand network.
- Cost efficiencies through joint purchasing and better use of respective strengths in home markets.

Absent the Alliance, the majority of these direct and indirect benefits are unlikely to be recognised and Virgin Australia will review the viability of each of its trans-Tasman routes. Without the Alliance Virgin Australia’s financial performance will deteriorate and its materially weakened schedule frequency and breadth and network connection offer against Qantas-Jetstar/Emirates will undermine the broader strategic benefits to Virgin Australia of operating on the Tasman. Virgin Australia will have a weaker product offering and have a reduced ability to attract both business and leisure passengers. As a result, Virgin Australia 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. In addition, without the Alliance there will also be adverse consequences for consumers in terms of connectivity, flight disrupt management and fare consequences on connecting journeys. Absent the Alliance, new routes become much less likely due to inability of the individual carriers to generate the required traffic.

Absent the Alliance the performance of key business markets such as Auckland-Sydney and Auckland-Melbourne will be negatively impacted due to the inability to compete with the Qantas/Emirates frequency offering on such routes. Virgin Australia has limited ability to substantially increase the frequency of its stand-alone Tasman services, as matching the frequency levels of competitors would require significant investment in new aircraft which could not be justified as stated in section 2. Virgin Australia may also need to reduce frequencies on other routes in order to reduce any losses and to more profitably redeploy capacity. It may be the case that Virgin Australia capacity withdrawn from the Tasman could more profitably be deployed on other Virgin Australia Group routes.

Virgin Australia will have low frequencies on the Tasman, limited ability to substantially increase the frequency of its stand-alone Tasman services and no capacity to offer a breadth and depth of services that would be competitive with Qantas-Jetstar/Emirates. These factors are key to a business traveller’s airline choice along with loyalty program and lounge benefits (which are enhanced though broader networks on which points can be earned and burned). Absent the Alliance, some very tangible public benefits around reciprocal lounge and FFP arrangements would immediately be placed in jeopardy.

**PUBLIC VERSION**  
**VIRGIN AUSTRALIA COUNTERFACTUAL**

**4.1.1 *Virgin Australia will review its benefits offering on the Tasman***

Under the Alliance, each airline allows their paid lounge membership program members virtually unlimited use of each other's lounges when travelling on the Tasman or on each domestic network. This type of cooperation is not typical of airline lounge relationships, even within strategic alliances. This benefit would not continue absent the Alliance. This arrangement allows Virgin Australia's lounge members in Australia to use Air New Zealand's international lounges in Australia and New Zealand when travelling on the Tasman or on domestic New Zealand flights in addition to lounge entry benefits with Virgin Australia when travelling domestically in Australia. This level of access would otherwise not be possible for these customers unless they achieved the relevant tier status on an applicable frequent flyer program, or unless they paid to join Air New Zealand's paid lounge membership program in addition to Virgin Australia's lounge program.

With regards to other lounge entitlements driven by Velocity tier status or fare entitlement (Premium Economy or Business Class), absent the Alliance it is assumed that both parties would review entry charges and effect an arms-length charging regime. This additional cost would force Virgin Australia to review this offering (which may involve limiting benefits), or to recover the cost differential through fare increases.

From a frequent flyer program perspective, it is also assumed that both parties would review accrual and redemption access and commercial terms absent the Alliance. Changes in these terms would at the very least force Virgin Australia to review the offering to members, which may involve recovering cost through lower accruals or more expensive redemptions, or potentially removing benefits altogether. Velocity Rewards airline accrual partners are currently limited to Virgin Australia's codeshare partners. Absent the Alliance it is therefore likely that 3.2 million Velocity Rewards members in Australia and New Zealand (at the end of FY12) would no longer be able to accrue points on Air New Zealand services, or redeem points across Air New Zealand's network.

There are other benefits reciprocally available to Virgin Australia's high value guests travelling on Virgin Australia's services that would be in jeopardy absent the Alliance. These include priority check in, priority baggage handling, additional checked baggage allowances, additional cabin baggage, priority seating and priority boarding. These benefits have been identified as key drivers of customer choice amongst tiered frequent flyer program members who are entitled to receive them. Absent the Alliance the frequency of services on which these benefits are available to these guests would immediately be limited unless they were able to attain the required status level on both airlines' frequent flyer programs.

**4.1.2 *Virgin Australia will not enter into a code share agreement with Air New Zealand whilst Virgin Australia operates on the Tasman regardless of how substantial or insubstantial such presence***

There is no commercial prospect that Virgin Australia and Air New Zealand will code share on each other's trans-Tasman services whilst Virgin Australia and Air New Zealand both operate on the Tasman, regardless of how substantial or insubstantial each carrier's presence on the Tasman is.

Absent the Alliance, the Applicants would not have the commercial incentive to enter into a simple code share arrangement or another form of shallower alliance. This is because, in code sharing and other standard arrangements, parties continue to have an incentive to maximise their own economic benefit and code share would only drive passengers onto the other carrier's services without any possibility of sharing in the benefit.

It is unlikely that Virgin Australia would enter a code share on domestic New Zealand services absent codeshare on Tasman services. However, as noted above, even if such arrangements could be achieved, the service offering under this arms-length non-Alliance code share will be inferior to that under the Alliance, and the parties will have limited incentive to offer attractive pro-rates, where they cannot share the full revenue. In fact, Air New Zealand has stated that absent the Alliance it would not offer Virgin Australia an interline or Special Prorate Agreement in relation to

**PUBLIC VERSION  
VIRGIN AUSTRALIA COUNTERFACTUAL**

domestic New Zealand traffic.<sup>5</sup> In a world without a code share arrangement, even assuming that Virgin Australia and Air New Zealand enter into an interline arrangement for domestic connections, fares overall will be higher. Each carrier will naturally set fares so as to achieve a profit margin on the sector they operate, without taking into account the overall benefits of stimulating passengers through one overall lower fare for both sectors ("double marginalisation"). Absent the Alliance this effect would immediately lead to an increase in fares involving before or beyond sectors in domestic New Zealand and domestic Australia, allowing Qantas-Jetstar/Emirates to virtually monopolise many of these origin and destination pairings where no direct trans-Tasman routing exists.

On a stand-alone basis (that is without the Alliance), Virgin Australia cannot sustain a level of operations that would provide a competitive corporate offer against Qantas/Emirates. That is, its stand-alone operations would not deliver a material domestic corporate market benefit.

For the reasons highlighted above, the Alliance makes it much more likely that Virgin Australia will maintain a substantial and competitive presence on the Tasman.

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<sup>5</sup> Air New Zealand public counterfactual submission page 1.