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LAWYERS

Applications for reauthorisation of the Virgin Australia and Air New Zealand Australian Airline Alliance

Confidential submission in response to interested party submissions

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Contents

1 Introduction

The Applicants thank the Commission for providing them with the opportunity to respond to submissions made by third parties in relation to the reauthorisation of the Australasian Airline Alliance (the **Alliance**).

The submissions by third parties overwhelmingly support reauthorisation of the Alliance, and recognise that the Alliance has delivered a range of public benefits.

The Applicants submit that these benefits are substantial and include:

- the introduction of 628 additional online connection options and many additional frequencies including new routes (Perth-Christchurch and Auckland – Sunshine Coast);
- a better breadth and depth of schedule for consumers to choose from;
- lounge and frequent flyer reciprocity;
- stimulation of passengers on Alliance services and the Tasman overall; and
- lower average fares as a result of cost saving and efficiency improvements, amongst other benefits.

In a short timeframe the Alliance has achieved the objectives it set out to achieve when it first sought and obtained authorisation and there are further and deeper benefits to be obtained through reauthorisation. The Alliance allows the Applicants to offer a breadth and depth of schedule and connectivity as well as enhanced products and value-added services that customers value, and which neither party to the Alliance is capable of providing alone. The Alliance is thereby able to provide an offering that can compete effectively with the offering of the Qantas/Jetstar/Emirates group.

It is in relation to the necessity for capacity conditions that the Applicants tend to disagree most stridently with the majority of third party submissions. As the Alliance has now demonstrated its ability to deliver benefits that were once only theoretical within a short window of operation, without any anti-competitive detriment on the Tasman or any individual route, the Applicants consider that the capacity conditions should be removed.

The Applicants agree with the Australian Government Department of Infrastructure and Transport that “the Qantas-Emirates alliance acts as a strong competitive counterweight” and “barriers to entry are sufficiently low that if the market is left to operate naturally and competition was to wane, additional competitors are likely to enter the market, causing the market to reach a natural balance point”.

The Applicants also note that Christchurch International Airport Limited (**CIAL**) has on receipt of further information and data told the Commission that it supports reauthorisation of the Alliance, for a period of 5 years with no capacity commitments into Christchurch.

2 Significant evidence of Alliance-driven benefits

In its short operation, the Alliance has resulted in substantial public benefits without any anti-competitive detriment on the Tasman or on any individual route. The Alliance has delivered on its key objective of increasing passenger traffic on Alliance services through the provision of an improved service offering which customers value including increased

online connection options, better schedule spread, increased coded frequencies, new frequencies and new trans-Tasman services as well as enhanced value added services through frequent flyer and lounge access reciprocity. The Applicants have already provided a great deal of data and information evidencing these benefits in the 8 March 2013 submission accompanying their applications for reauthorisation (**Submission**)[1] and in response to subsequent information requests by the Commission. The Applicants will not reiterate that evidence in detail here.

However, the Applicants do consider it necessary to provide a response to some of the specific claims that have been made in certain third party submissions. The Applicants note that many of these claims are based upon external data sources and anecdotal feedback, which has its limitations and does not provide robust information that can be relied on to support the claims made in the submissions of interested parties. The incorrect and otherwise unsupportable conclusions reached by some third parties in their submissions are a result of their reliance on this inaccurate information. The Applicants will address these points in further detail below.

2.1 Combined average fares under the Alliance have decreased

Not only did the trans-Tasman combined average fare for the Alliance decrease from the Pre Alliance Year to Year 1, the combined average fare for each individual trans-Tasman route to or from Christchurch also decreased over this period. Certain submissions from interested parties suggested that this was not the case. In response, the Applicants note that submissions including conclusions based on data sourced from Sabre Segment will not include all the relevant sources of revenue information required to enable a proper and accurate construction of average fare information.

For example, the Sabre Segment average fare data is likely to be based on bookings made via global distributions system (GDS) and use estimates for the bookings made via other channels. However, a large percentage of total bookings are made online or directly with airlines rather than via GDS. As a result, the Sabre Segment average fare data would comprise of estimated information for a large proportion of passengers leading to inaccuracies in the data set. For instance, [**CONFIDENTIAL**]% of Air New Zealand's trans-Tasman passengers book directly online and a further [**CONFIDENTIAL**]% book through other direct channels. Similarly, Virgin Australia has historically had strong sales performance via online and direct channels with [**CONFIDENTIAL**]% of bookings being made direct. Conversely, Virgin Australia's bookings through GDS providers on trans-Tasman sectors were [**CONFIDENTIAL**]% in FY2012.

[**CONFIDENTIAL**] Customers shopping online for travel are generally highly price sensitive – they are more likely to be travelling for leisure (as opposed to business) and are typically more flexible with their travel plans. Accordingly, online customers take a disproportionate amount of the lowest fares available (compared to those booking through traditional indirect sales channels such as travel agencies). [**CONFIDENTIAL**]

The Applicants submitted data on the combined average fares of the Alliance by sector in the Submission[2] and further data has been provided to the ACCC in response to subsequent information requests. Unlike the Sabre Segment data, this data reflects the

[1] See section 3 of the Confidential submission in support of application for reauthorisation lodged with the ACCC by Virgin Australia and Air New Zealand on 8 March 2013 (**Submission**).

[2] See Confidential Annexure H of the Submission.

actual fares paid, and is fully informed in terms of the booking source mix including GDS, agency, direct and online sales channels.

The Applicants also note that the submissions of some interested parties provided trans-Tasman airfares for Virgin Australia and Air New Zealand in US dollars. The strengthening of the Australian and New Zealand dollar over the last few years and the changing US dollar exchange rate mean that, even if it was assumed that average fares had remained constant instead of decreasing, fare data cited in US dollars would likely show fares as rising relative to 2009. In its submission the Key Wellington Stakeholders (**KWS**) states that its fare monitoring data shows airfares have increased on the Wellington-Brisbane route. This claim is not correct. KWS has had to rely upon less informed data than that provided to the ACCC by the Applicants.

The Applicants submitted data on the combined averages fares of the Alliance by sector in the Submission.[3] This data reflects the actual fares paid and is also subject to external audit in that it forms part of each airline's statutory financial statements. PWC also separately provides assurance services in relation to the reported revenue and compliance with the Alliance revenue definitions.

The Applicants' audited data is the best data available and shows that Alliance average fares for the trans-Tasman decreased by [**CONFIDENTIAL**]% from the start of the Pre-Alliance Year (Nov 2009) to Year 1. The data demonstrates that overall combined Alliance average fares on the Tasman have not increased but decreased, as have average fares on all Wellington routes with the exception of Sydney-Wellington.[4] Sydney-Wellington showed a relatively immaterial increase of [**CONFIDENTIAL**]% from the Pre-Alliance Year to Year 1.

The NZ Airports Association submission suggests that the data provided by the Applicants does not take into account ancillary revenue (ie, additional charges that passengers may pay for services such as luggage, meals and in-flight entertainment).[5] This assertion is not correct.

Alliance average fares are derived from Alliance revenue which includes the full fare paid by the passenger irrespective of which product type the customer has chosen (eg, Seat, Saver, Works, Premium Economy etc). As a result, where meal, luggage allowance and in-flight entertainment is incorporated into the fare purchased or are purchased separately prior to check-in, this would be included as part of the ticket revenue and included in the average fare. However, as noted previously by the Applicants in their correspondence with the ACCC, Alliance revenue excludes some sources of true ancillary revenue (eg, additional on-board food and beverage sales) as this is discretionary spend by customers once they are at the airport or on-board. [**CONFIDENTIAL**].

Most importantly, any 'Ancillary' Revenue that is counted by the Applicants as 'ticketed passenger revenue' has remained consistent from the Pre-Alliance Year to Year 1.

2.2 Capacity is meeting, and in some cases exceeding, consumer demand

Submissions of certain interested parties state that capacity on trans-Tasman routes to and from Christchurch and Wellington is not meeting consumer demand.[6] However, the

[3] See Confidential Annexure H of the Submission.
[4] See Confidential Annexure H of the Submission.
[5] See submission lodged by NZ Airports on 3 May 2013, paragraphs 31-33.
[6] For example, see submission lodged by Key Wellington Stakeholders on 26 April 2013, paragraphs 67-85.

experience of the Alliance in selling tickets for trans-Tasman flights on Wellington and Christchurch routes has been that consumer demand is not increasing to the extent these interested parties suggest and that capacity is meeting, and in some cases exceeding, consumer demand.

The NZ Airports Association does not claim that the Alliance is failing to meet consumer demand. Instead, it notes what it describes as a slowing of the average annual rate of capacity growth by all airlines in the trans-Tasman market from pre-Alliance years.[7] The Applicants consider that the graph provided by the NZ Airports Association to support this point is misleading for a number of reasons. The starting point for comparing the rate of growth over time by the NZ Airports Association is 2003. Virgin Australia began operating trans-Tasman services in February 2004 and proceeded to add a significant amount of capacity into the market. As discussed above, the provision of capacity is related to there being consumer demand to support that capacity and demand does not always follow a continuous and steady rate of growth. For example, as shown in the submission of the NZ Airports Association trans-Tasman capacity has not increased continually or at a continually increasing rate. From 2005 to 2007 capacity decreased. Notwithstanding, the Applicants recognise the consumer interest in capacity growing in line with consumer demand and their own financial interest in providing the capacity to capture that demand. Contrary to assertions made in certain submissions, the Applicants consider that the recent growth has met or exceeded demand. This is evidenced by the [**CONFIDENTIAL**]% seat factor on WLG routes in Year 1, which is [**CONFIDENTIAL**] points below the Tasman average and the [**CONFIDENTIAL**]% drop in average fare on CHC routes which is [**CONFIDENTIAL**] points more than the decline in the total Tasman average fare.

The Applicants consider it important to note here that capacity should always be related to consumer demand. One issue with route-specific capacity conditions and the capacity growth factor is that they inhibit the Alliance from directing capacity to those routes where demand is highest, resulting in inflexibility and inefficiency in the allocation of resources and costs to both airlines and travellers.

The Applicants will now make some specific points regarding Christchurch and Wellington trans-Tasman routes.

(a) Christchurch Routes (being the trans-Tasman routes between CHC and SYD/MEL/BNE/OOL)

There was a significant reduction in demand for airline travel to and from Christchurch resulting from the earthquakes and aftershocks in the Canterbury region. Evidence of the significant reduction in demand for trans-Tasman travel to and from Christchurch was provided to the ACCC and formed the basis of the ACCC's decision to allow a variation to the Applicants' compliance with capacity conditions. As a result, capacity on Christchurch Routes has reduced over the last three years and Jetstar has also withdrawn from the CHC-BNE route. [8]

In response to the drop in passenger numbers experienced after the earthquake, the Applicants have continued to offer reduced fares across the trans-Tasman routes in order to stimulate demand and to maintain load factors. As mentioned above, average fares for routes into or out of Christchurch have fallen [**CONFIDENTIAL**]% in Year 1, which is [**CONFIDENTIAL**] points more than the decline in the total Tasman Alliance average fare.

[7] See The NZ Airports Association submission, paragraph 18-19.

If there was unsatisfied consumer demand, then the Applicants would not need to reduce fares by such a level in order to stimulate demand.

Additional capacity is now being added back onto these routes as the demand for these sectors improves and as demand for capacity increases in relation to Christchurch, the Alliance will respond by offering more capacity as it stands to profit by doing so. In fact, the Applicants recently announced the new service between Christchurch and Perth (initially operating from Dec 2013 to April 2014) which will add a further 19,488 seats flying into/out of Christchurch.

However, the Applicants want to be clear that the Alliance cannot be expected to replace all of the capacity removed by the exit of Jetstar. To expect the Alliance to do so would not be consistent with market forces and the fact that Jetstar made a commercially-informed decision to withdraw from servicing the CHC-BNE route in March 2012. At the time, a Jetstar spokesperson stated that the route had "not performed as we would have liked".[9] If there was additional substantial demand not being met, Jetstar would not have needed to withdraw from the CHC-BNE route. If Jetstar could not operate profitably on the CHC-BNE route, it would be unreasonable to expect the Alliance to be able to profitably replace all that capacity.

In addition, although Jetstar may have exited the CHC-BNE route, it is capable of re-entry if there was sufficient demand that was not being met. Jetstar has shown its ability to rapidly deploy capacity on to trans-Tasman routes in response to market opportunities and following authorisation of the Qantas-Emirates alliance this ability would potentially be enhanced as Qantas Group and Emirates optimise their collective Tasman operations and jointly market and sell their Tasman network.

(b) Wellington Routes (being trans-Tasman routes between WLG and SYD/MEL/BNE)

In deciding whether to enter the Alliance, the Applicants used Quality Service Index (QSI) modelling to identify likely passenger responses to the enhanced offering of the Alliance. QSI is a standard business analysis tool used and relied on by each of the Applicants and the wider aviation industry to inform commercial decisions. QSI analysis was supplied to the Board of each airline for internal decision purposes and quantified and confirmed each Board's commercial expectation that the Alliance would deliver significant benefit through substantial overall passenger stimulation on the Tasman and substantial increases in passengers on Alliance services. The predictions of the QSI analysis have been borne out in the actual operation of the Alliance with increased passengers and load factors on Alliance services and the increased provision of capacity and ability to offer lower fares than would be the case with the airlines operating independently.

However, due to capacity conditions on Wellington routes[10] the Alliance has been forced to allocate capacity without the demand to support it. Consequently Wellington route load factors have been consistently low. While the Applicants have been successful at lifting the collective load factor since authorisation, the load factor on the WLG routes still lags significantly behind other sectors at between [**CONFIDENTIAL**]% and [**CONFIDENTIAL**]%. As mentioned above, the average load factor for routes into and out of Wellington in Year 1 was [**CONFIDENTIAL**]%, which is [**CONFIDENTIAL**] points below the Tasman average. These load factors are typically unprofitable on the trans-Tasman.

[10] The Applicants note that the Alliance Capacity Implementation Agreement has an additional commitment on Wellington routes to the ACCC conditions.

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KWS state in their submission that overall growth in capacity on the Wellington routes has reduced in recent months. Capacity growth has slowed in Year 1 and Year 2 as there is insufficient demand to justify the strong capacity growth of Year 0. The Applicants grew capacity significantly at the commencement of the Alliance with capacity on Wellington routes in Year 0 being 13.5% ahead of Pre-Alliance Year. This marked increase in capacity was required to meet capacity commitments and as passenger growth has not grown in line with capacity growth the applicants have not been able to continue growing capacity at this level. However, capacity is still set to grow: the Applicants' planned capacity for Year 2 (year ending October 2013) is 2.1% above capacity for Year 1 and 19.3% above capacity for the Pre-Alliance year.

The Applicants consider that it is necessary to note again here that free market conditions do not necessarily always result in continuous growth. Growth is demand-driven, and sometimes there is not enough demand to support growth in supply.

In fact, it is a major flaw of the scenarios modelled by KWS in relation to the WLG-BNE route that they assume demand will always increase. In particular, KWS provide a series of modelled scenarios. These scenarios are one-sided, looking only at supply in isolation. Under normal market conditions, supply would not realistically continue to rise in the manner modelled by KWS. Increased supply can only occur where there is available aircraft to provide that supply. The WLG-BNE route has to compete with demand on other more profitable routes for supply of capacity by existing aircraft. Before any new aircraft would be acquired to increase supply, high demand across multiple routes is needed because a new aircraft delivers substantial new capacity. The modelling carried out by KWS is too simplistic to reflect the reality of aviation economics.

The Applicants note that if the capacity conditions were removed and the Alliance was able to adjust capacity on this route to suit consumer demand, the Wellington routes would still not be in a position of "restricted supply" because Wellington flights are operating with so many empty seats. While passengers have increased [**CONFIDENTIAL**]% from the Pre-Alliance Year to Year 1 on the BNE-WLG route, the load factor has still fallen by [**CONFIDENTIAL**]%. While a [**CONFIDENTIAL**]% increase in passengers to Year 1 might seem reasonable, it is far below the [**CONFIDENTIAL**]% increase that needed to occur for the load factor on the BNE-WLG route to be at the Year 1 trans-Tasman average for the Alliance of [**CONFIDENTIAL**]%. Any adjustment of service supply to be more in line with lower demand levels is only likely to result in a more reasonable load factor, with no decrease in the number of passengers travelling on the Alliance services, because there are empty seats to be filled.

In addition, the Applicants note that, beyond a certain point of demand, increasing capacity fails to provide real benefits to customers. For example, once services exceed 14 trips a week, wingtip flying is likely to result.[11] In the Final Determination, the ACCC acknowledged that increased schedule spread made possible under the Alliance would likely be a direct source of public benefit.[12] In conclusion, operating capacity that is unmatched to demand on Wellington flights is inefficient and costly, which in the end is costing the consumer.

[11] Wing tip flying is defined as a situation where there are two flights, on the same sector, and they both depart in the same morning or afternoon or less than 3 hours apart; or where there are more than two flights per day on a given sector and any of those flights depart within 1 hour of each other.

[13] See Key Wellington Stakeholders submission, paragraph 84.

2.3 No significant increase in indirect travel due to a lack of capacity on Christchurch or increased fares Wellington on or Christchurch routes

Combined Air New Zealand and Virgin Australia data show that the proportion of indirect traffic on the CHC-BNE, CHC-MEL and CHC-SYD routes is still equal to 2010 volumes and is between 4- 6%.

CHC-OOL is the only route on which the proportion of indirect travellers is greater than 10%, and this reflects the fact that the CHC-OOL route is not served daily by the Alliance while at the same time, the AKL-OOL route has an increased choice of good connections due to the removal of wingtip flying made possible by the Alliance.

KWS state that Wellington has the highest number of Brisbane passengers flying via other ports (supposedly 10%) and cite Statistics NZ data as evidence. KWS consider this indicates that the level of capacity and/or the price of airfares on this route are not satisfying the market[13] and do not accept that the level of capacity on the WLG-BNE route is inefficiently high.[14]

The Applicants strongly refute this contention. Competition from indirect services shows consumers have other viable travel options. From the Pre-Alliance Year to Year 1, the Applicants have increased capacity on this route by 10.6%, increased frequencies by 2.5% and decreased Alliance average fares by [**CONFIDENTIAL**]%. Over the same period, passengers increased by just [**CONFIDENTIAL**]%. Qantas competes indirectly on this route and has competed indirectly on this route since before the Alliance was implemented. If consumers decide to travel on an indirect flight with Qantas, this does not reflect a withholding of capacity by the Applicants. If it were the case that the level of capacity was being restricted and/or the price of airfares was anti-competitively high this would only encourage entry from Qantas or Jetstar. There are no barriers to Qantas or Jetstar entering this route. They both already have operations at each of Brisbane and Wellington airports and could readily commence direct services in competition with the Applicants.

Moreover, the Applicants note based on their own origin and destination data, that there has not been an increase in the number of indirect passengers travelling between Wellington and Australia. In fact, the number of Alliance passengers travelling indirectly between Sydney and Wellington has decreased from 8% in 2010 to just 2% in 2012. This reinforces the Applicants' belief that there is surplus capacity on this sector. The Applicants' data also shows that indirect travel between Brisbane and Wellington has remained unchanged at 3% in both 2010 and 2012, and indirect travel between Melbourne and Wellington has decreased from 8% to 6% for the same period. The data also shows that little has changed in relation to indirect flying patterns on Christchurch Routes. Please see Attachment A for further detail.

Indirect travel can occur for many reasons (ie, convenience, price, availability, customer needs). The data is unable to tell us why a passenger has elected to travel indirectly. However, the fact that a consumer may choose to fly out of/into one airport rather than another to get from their point of origin to their ultimate destination demonstrates that consumers have choice and can and do make alternative travel arrangements.

[13] See Key Wellington Stakeholders submission, paragraph 84.
[14] See Key Wellington Stakeholders submission, paragraph 84.

2.4 The Alliance must be able to make commercial decisions in relation to the routes and services it operates

The Applicants note that it is impossible for an airline schedule to meet the demands of every consumer. The Applicants recognise that there will be times when consumers cannot find an appropriately timed flight either because the suitable flights are full or do not exist. Airlines obviously want to please as many consumers as possible because doing so results in customer satisfaction, more traffic, higher yields, increased revenue, and ideally profit. However, it is not possible for the Alliance to offer enough services to suit every customer regardless of the applicable load factors. There are significant costs in operating scheduled services and there needs to be sufficient demand to commercially justify the provision of flight services.

For example, since the Christchurch earthquake, a large amount of ski traffic is travelling to Queenstown. The Applicants have responded to this shift in consumer demand and significantly increased capacity between Queenstown and Australia.

3 The benefits delivered are a direct result of the Alliance

The KWS submission questions whether the overall increased capacity and reduced fares on the Tasman are a result of the Alliance. It contends that these benefits could necessarily follow from the capacity conditions required by the ACCC, or even potentially from market conditions.[15] This argument is also made by Qantas and Emirates in their submissions.

The Applicants disagree strongly.

The core of the Applicant's case for authorisation in 2010 was that the alliance of the networks and businesses of Virgin Australia and Air New Zealand on the Tasman would lead to a material enhancement of both airlines' products in a manner not otherwise available to each airline individually (ie, greater choice of flights, better online connections, better breadth and depth of schedule and enhanced loyalty programs and lounge benefits). These expected outcomes have been realised by the Alliance with continued and deeper benefits to follow. Of particular note, Virgin Australia has dramatically improved its customer facing product on the trans-Tasman. Absent the Alliance, it would not have committed to this investment in the same timeframes. Based on the standard methodology widely used by carriers, airports and consulting firms in the aviation industry (QSI analysis), it was forecast that consumers would respond to the enhanced offering under the Alliance with increased demand for Alliance air services. As a result, the consumer reaction to the Alliance would mean that the Alliance would acquire some new passengers through stimulated demand for trans-Tasman services as well as some passenger substitution from other carriers. This effect has occurred and would not have been achievable individually, especially in the short timeframe that the Alliance has been implemented.

When the Applicants first applied for authorisation, the contention was that this would result in higher load factors, lower costs per seat sold and decreased average fares both on direct and connecting journeys. These results have been delivered – and, contrary to submissions from certain parties, there is a significant improvement in the offering able to be provided to consumers since 2010. The benefits have also been achieved notwithstanding the excess capacity the Alliance has had to deploy on some routes to

[15] See Key Wellington Stakeholders submission, paragraph 67.

meet capacity conditions. On routes such as BNE-DUD and the WLG routes, the continuation of unsustainably low load factors (which imposes a higher cost per seat on the Applicant's) will ultimately lead to higher fares overall than would be necessary if those resources were matched to demand and deployed more efficiently.

The Applicants have provided comprehensive arguments and supporting data to demonstrate that public benefits have arisen from the Alliance itself, and not the capacity conditions.

The public benefits delivered by the Alliance are the enhanced products and services that consumers have shown they value by increasing their demand for Alliance services. The increased demand for Alliance services has, in turn, resulted in increased load factors and additional capacity without a corresponding increase in fares. These benefits were the driving commercial rationale for the Alliance – they are logical and empirically demonstrated – and they have actually arisen due to the operation of the Alliance.

4 Capacity conditions are distortive, costly and not required

4.1 No requirement for capacity conditions: the trans-Tasman is a highly competitive market

In its submission to the ACCC, the Australian Department of Infrastructure and Transport acknowledged that the "Australian/New Zealand air services market is one of the most open in the world".[16] The competitive nature of the trans-Tasman market stems not from the number of carriers present on a particular route but from its liberal aviation policy, short haul nature, high proportion of traffic on a few main routes (allowing an airline to access the majority of trans-Tasman traffic by entering only a few routes) and its low barriers to entry.[17]

The submission of the Australian Department of Infrastructure and Transport emphasises these very elements of the Trans-Tasman market. It concluded that "barriers to entry are sufficiently low that if the market is left to operate naturally and competition was to wane, additional competitors are likely to enter the market, causing the market to reach a natural balance point".[18]

The airlines of over 30 countries currently have rights to commence direct Australia-New Zealand services under bilateral air services agreements with Australia and over time there have been multiple entrants into the Tasman market. That more FFCs do not choose to compete in the trans-Tasman market does not, for the most part, result from an inability to do so. Instead, it is a reflection of the challenging and competitive nature of the trans-Tasman market, one that many FFCs have found difficult to make a profit in.

Since the Applicants applied for reauthorisation, the Qantas-Emirates alliance has been approved. The Qantas-Emirates alliance is now a stronger competitor on the Tasman. KWS state in their submission that the alliance of Qantas-Emirates will not affect its routes because there has been no consolidation as a result of the alliance on those routes. However, the Applicants note that the fact that Qantas-Emirates is now Tasman wide means Qantas/Jetstar and Emirates may optimise their approach throughout the

[16] See submission lodged by Australian Government, Department of Infrastructure and Transport submission on 12 April 2013, page 2.

[17] Note: taken from 2010 V/NZ submission in response, par 4.1.

[18] See Australian Government, Department of Infrastructure and Transport submission, page 5.

network to strengthen all operations including Qantas's Wellington operations. The Applicants understand the benefits of doing this because optimising the VA/NZ Tasman network was a key rationale for entering into their own Alliance. For example, under the Alliance Air New Zealand moved its operations off the WLG-BNE route so that Virgin Australia could operate services in and out of its own BNE hub, and thereby delivered a more efficient allocation of resources. A series of changes of this kind in combination enabled a broader, more efficient and more sustainable network.

Qantas and Emirates have already begun making similar moves to more effectively allocate capacity on the Tasman. For example, Emirates has recently announced that it will fly an A380 instead of a B777-300 on the AKL-BNE route.[19] This up-gauge will provide an extra 98,550 seats on the route annually. This in effect frees up the Qantas-Emirates alliance to shift, for example, a smaller, more suitable aircraft operated by Qantas wherever demand requires it, without affecting capacity on AKL-BNE. In addition, the Qantas-Emirates alliance delivers the ability to collaboratively sell some of the excess capacity already on the route. Qantas/Emirates operated an estimated average load factor of 75.6% on the trans-Tasman for yearend May 2013[20] meaning Qantas/Emirates have the ability to carry more passengers on the Tasman without increasing capacity.

A key component of the commercial rationale for the Alliance was to enable the Applicants to "achieve a better competitive position against the Qantas-Jetstar Group and against Emirates' marginally-priced Tasman services and to generally strengthen each Applicant's position in the broader Australasian and global aviation markets."[21]

The Australian Department of Infrastructure and Transport notes the power of the Qantas-Emirates alliance, stating that "the Qantas-Emirates alliance acts as a strong competitive counterweight to the Virgin Australia-Air New Zealand alliance on trans-Tasman routes, including the routes Virgin Australia and Air New Zealand both currently serve in their own right."[22]

Under the Qantas/Jetstar-Emirates alliance, Qantas, Jetstar and Emirates can coordinate broadly across their air passenger and cargo transport operations and related services (joint procurement, engineering and flight training) including the coordination of price, capacity, scheduling and planning on any or all existing and new routes. The Alliance has, as anticipated, allowed the Applicants to improve their competitive position against the Qantas-Jetstar Group in manner which would not have been achievable without the Alliance. With the recent approval of the Qantas-Emirates alliance and its potential impact on competition and consumer outcomes on the Tasman, the continued role of the Alliance as a competitive constraint on Qantas is more crucial than ever.

Without the Alliance the Applicants on their own do not have an offering that is comparable to the alliance of Qantas/Jetstar and Emirates in terms of breadth and depth of schedule or distribution and marketing strength. Neither party is capable of constraining the Qantas/Jetstar-Emirates group alone. For Virgin Australia, the Alliance not only improves Virgin Australia's offering on the trans-Tasman, but is also important to strengthen its competitive position against Qantas in domestic Australia and other markets.[23] For Air New Zealand, the Alliance provides an improved trans-Tasman

[19] Emirates to Offer All-A380 Service in Auckland, see: http://www.scoop.co.nz/stories/BU1305/S00631/emirates-to-offer-all-a380-service-in-auckland.htm

[20] Figures are based on Air New Zealand market data.

[21] VA/NZ initial submission to the ACCC dated 4 May 2010, at p 17.

[22] See Australian Government, Department of Infrastructure and Transport submission, page 4.

[23] It is worth noting here that Emirates states on page 2 of its submission in response that its own Alliance will only have 39.6 % of the market in terms of total origin/destination passengers. The Applicants note that passenger shares can and should vary

offering, as well as access to the Australian domestic network on terms that it cannot obtain absent the Alliance.

The modelling conducted by The NZ Airports Association in its submission does not take account of any of this competitive tension.[24] In fact, the modelling does not contain any market analysis. It simply assumes that without capacity conditions the Alliance will be able to raise prices and for this reason the modelling is flawed.

4.2 The number of players in a market is not determinative of the level of competition

The existence of 2 players operating on a sector does not in and of itself mean there is a lack of competition. There may not be the demand to sustain more than 2 players and the number of players alone does not determine the level of competition. The Applicants note that a similar competitive dynamic exists in the New Zealand domestic market where Air New Zealand and Jetstar are the only two carriers, yet this market remains highly competitive. Both parties have grown capacity ahead of the demand curve and the competitiveness of the NZ domestic market has resulted in total market capacity on competitive routes having been maintained despite the exit of Pacific Blue in 2010. In addition, further capacity increases have occurred with Jetstar adding a further aircraft in November 2012 and Air New Zealand also increasing capacity through extra frequencies and up-gauging aircraft on sectors like AKL-ZQN and AKL-CHC. Total market capacity on competitive routes will increase by 10% from mid-November 2012, as a response to market demand. As well as increased capacity both parties offer fares on a regular basis below lead-in fare levels.

4.3 Capacity conditions are distortive and costly to both the Applicants and consumers

Capacity conditions are unnecessary in a competitive market like the Tasman. However, KWS suggests that the Applicants' concerns in relation to the capacity conditions are not well-founded. The NZ Airports Association goes further and states that the only downside for the Applicants arising from capacity conditions "would appear to stem from the circumstance in which they would seek to restrict capacity to a level below natural market growth".[25] Unfortunately this is not true – capacity conditions distort market forces as well as the incentives and actions of existing and potential participants in that market. They disrupt the markets allocation of resources and are costly to both consumers and the airlines. Most significantly, they prevent the Alliance from freely directing capacity where it is most demanded by the travelling public.

While it is difficult to calculate precisely the loss of revenue and costs arising from the inefficiencies created by the operation of the capacity conditions, we can make some informed estimates and these estimates show that the cost is high. While some information was given about this in the Submission, the Applicants have subsequently carried out more detailed work to estimate this loss of revenue on capacity condition sectors and an estimate of the actual costs in relation to Wellington routes were made in a presentation to the MOT. The Applicants are happy to share these estimates (and the basis on which they were calculated) with the ACCC as well.

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over time. For this reason, capacity is a more appropriate measure. On this basis, the Qantas-Emirates alliance has 45.8% of Tasman capacity and the Air New Zealand-Virgin Alliance has 50.1%. These figures are based on BITRE figures for FY 2011-2012.

[24] See The NZ Airports Association submission, paragraph 24.

[25] See The NZ Airports Association submission, paragraph 22.

Capacity conditions can, and do, restrict the Alliance from reacting efficiently to market conditions and demands and achieving optimal seat utilisation, as discussed in more detail in the Applicants' reauthorisation submission.[26] The Wellington routes are significant as an example of where this is currently occurring. Capacity conditions have created an oversupply on the Wellington routes and the operation of market forces is necessary to bring supply back to equilibrium with demand. While the problem in relation to Wellington is significant enough to make it unique, all the capacity conditions, by their very nature, create a measure of inflexibility and (to the extent that they hamper otherwise efficient resource allocation) a measure of inefficiency.

Capacity conditions also cause distortion in other related markets such as those in which airports operate. Airports on routes subject to capacity conditions gain significant advantage from those conditions. The Alliance is obliged by the capacity conditions to offer capacity on certain routes when oftentimes the capacity the Alliance provides on those routes would be better directed to other sectors. Instead, the airports and city destinations on capacity-condition routes are benefiting from guaranteed capacity at the expense of other routes or destinations.

The solution is to allow the Applicants to allocate capacity in line with demand. The Alliance produces, and has produced, a net public benefit. In fact, it is pro-competitive in that it enables a more comparable competitive offering to that provided by the Qantas-Emirates alliance. As a result the conditions are not necessary to satisfy the public benefits test and in fact create costs and inefficiencies, which ultimately must be passed on to consumers. It is for this reason that the Applicants seek unconditional reauthorisation, and it is appropriate that this be for a period of no less than 5 years.

4.4 No need for new or wider capacity conditions

The Applicants note that several New Zealand airports and their associated stakeholders have argued for an increase in, or the retention of capacity conditions. Dunedin International Airport (**DIAL**) would like capacity conditions on its SYD-DUD and MEL-DUD routes and KWS would like the Wellington route capacity conditions to remain.

In response to these submissions, the Applicants note the unusual position of some New Zealand airports in relation to capacity conditions. The operation of route specific capacity conditions ensures that the Alliance must use the particular airport facilities to a specified extent regardless of the cost and commerciality of doing so and regardless of demand. This gives the airports incentives not driven by natural market forces and not pro-competitive by nature. We also note that no Australian airports have submitted on the reauthorisation application. Both the New Zealand airports and their associated stakeholders have their own subjective interests to advocate, but it must be remembered that their comments do not reflect consumer demand or what is necessary to effect efficient operation of the air services market. It is not the purpose of the capacity conditions or the authorisation process to force the Applicants to underwrite the business of particular airports. The capacity conditions were offered by the Applicants when the public benefits of the Alliance were unproven. However, now the Alliance can evidence the benefits of the Alliance and it is clear that they outweigh any possible public detriments. No new or wider capacity conditions are warranted.

[26] Submission, paragraph 5.11 to 5.24.

5 Third Party Submissions overwhelmingly support reauthorisation

Despite differences of opinion in relation to the terms of reauthorisation and appropriateness of capacity conditions, the submissions by third parties overwhelmingly support reauthorisation of the Alliance and recognise that the Alliance has delivered a range of public benefits.

In its initial submission to the ACCC, CIAL recommended that the ACCC reauthorise the Alliance"[27] and that the "co-joining of the Air New Zealand and Virgin Australia networks has stimulated new traffic into the Australian market beyond the eastern Australia hub airports of SYD, MEL, BNE".[28] The Applicants also note that CIAL has on receipt of further information and data told the Commission that it not only supports reauthorisation of the Alliance but supports reauthorisation for a period of 5 years with no capacity commitments into Christchurch.

The New Zealand Airports Association also supports the reauthorisation of the Alliance. In its submission, it notes that some of the benefits flowing to the carriers from operating as an Alliance can be "passed on to the travelling public in the form of access to broader and deeper networks, enhanced flying schedules and the sharing of frequent flyer benefits".[29]

The KWS "recommend that the Application for reauthorisation of the Alliance is granted".[30] The KWS accepts that "the Alliance has brought some of the benefits that have been claimed, such as better schedule spread, reduced wingtip flying and reciprocity for frequent flyer programmes and lounge access".[31] It also recognises that the benefits of the Alliance to the carriers "can potentially be passed on to consumers in the form of enhanced schedules, service offerings and lower fares".[32]

The last of the responding airports, DIAL, also supports renewal of authorisation for the Alliance, specifically for a five year period.

Finally, the Australian Government Department of Infrastructure and Transport notes that:

> *On balance, the Department considers that continued cooperation between Virgin Australia and Air New Zealand on the trans-Tasman is positive and consistent with aviation policy settings.*[33]

All relevant stakeholders support the reauthorisation of the Alliance. In these circumstances, the Applicants consider that the benefits of the Alliance have been proven to all stakeholders and the ACCC should reauthorise the Alliance.

[28] See Christchurch International Airport Limited submission, paragraph 31.
[29] See New Zealand Airports Association submission, paragraph 5.
[30] See Key Wellington Stakeholders submission, paragraph 30.
[31] See Key Wellington Stakeholders submission, paragraph 21.
[32] See Key Wellington Stakeholders submission, paragraph 63.
[33] See Australian Government Department of Infrastructure and Transport submission, page 4.

6 Conclusion

The submissions by third parties on the whole support reauthorisation of the Alliance, in recognition that the Alliance has delivered a range of public benefits.

The Applicants are seeking unconditional reauthorisation of their Alliance for a further period of not less than 5 years. The Applicants have provided detailed evidence supporting their application for unconditional reauthorisation of the Alliance.

The submissions from interested parties provide no persuasive arguments as to why reauthorisation should be denied.