PUBLIC VERSION

CHRISTCHURCH INTERNATIONAL AIRPORT LIMITED

SUBMISSION ON

APPLICATION FOR RE-AUTHORISATION OF AUSTRALASIAN AIRLINE ALLIANCE BY VIRGIN AUSTRALIA AIRLINES AND AIR NEW ZEALAND

03 MAY 2013

CONTENTS

Introduction

1 Christchurch International Airport Limited (*CIAL*) welcomes the opportunity to submit to the Ministry of Transport (*MOT*) on the application for re-authorisation of the Australasian Airline Alliance Agreement and related agreements (together, the *Alliance*) by Virgin Australia Airlines and Air New Zealand Limited (together, the *Applicants*).

2 CIAL's submission is based on our review of the Applicants' redacted application for re-authorisation, and a briefing provided by representatives of Air New Zealand on key aspects of the Alliance. CIAL has also submitted to the Australian Competition and Consumer Commission (*ACCC*) on the Applicants' application for re-authorisation.

3 CIAL endorses the New Zealand Airports Association (*NZ Airports*) submission on the Applicants' application for re-authorisation.

4 CIAL takes this opportunity to acknowledge the valuable services the Applicants have provided, and continue to provide, through Christchurch Airport (*CHC*). In particular, we appreciate that the Applicants have endured a period of market distortion, resulting from the challenges that have faced Christchurch city and the Canterbury region following the Canterbury earthquakes. However, as momentum picks up with the rebuild, and continued long-term migration occurs, demand for services has returned, and consumer sentiments reflect a growing awareness of a lack of capacity provided by the Applicants on their current routes through CHC. The recently announced CHC-Perth service[1] demonstrates the increasing demand for trans-Tasman services in the region.

5 CIAL supports the continuation of the Alliance, provided it is re-authorised for a period of 3 years and includes the capacity commitments outlined below.

Executive Summary - CIAL supportive of re-authorisation subject to certain capacity commitments

6 CIAL **recommends** that the MOT only re-authorise the Alliance if the Applicants revise their application to:

6.1 request re-authorisation for a period of 3 years;

6.2 renew the Trans Tasman capacity commitment in the Alliance Capacity Implementation Agreement;[2] and

6.3 include a new commitment in the Alliance Capacity Implementation Agreement to grow capacity on each of their current, and any future, routes through CHC (such as the newly announced CHC-Perth route) in accordance with the minimum seat capacity commitments currently applying to each of the nominated sectors.[3] This commitment will ensure that the Applicants provide sufficient capacity to meet present and future demand through CHC, as would otherwise be met in a competitive market.

[1] To operate between December 2013 and April 2014.

[2] See clause 2(c) Alliance Capacity Implementation Agreement (21 December 2010).

[3] See clause 2(a)(i) + (ii) Alliance Capacity Implementation Agreement (21 December 2010).

7 The Applicants' current routes through CHC are:

7.1 CHC - Brisbane (*BNE*)

7.2 CHC-Melbourne (*MEL*)

7.3 CHC-Gold Coast/Coolangatta (*OOL*)

7.4 CHC-Sydney (*SYD*)

(*CHC Routes*)

8 CIAL represents the interests of consumers, businesses and other stakeholders who rely on competitive air fares and effective connectivity to reach international markets. The CHC Routes provide crucial connectivity to global destinations and markets. We accept that, in certain circumstances, airline coordination is necessary to promote stakeholder interests, and we are not opposed to the Alliance in principle.

9 However, CIAL is strongly opposed to the Alliance being approved unconditionally, given the material competition issues raised by the Alliance on the Tasman and at a South Island-specific level. If the MOT approves the Qantas Group/Emirates alliance, this Alliance could constitute the other half of a duopoly on the Tasman. The material competition issues raised by the dynamic of two alliances with market power will not be fixed in the absence of capacity conditions.

10 In addition to a trans-Tasman capacity condition, route-specific seasonal capacity conditions are necessary on the CHC Routes. Since the Alliance started operating on the CHC Routes:

10.1 average fares have increased without a corresponding improvement in service levels – making the balance of benefits and detriments from the Alliance very finely balanced;

10.2 consumer demand has not been met – load factors are at record highs, services have been withdrawn, and there are strong consumer sentiments reflecting a growing frustration with the lack of capacity provided by the Applicants on the CHC Routes; and

10.3 material competition concerns have been raised - if the MOT authorises the Qantas Group/Emirates alliance, three of the CHC Routes will be subject to a duopoly, and the remaining Route (CHC-BNE) is already subject to a monopoly exercised by the Applicants. The lack of independent carriers on the CHC Routes, coupled with the unlikely prospect of competitive constraint coming from a new entrant or fifth freedom carrier (*FFC*) in the future, means that – in the absence of route-specific capacity conditions – the Applicants will likely have the incentive to exercise market power by unilaterally continuing to increase prices or reduce capacity on the CHC Routes.

11 In re-authorising the Alliance, the MOT must be satisfied that the benefits of the Alliance proclaimed to date have in fact been realised, and that the Alliance promotes – and will continue to promote - the public interest.

Average fares have increased

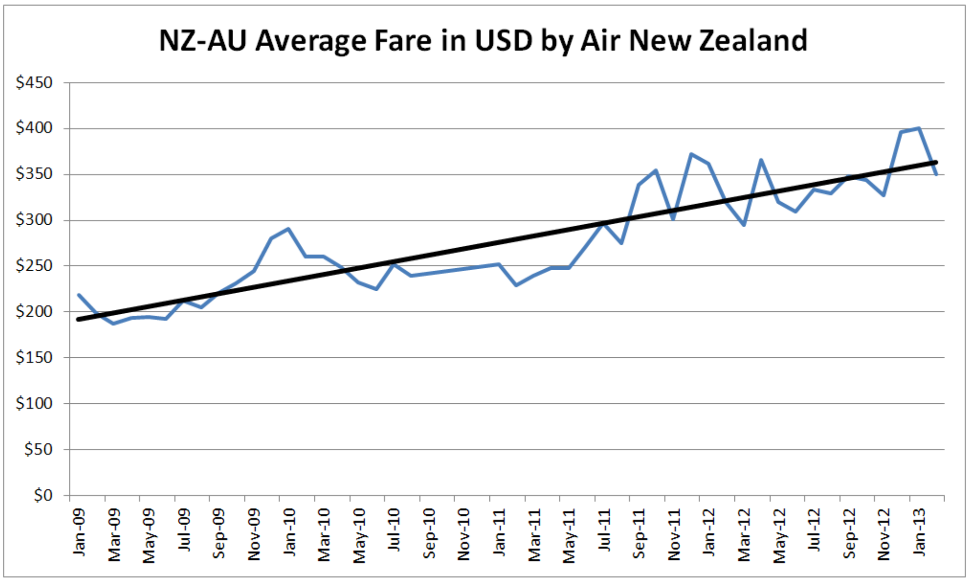
Applicants' claim that average fares has decreased is misleading

12 The Applicants' claim that average fares have decreased under the Alliance is misleading because their calculation of 'average fare' does not reflect the price consumers typically pay when travelling - a price which has increased under the Alliance at both the trans-Tasman level, and on the CHC Routes.

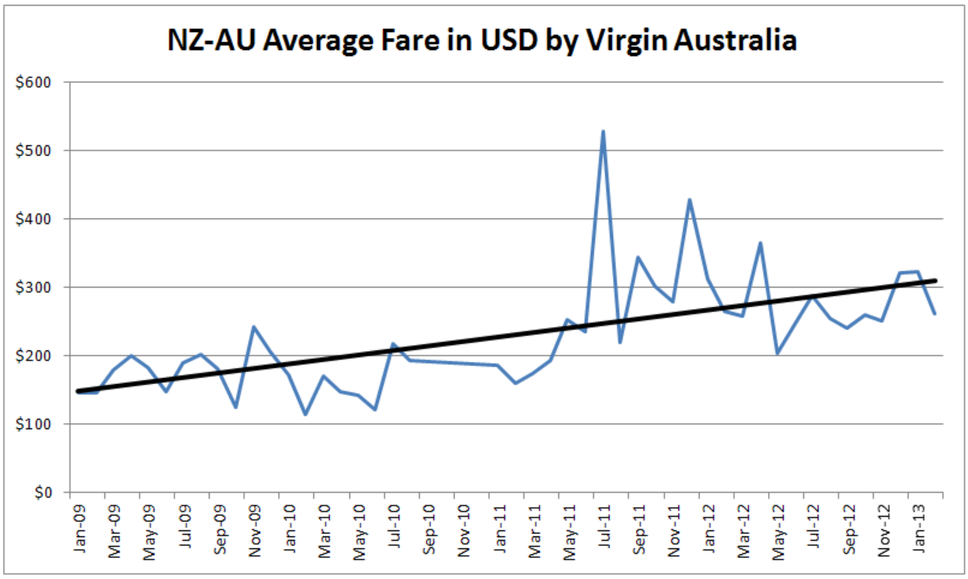
13 A more appropriate measure of the change in fare levels since the Alliance started operating would have been the median price paid. Median figures strip out extreme highs and lows, noting instead the midpoint of all fares paid – providing a better reflection of the movement in competitive fare levels over the Alliance period. Unfortunately, access to median fares data is not available or easily obtainable for stakeholders to comment on. The MOT should seek re-assurances that the claimed benefit of lowered fares is a reality for most consumers now, compared to before the Alliance came into effect.

14 The Applicants' claim to decreased average fares is also misleading because it does not take into account the additional charges that passengers pay for services such as luggage, meals and in-flight entertainment. These ancillary charges are sources of revenue that are not always reflected in ticket prices but are an additional cost to passengers, making an assessment of air fares alone opaque. As argued by NZ Airports, the MOT should consider total revenue earned by the airlines when assessing average air fares. Ancillary charges account for a substantial proportion of Air New Zealand's overall revenues.

15 In any event, the following graphs (reflecting segment fares and based on data sourced from industry databases) illustrate an increase in the Applicant's average trans-Tasman fares over the period of the Alliance.

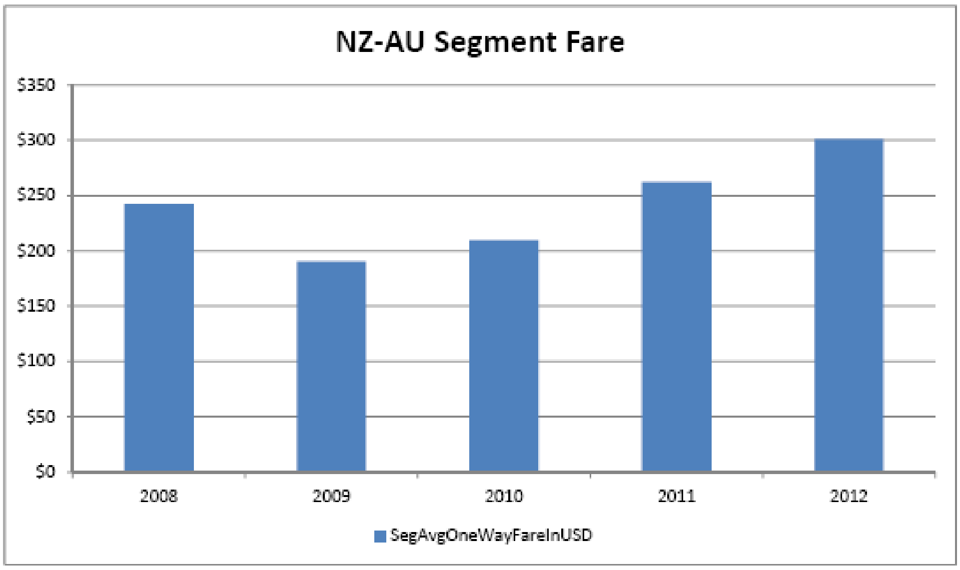


Source: Sabre Segment

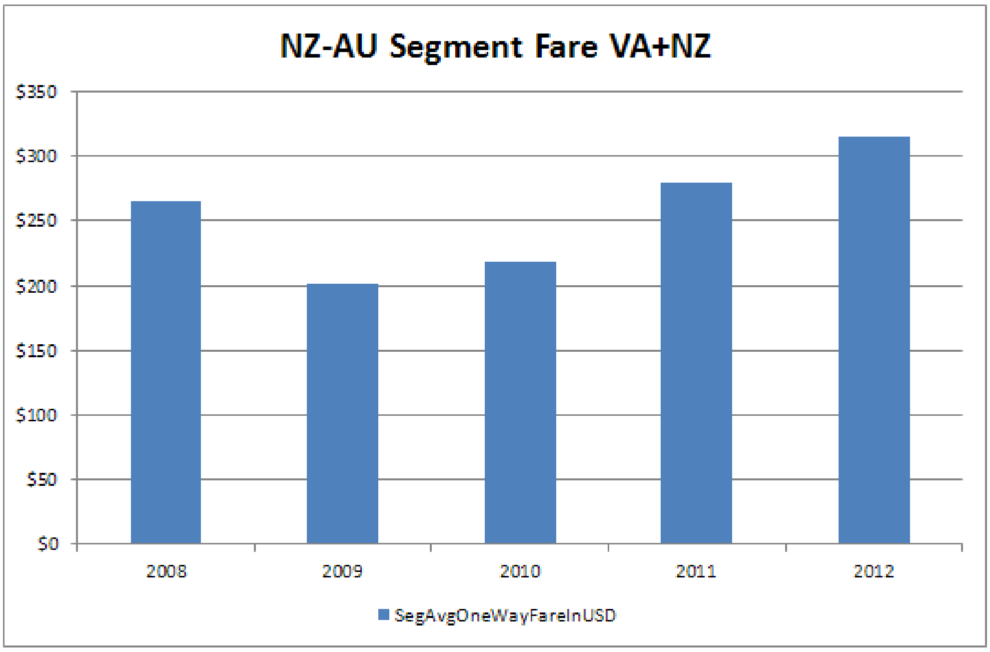


Source: Sabre Segment

16 The following graphs illustrate how the Applicants' fare increases compare with other carriers on the trans-Tasman.



Source: Sabre



Source: Sabre

17 At **Appendix A** we provide graphs illustrating how the Applicants' respective fares have increased on each of the CHC Routes.

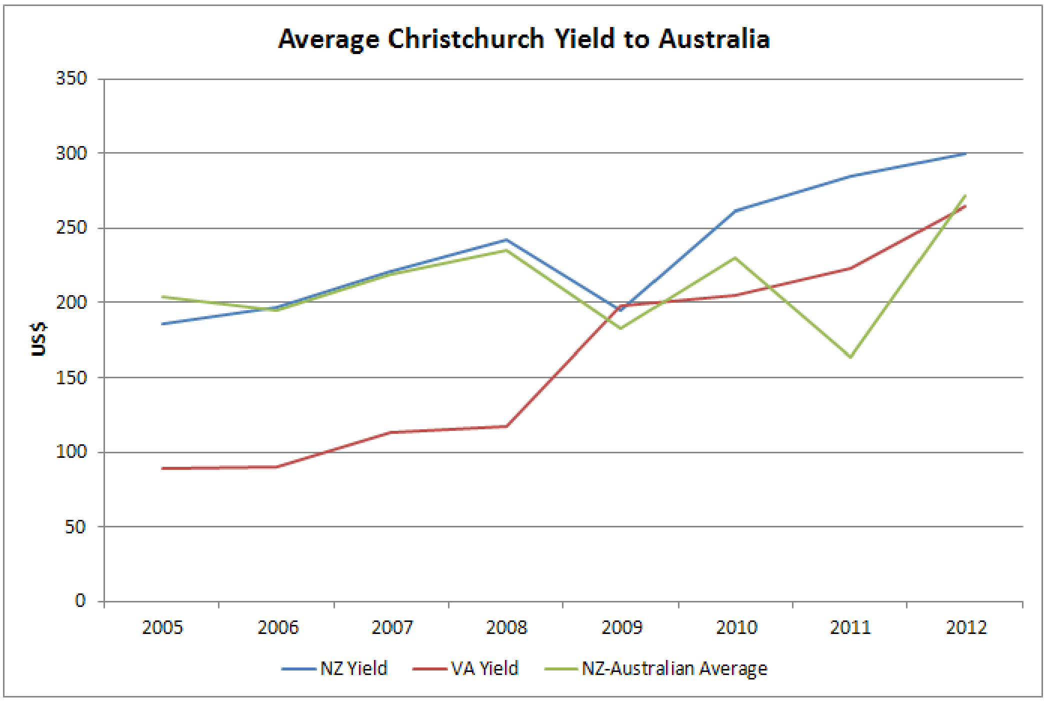
Virgin's fare increases are not commensurate with expected service standards

18 The change in business model implemented by Virgin Australia has increased air fares across the Tasman as well as the airline's yields.[4] As illustrated by the graph on the following page, Virgin Australia's yields in the Christchurch market now reflect the national average yield with a vast improvement in yields occurring in 2009 and 2010 at approximately the time of the first Alliance application.

19 However, Virgin Australia's fare levels are not commensurate with the service standard consumers expect for the price paid to travel with the airline. As a reaction to this, CIAL is aware of many South Island consumers travelling to other airports (for example, Auckland (*AKL*)) to get on an Air New Zealand international flight, because of Air New Zealand's higher service levels and more commensurate fares.

[4] As stated by Virgin Australia CEO John Borghetti: "*We are already seeing the benefits of the system, with our proportion of bookings through the Global Distribution System (GDS) increasing five-fold since its launch in mid-January*, Borghetti added these bookings typically had a "*10 percent yield premium to average bookings.*" (Available at: http://www.virginaustralia.com/nz/en/about-us/media/2013/VAH_HY_RESULTS_DEC_2012/)

Restriction of Publication of Part Claimed



Consumer demand on CHC Routes has not been met

20

21

22 Further, the prognosis for traffic from and to New Zealand is one of growth:

22.1 IATA anticipates expansion of New Zealand international traffic to equate to 5% annual compound growth rates between 2011 and 2016.

22.2 The New Zealand Ministry of Business, Employment and Innovation has projected a 5% CAGR growth in Australian visitors to New Zealand between 2011 and 2018.

22.3 The Australian Tourism Forecasting Committee of the Ministry of Resources, Energy and Tourism anticipates a lower growth rate of 1.9% CAGR between 2011 and 2016.

23 According to IATA's projections, New Zealand airports will handle slightly over 2 million more international passengers by 2016. Australia remains New Zealand's largest international market, as well as a gateway for connecting passengers to destinations worldwide. The Australian Ministry of Resources, Energy and Tourism projects an additional 226,000 New Zealand passport holders travelling to Australia by 2018. The New Zealand Ministry of Business, Employment and Innovation forecasts 956,000 additional Australian passengers to New Zealand by 2016; equivalent to 2,600 additional daily solely Australian resident passengers.

Traffic	Period	CAGR	Source
Australian Visitors to New Zealand	2011-2018	5.0%	*New Zealand Ministry of Business, Employment and Innovation*
New Zealand Visitors to Australia	2011-2016	1.9%	*Ministry of Resources, Energy and Tourism*
International Traffic to/from New Zealand	2011-2016	5.0%	*IATA Airline Industry Forecast*

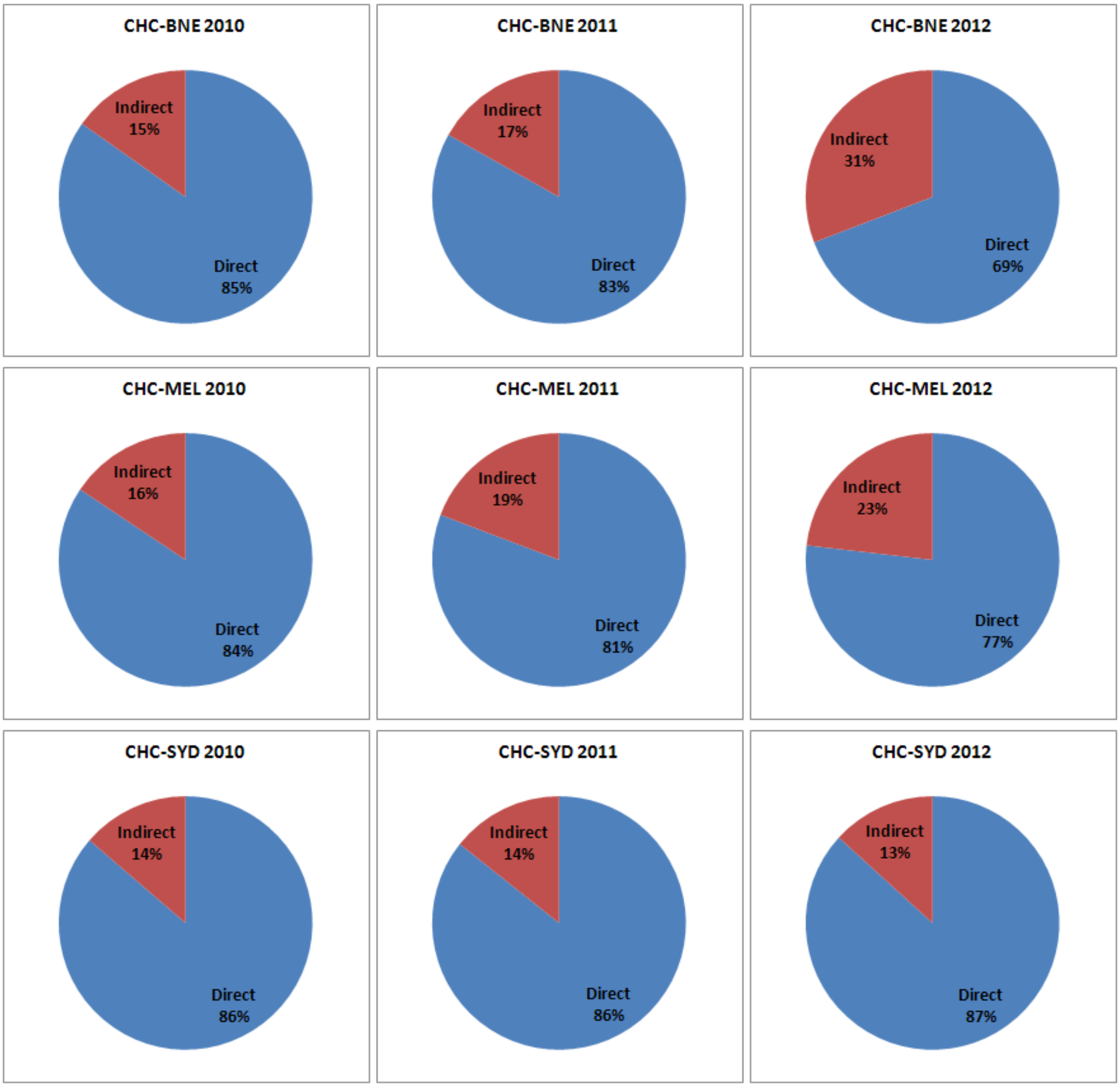
Air service withdrawals

24 Capacity on the CHC Routes has reduced over the last three year period – largely because of the reduced demand for air services resulting from the Canterbury Earthquakes. For example, Jetstar removed its service on the CHC-BNE route in March 2012, resulting in the Applicants now enjoying a monopoly on one of the largest trans-Tasman city pairs.

25 Some additional capacity is slowly being added back onto the CHC Routes as the Applicant's operational profitability improves. Since the withdrawal of Jetstar from the CHC-BNE route, the Applicants have added some additional frequencies, but not enough to entirely meet demand.

[5] Taken from Air New Zealand briefing to CIAL on the Alliance (16 April 2013)

26 As shown in the graph below, a significant and a growing volume of passengers still transit via other points due to lack of capacity on the CHC Routes. Over 30% of passenger volumes between CHC and BNE now transit at another airport.



Source: Sabre

27 The increasing numbers of passengers required to transit via other points on the three largest CHC Routes has occurred as schedules have been coordinated and capacity and competitive options have been removed.

Practical examples of consumers being constrained in reaching the South Island

28 Insufficient capacity to meet demand through CHC is a seasonal issue on certain CHC Routes, and a year-round issue on others. An overall lack of capacity has resulted in the Applicants operating inconvenient flight times for some consumer segments, meaning many consumers have to take an indirect route, or not travel to New Zealand at all.

29 For example, Ski field operators have expressed particular concern to CIAL about:

29.1 the detrimental effect that lack of appropriately timed services through CHC will have on South Island ski pass sales, including on school groups (large enough to fill an aircraft) for whom a 12am arrival time is unworkable. The convenient, mid-afternoon arrivals into CHC were removed with approval from the ACCC and the MOT at a time when demand had declined. However, as these consumer segments are discovering, demand is returning but is not being met with sufficient capacity or appropriate schedules; and

29.2 the real possibility that, if there was a late rush in ski pass sales due to good snow, the Applicants would not have sufficient capacity to service this demand.

30 The 12am arrival time is also inconvenient for passengers having to commute considerable distances to reach accommodation outside of Christchurch in the wider Canterbury region, due to a lack of accommodation in Christchurch City.

31 The monopoly position of the Applicants on the CHC-BNE route means that consumers often have to pay the highest fares to travel the route – turning many off travelling at all. For example, CIAL is aware that in May/June 2012, out of a total 14 booking classes available to one travel agent on the CHC-BNE route, only the 4th and 5th highest booking classes with Air New Zealand were available - making the airfare over NZD $1,100 for a return trip.

32 CIAL has also received industry feedback from off-shore wholesalers in Australia, Asia and North America that, since the Alliance was formed, there has been a notable decline in reasonably priced fare categories to CHC - reducing demand from off-shore markets that rely on transiting in Australia en-route to CHC.

33 Further, recent research by Australia's Tourism and Transport Forum shows that between October 2010 – June 2012 (over the period of market distortion resulting from the earthquakes):

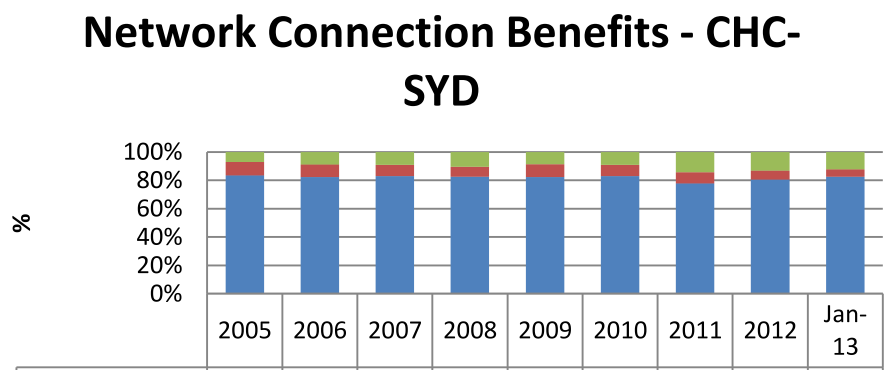
33.1 airfares from SYD to CHC were higher than those from SYD to AKL (the average SYD-AKL airfare was $436.49, while the average SYD-CHC airfare was $477.72); and

33.2 there was a significant variance in potential airfares paid to travel from SYD to CHC, as compared to travelling from SYD to AKL (for SYD-AKL airfares ranged from $265.70 - $1,310.30, while for SYD-CHC airfares ranged from $260.30 - $2,289.40).[6]

Benefits of onwards connections are uneven

34 The co-joining of the Air New Zealand and Virgin Australia networks has stimulated new traffic into the Australian market beyond the eastern Australian hub airports of SYD, MEL, BNE. However, the reverse is not occurring in New Zealand.

[6] Tourism & Transport Forum Australia *An Australia-New Zealand Air Corridor* (April 2013) at 6.



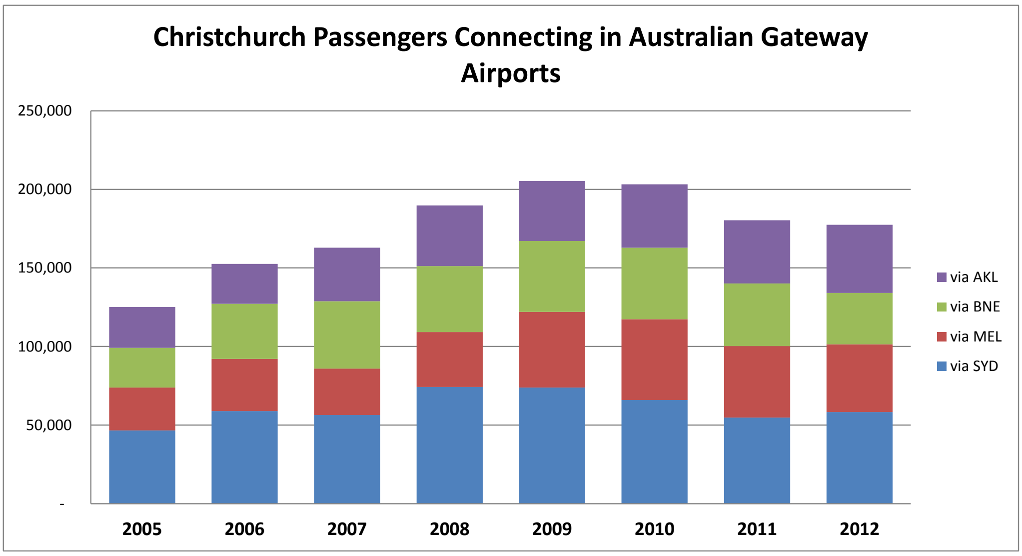
	2005	2006	2007	2008	2009	2010	2011	2012	Jan-13
Beyond SYD	7.08	8.91	9.2	10.42	8.69	9.19	14.22	13.12	12.26
Behind CHC	9.52	8.75	7.87	7.04	9.08	7.83	7.88	6.35	5.16
Point-to-point	83.40	82.34	82.93	82.54	82.23	82.98	77.90	80.53	82.58

35 The reducing share of traffic to New Zealand beyond the main points of AKL, Wellington (*WLG*) and CHC is of concern. Traffic to the rest of the South Island is falling as a share of total traffic. Whilst this traffic may be less attractive to the airlines in terms of yield, it is clear that the two airlines are maximising higher yielding connections into Australia. CIAL's research indicates that this is also the case in Sydney. This is not a purely Christchurch Airport phenomenon but is a yield maximisation strategy.

36 The Applicants are in principle, of course, entitled to pursue higher yields. The concern arises when they pursue this normal commercial strategy in a market where they face fewer competitive constraints. In a less competitive market consumers will suffer as quality is withdrawn and prices rise unconstrained.

37 The Alliance proposed by the Applicants will reduce competition and raise these concerns.

38 Despite challenging conditions in Christchurch, the market requires growing access to Australian gateways to provide access to multi-sector itineraries. As illustrated in the following graph, the Christchurch market uses Tasman services to access destinations other than the point-to-point service.



39 Access to the Sydney, Melbourne and Brisbane networks is essential for Christchurch passengers wishing to connect beyond Australian gateway airports. What is clear is that Auckland cannot provide either the range of capacity required to satisfy this connecting market to Australia.

The Applicants will have the incentive to exercise market power

40 The Applicants will likely have the incentive to exercise market power by unilaterally increasing fares or reducing capacity on the CHC routes due to:

40.1 the highly concentrated nature of the CHC Routes; and

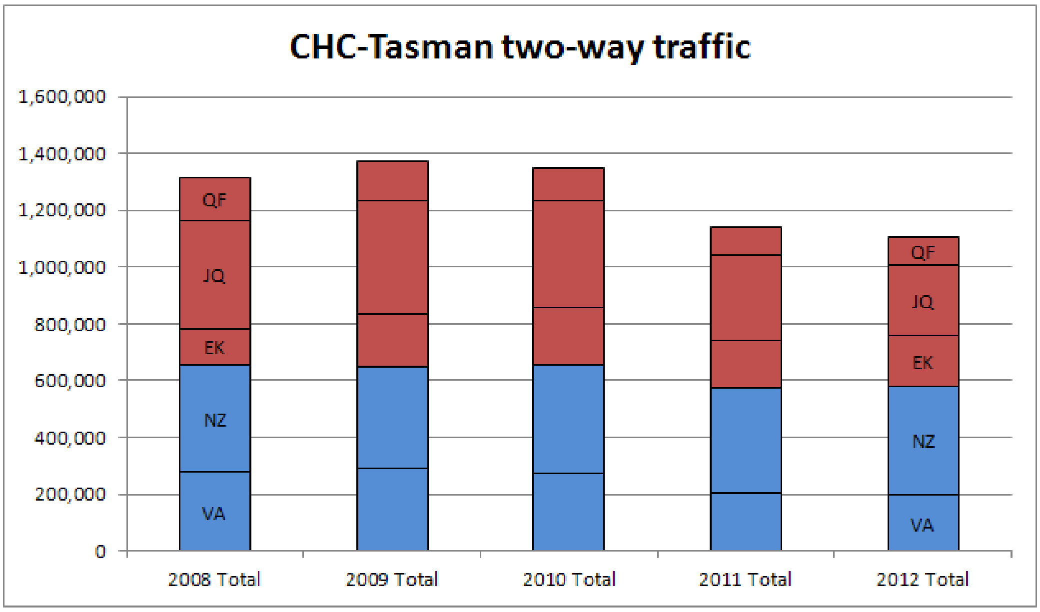
40.2 the unlikely prospect of competitive constraint coming from a new entrant or FFC.

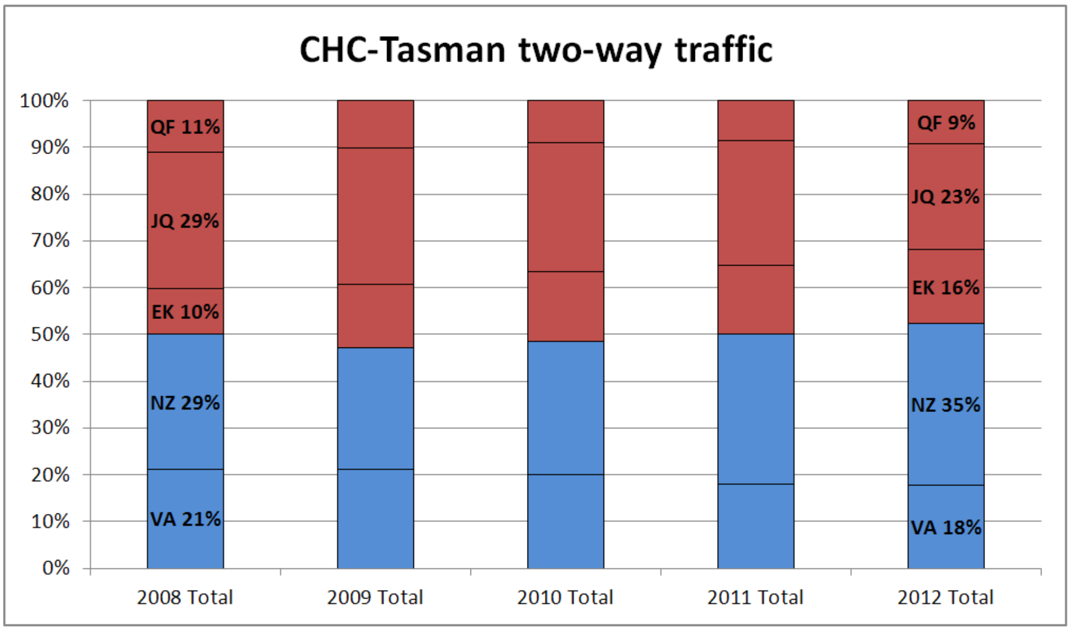
CHC Routes are highly concentrated

41 If the MOT approves the Qantas Group/Emirates alliance, which could extend to cover Jetstar services, there will be no independent airlines operating on any of the CHC Routes. CHC-MEL, CHC-OOL and CHC-SYD are subject to a duopoly, and CHC-BNE is subject to a monopoly - exercised by the Alliance.

42 The only destination in New Zealand with competitive offerings on Tasman sectors is Auckland, precisely because of the existence in the market of FFCs on some routes.

43 The following graphs illustrate the proportion of two-way passenger traffic transported by the Qantas Group/Emirates alliance on the one hand, and by the Applicants on the other.





Source: CIAL

44 On the CHC Routes in 2012, the Applicants transported the following levels of overall, two-way passenger traffic - with remaining passenger traffic transported by Qantas Group/Emirates:

44.1 CHC-SYD - 32%

44.2 CHC-OOL – 30%

44.3 CHC-BNE – 96%

44.4 CHC-MEL – 62%

45 Graphs illustrating these figures are provided at **Appendix B**.

46 Despite increasing demand on the CHC-BNE route, Jetstar is unlikely to re-enter the route in the short-term. This is because Jetstar has no international A320 base at BNE, meaning there are additional overhead costs for the airline to service the route (should they wish to re-commence a single service). Jetstar does not operate any services from BNE to airports in New Zealand.

Lack of competitive constraint from new entrant or FFC

47 There is also a lack of competitive constraint offered by a new entrant or FFC on the CHC Routes. A FFC must have the confidence and brand strength to willingly enter the home markets dominated by a duopoly.

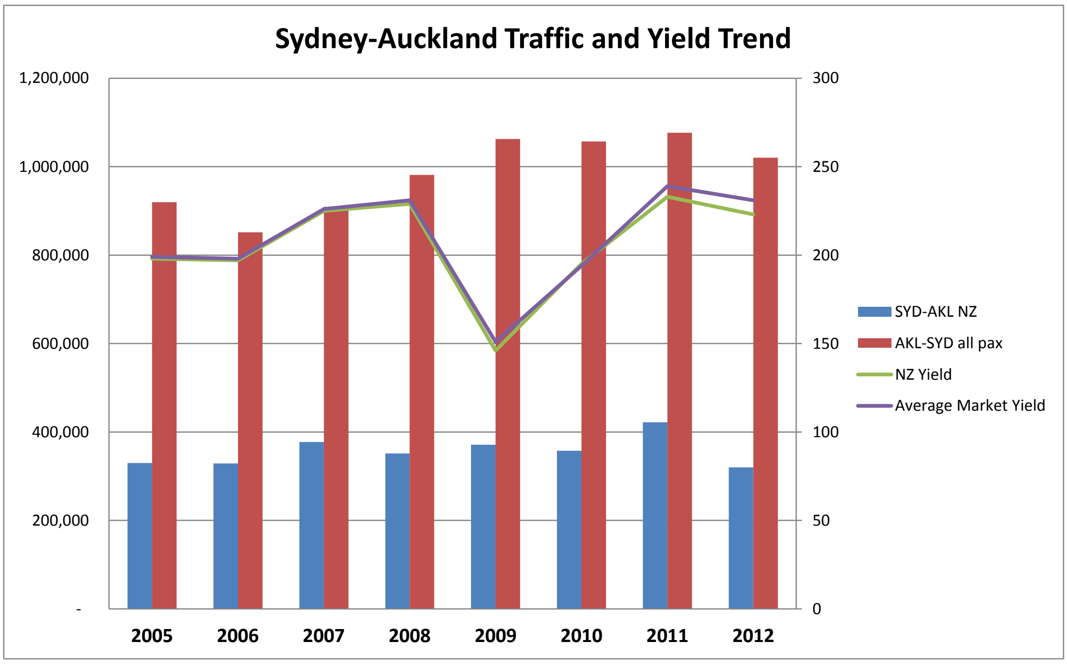
48 No independent FFC currently operate on the CHC Routes, and the notion of a FFC having the incentive to operate services on the Tasman is a red-herring in respect of a large number of carriers originating in Asia.

49 For it to be feasible for a FFC to operate the Tasman, air service agreements (*ASA*) between the three countries (Australia, New Zealand and the third nation where the airline has it's principle place of business) must all align. However, in many instances ASAs require that only one point beyond Australia may be served, or a specific point is named - often AKL. For example, the existing ASAs between Indonesia, Taiwan, South Korea and Australia all have limited FFC flying opportunities to CHC, due to the restrictive ASAs negotiated by Australia.

50 Potential FFCs often operate wide body aircraft to Australia (with the possible exception of Indonesian carriers that may operate to Australia using a narrow-body aircraft), limiting the choice of final destination airports in New Zealand for these FFCs to AKL and CHC. Where WLG is an option, FFCs are potentially further limited by the airport's curfew and/or runway length.

51 Consequently, airlines from places such as Indonesia, South Korea and Taiwan have little choice in being able to fly to CHC or other points in New Zealand due to the third country ASA with Australia. These FFC opportunities are further diminishing over time as deeper partnerships (such as agreed interline agreements or special pro-rate agreements) with other FFCs discourage partners to compete head to head by adding additional capacity.

52 At Auckland Airport, where fifth freedom competitive constraint is exercised, Air New Zealand's yields almost exactly match those of the market average and have done for the past eight years. This is illustrated by the following graph.



Capacity conditions are necessary to protect the public interest

53 Given the material competition issues raised by the Alliance, and the fine balance of public benefits and detriments resulting from the Alliance on the CHC Routes, the Applicants should be required to grow seasonal capacity on the CHC Routes.

54 A trans-Tasman capacity condition is also necessary. CIAL is firmly of the view that the existing and current capacity operated by the Applicants is a floor in operational capacity, and that new and added capacity should continue on each of the sectors.

55 The following arguments made by the Applicants against the imposition of capacity conditions lack merit:

55.1 no route-specific anti-competitive detriment will occur due to the competitive constraint offered by FFC and Jetstar;

55.2 capacity conditions distort the market and are costly; and

55.3 the Alliance is in the public interest without any need for capacity conditions.

56 CIAL addresses each of these arguments below.

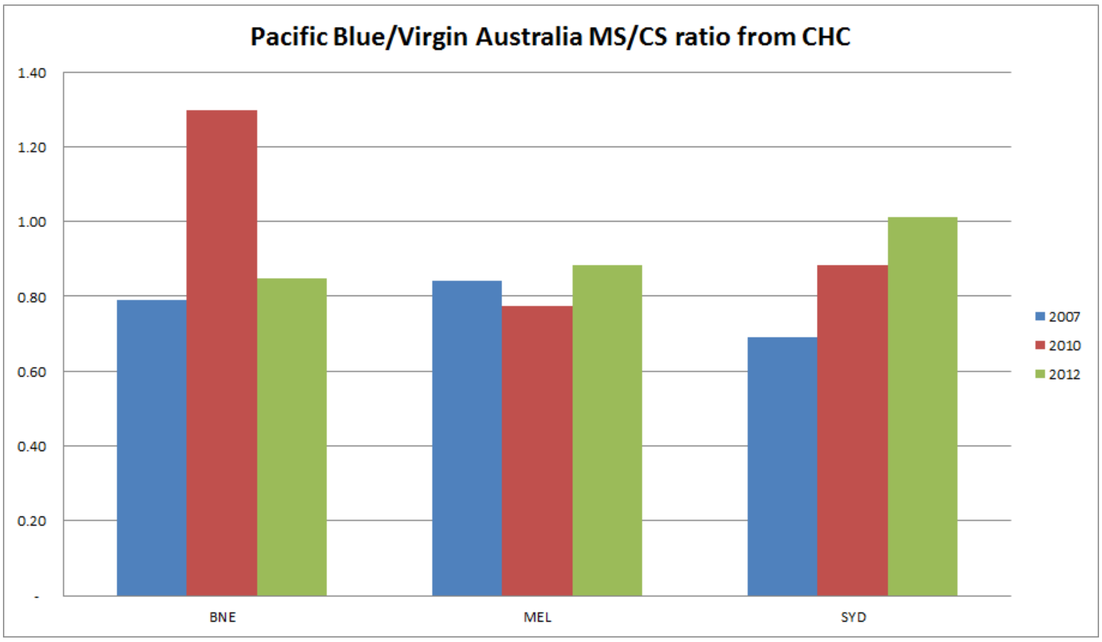
Competitive detriment will occur

57 The existence of the duopoly on the CHC Routes, and the very weak prospect of new entrant or FFC entering the CHC Routes (discussed in detail above), means that there is a strong risk of anti-competitive detriment occurring. The airlines will have sufficient market power to unilaterally increase airfares and/or reduce or withhold capacity.

58 This is effectively what is taking place in the Christchurch market. Air New Zealand's share of traffic has been concentrating over time. The market share/capacity share ratio method measures the level of passenger traffic relative to the level of capacity injected into the market by a given carrier on a competitive

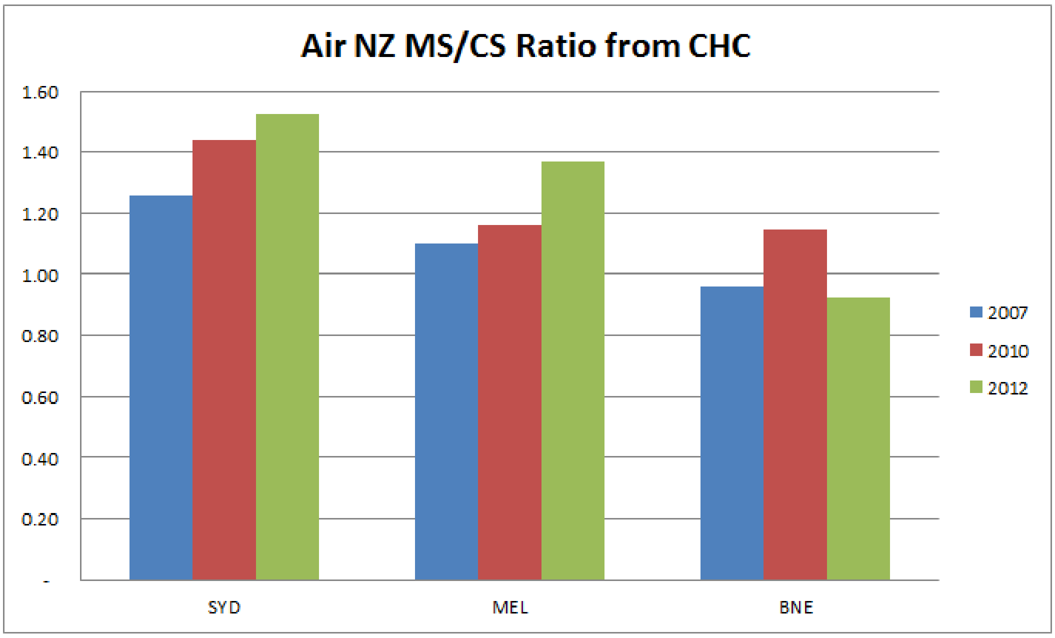
route. A score of 1 using this method indicates that inputted seats are in balance with passengers carried. Scoring below 1 indicates a position of weakness and a score of higher than 1 indicates that an airline has a more dominant position (for whatever reason: price, local patronage, superior product/schedule).

59 As illustrated by the following graphs, it is clear that Pacific Blue (now Virgin Australia), was not previously in a strong position, relative to that of Air New Zealand. Pacific Blue scored less than 1 but this trend is improving over time. It is particularly clear that Virgin's position was improving on the Sydney route.



60 Air New Zealand's position was largely stronger, even before the Alliance with Virgin Australia was approved. Since approval, Air New Zealand has seen its competitive strength rise sharply on the Melbourne and Sydney routes. The high MS/CS scores illustrated in the graph on the following page indicate that Air New Zealand has a position of dominance on the two major routes to Australia from Christchurch.

61 Air New Zealand's MS/CS scores are the highest at Christchurch. From CIAL research commissioned to better understand the change in market dominance, Air New Zealand's scores are slightly higher than those the airline attracts at Wellington, and are considerably higher than the scores at Auckland.



Capacity conditions are not unduly distortive or costly

62 The Applicants argue that capacity conditions reduce their ability to flexibly adjust supply to demand. In support of this argument they cite the impact of the Christchurch earthquakes on demand and explain that variation approval took six months. They also reference three separate instances in which they have had to apply for variations due to exceptional circumstances, and explain that the costs of such applications are passed onto consumers.

63 The inflexibility and costs associated with capacity conditions are necessary consequences of the fact that the airlines are being allowed to collude. Without capacity conditions, and the associated requirement to apply for variations, the Applicants could unilaterally alter capacity without any regard to the public interest.

64 The variation application regime has worked very effectively over the course of the Alliance to date, and, as echoed in the NZ Airports submission, the time and cost involved in making applications for variations should not be overstated. Any costs that are passed onto consumers as a result of an application for variation would be insignificant compared to the consumer detriment resulting from an unregulated alliance.

65 Over the past three years, the Applicants have been exemplary in their continued engagement with CIAL through the variation application regime - during which time the Canterbury region has faced enormous challenges resulting from the earthquakes. A reallocation of capacity was made to reflect the changing demand profile of the region. While there was a slight delay in reallocating capacity, the existing capacity conditions were not an unreasonable inhibitor to the Applicants, especially considering the unprecedented scale of the change to schedules and capacity required in New Zealand's second largest city, and Air New Zealand's second largest port of operations.

Capacity conditions are necessary to protect the public interest

66 Contrary to the Applicants' assertion, and as demonstrated in this submission from the data available to CIAL, the public benefits are finely balanced – almost none of these benefits having been experienced on CHC Routes.

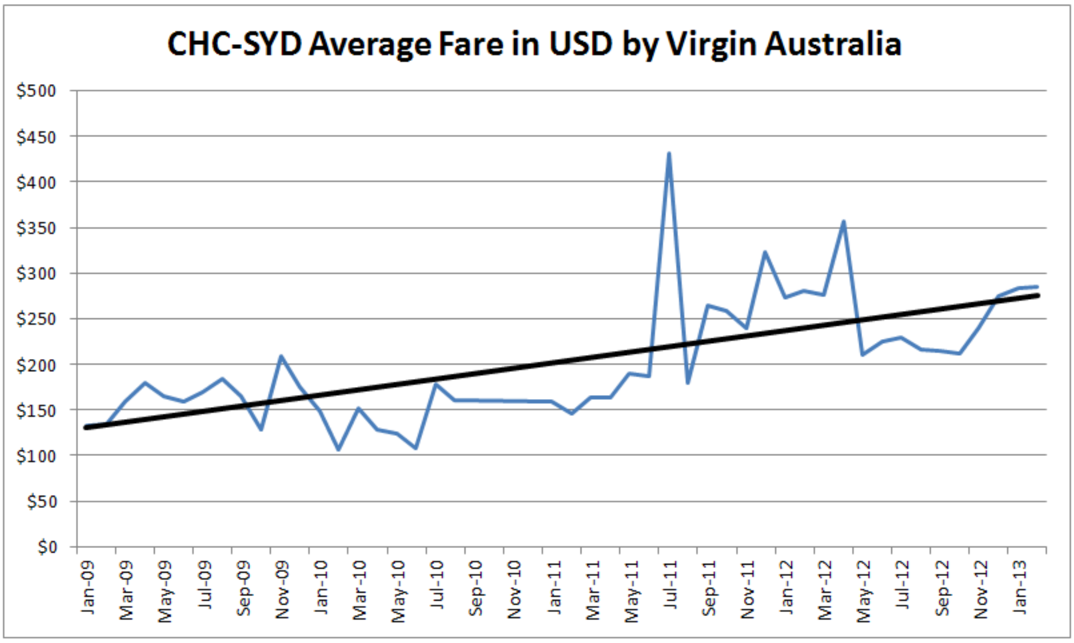
The benefits of a three year authorisation term have been proven

67 The MOT should only re-authorise the Alliance if the Applicants revise their application to request re-authorisation for a period of three years. Having regard to the multitude of significant market events that have occurred in the past three years, the MOT should have the ability to revisit the Alliance and consider whether or not it continues to be in the public interest, sooner rather than later.

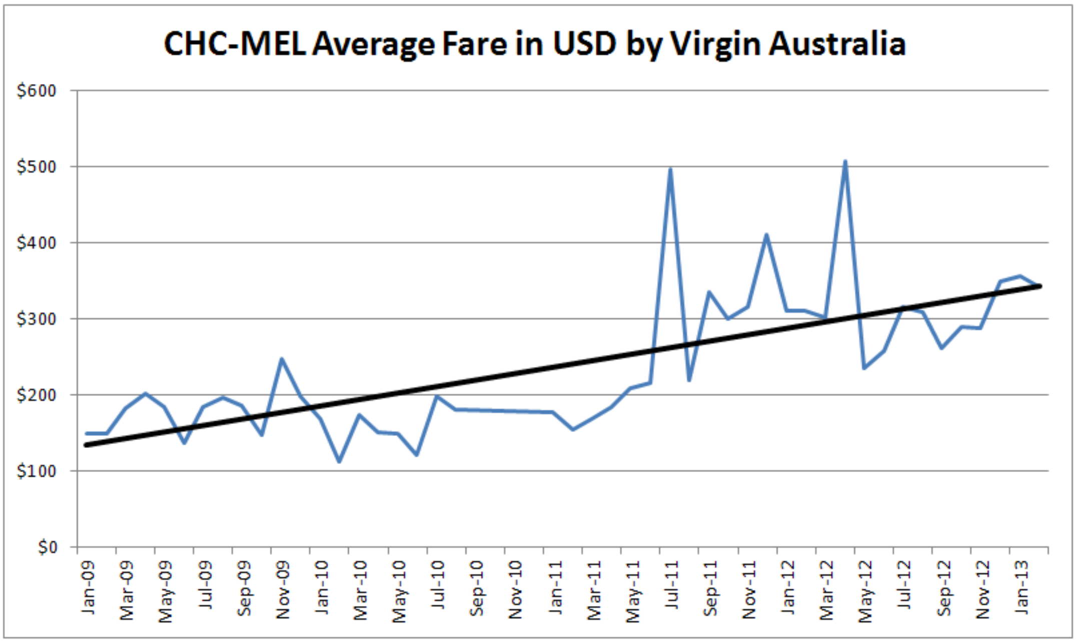
68 A three year term will also likely coincide with the renewal of Qantas/Emirates alliance (should the MOT approve that alliance and should Qantas/Emirates apply for re-authorisation), making it an appropriate time to assess the trans-Tasman market as a whole.

Appendix A – Average fare increases on CHC Routes

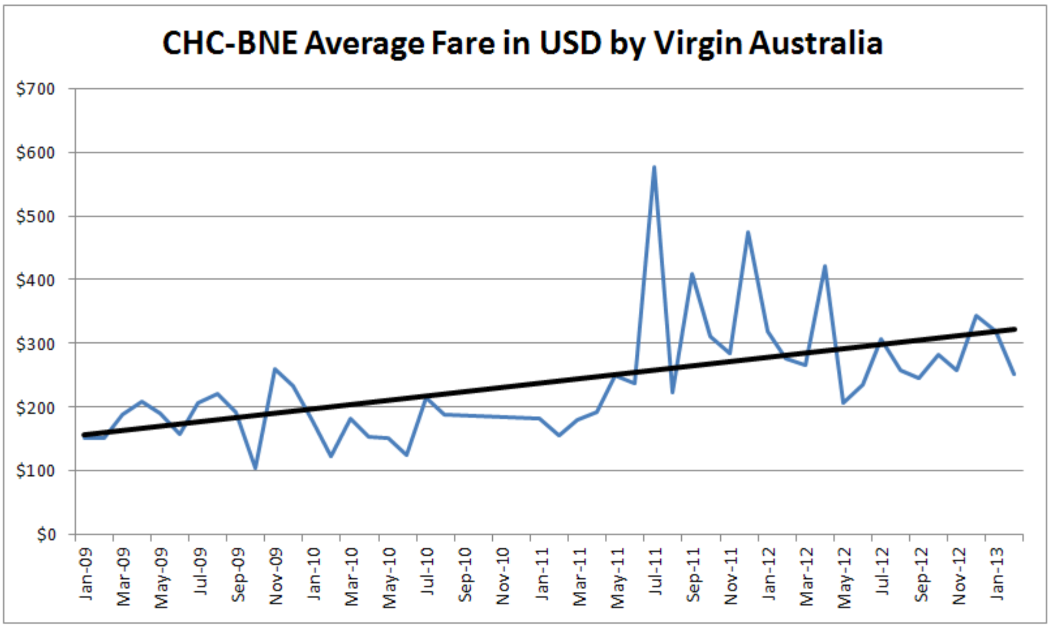
69 The following graphs illustrate how Virgin Australia's average fares on the CHC Routes has increased under the Alliance:



Source: Sabre Segment

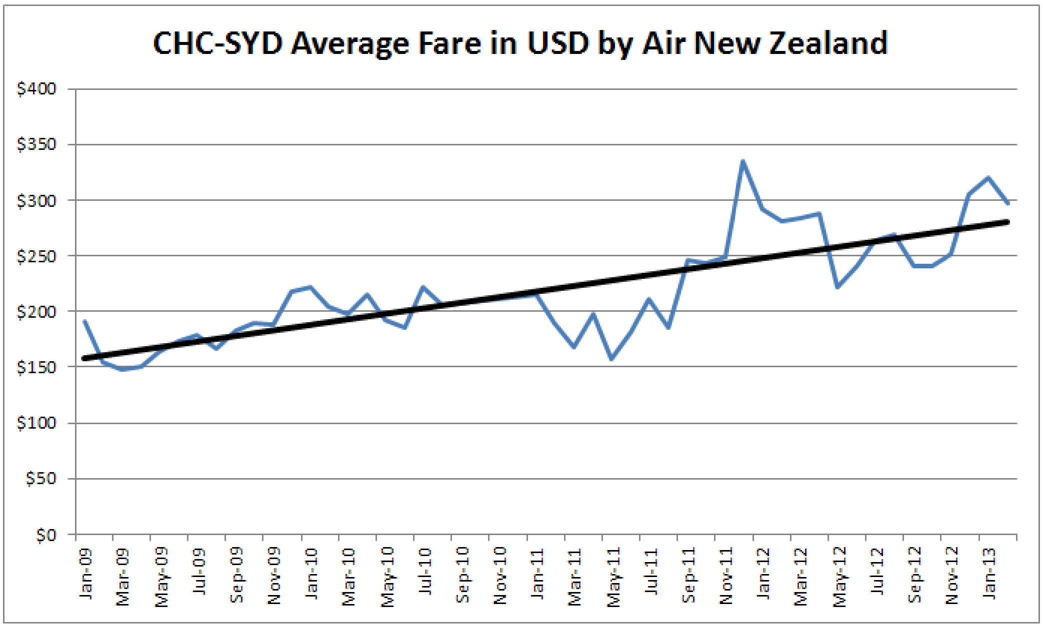


Source: Sabre Segment

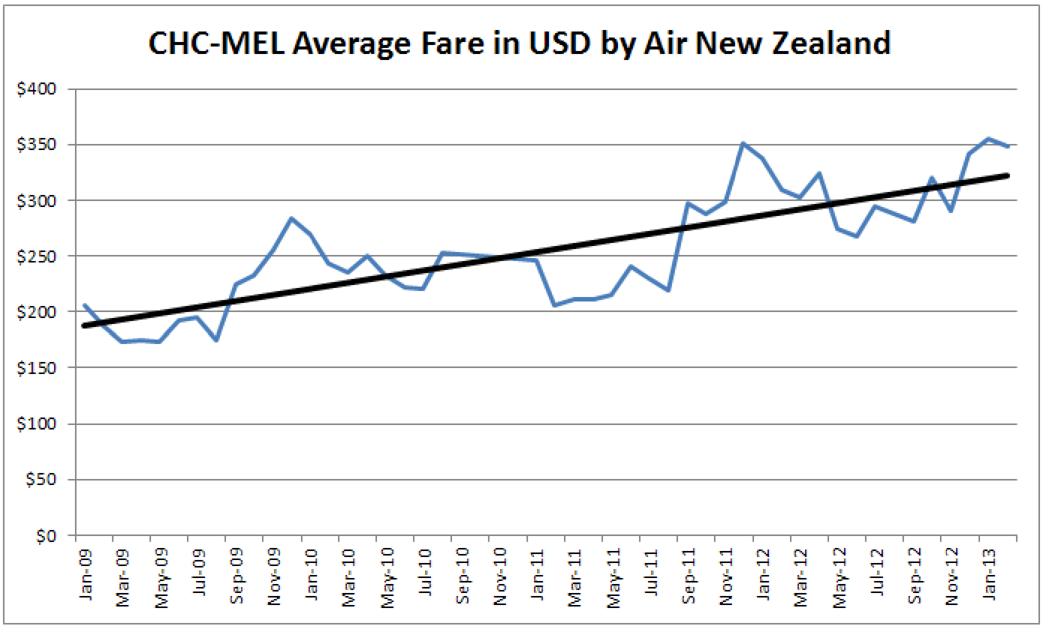


Source: Sabre Segment

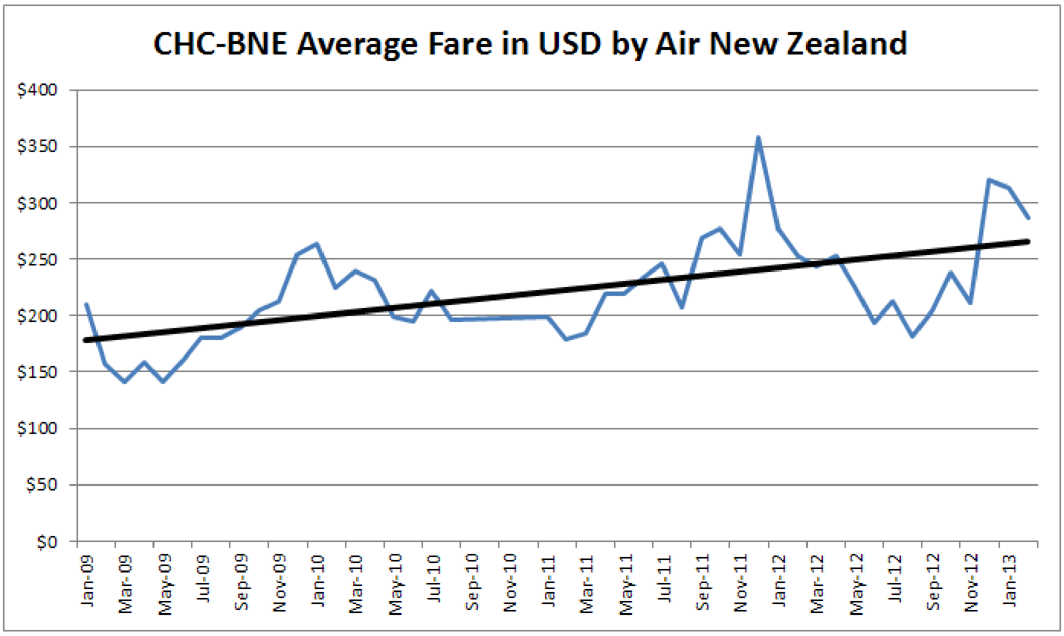
70 The following graphs illustrate how Air New Zealand's average fares on the CHC Routes have increased under the Alliance:



Source: Sabre Segment



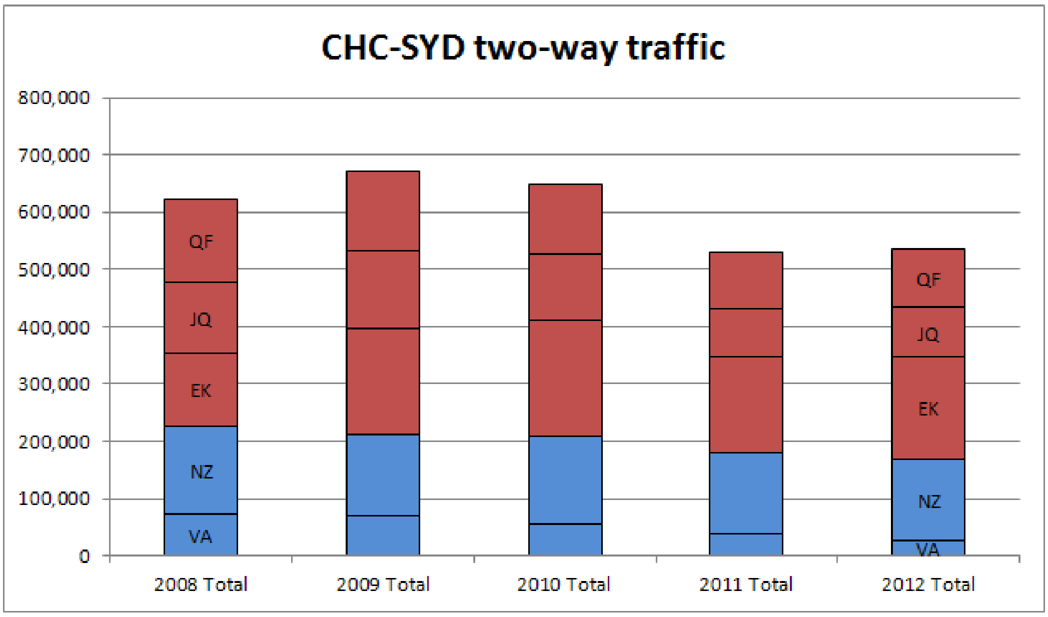
Source: Sabre Segment

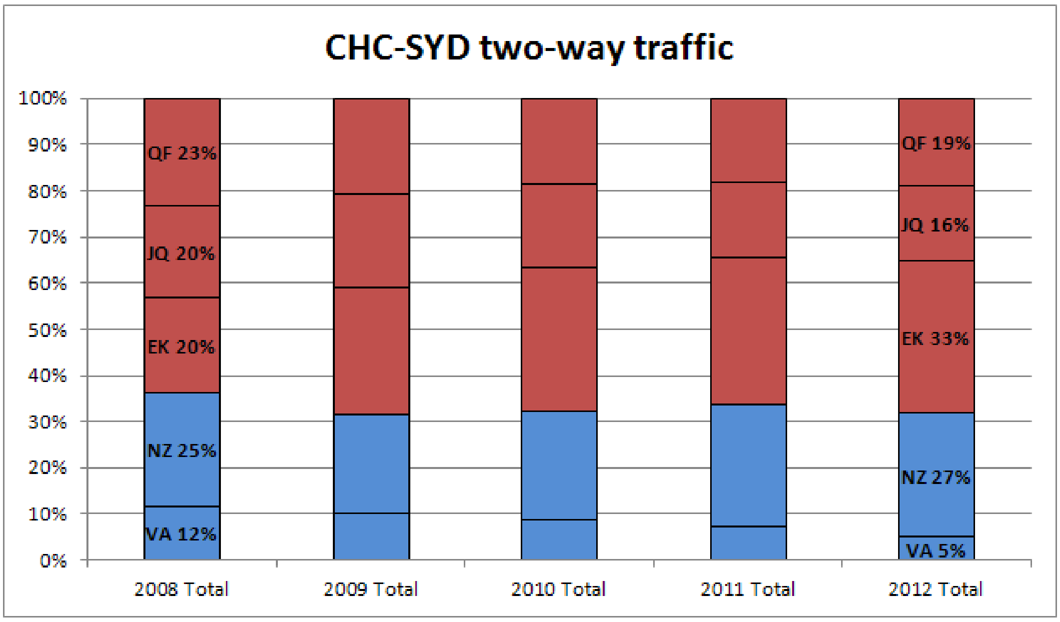


Source: Sabre Segment

Appendix B – Share of passenger traffic transported by the Applicants on each of the CHC Routes

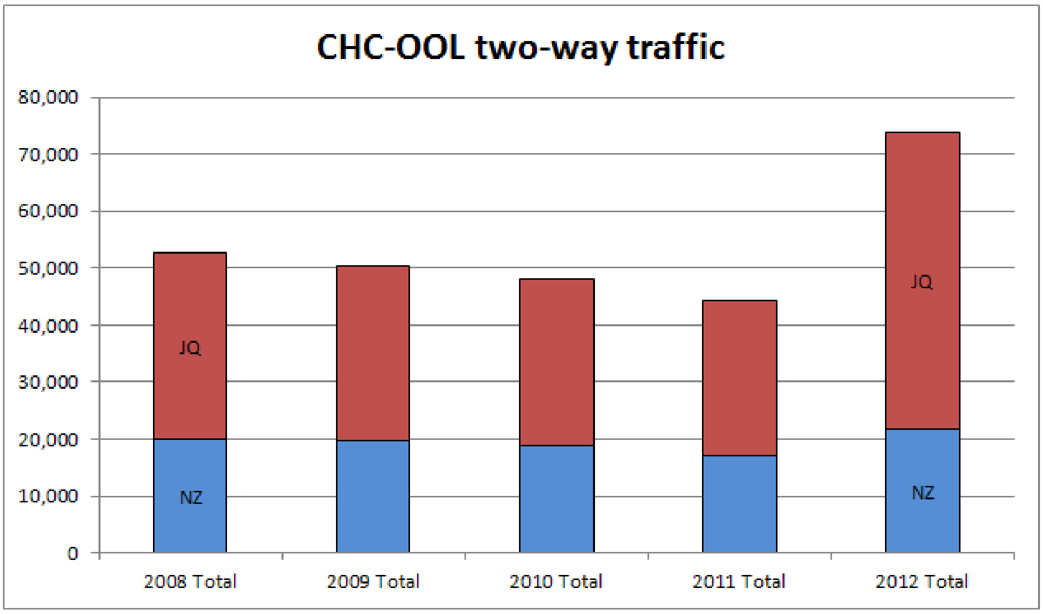
CHC-SYD

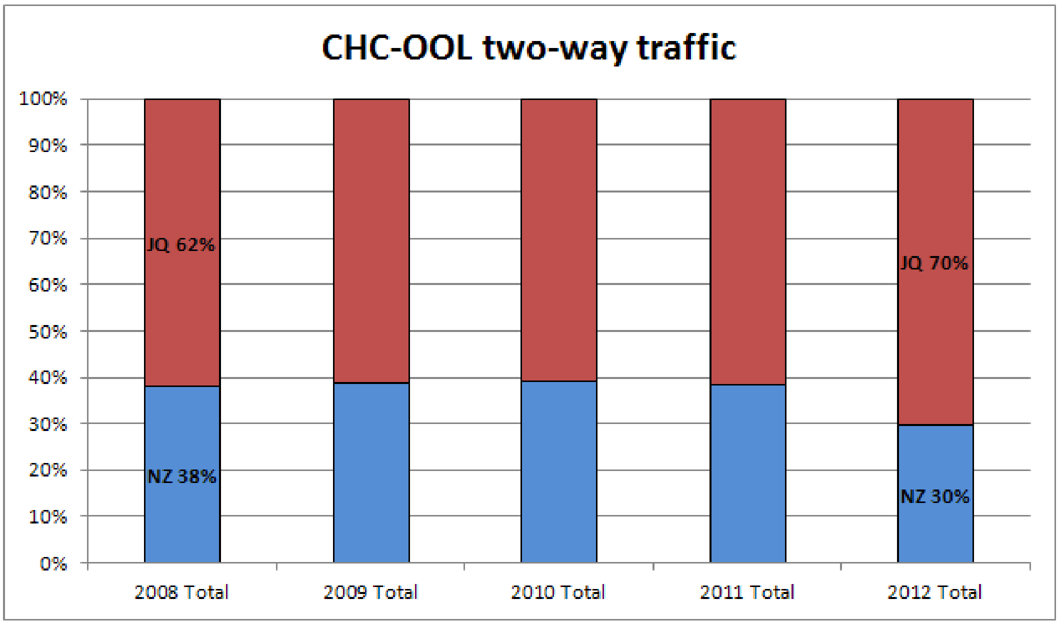




Source: CIAL

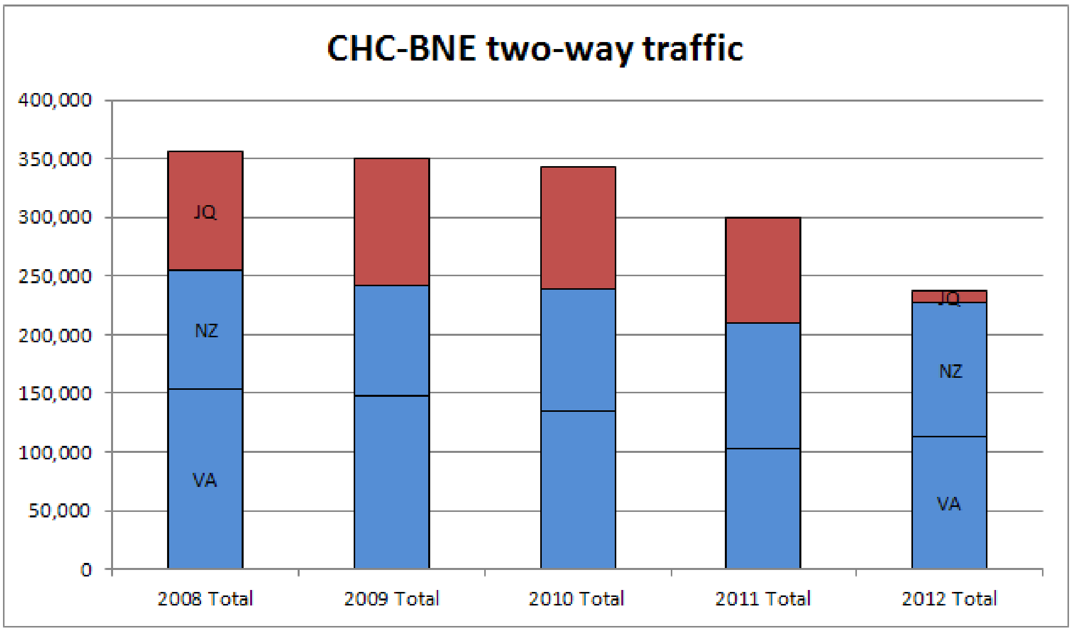
CHC-OOL

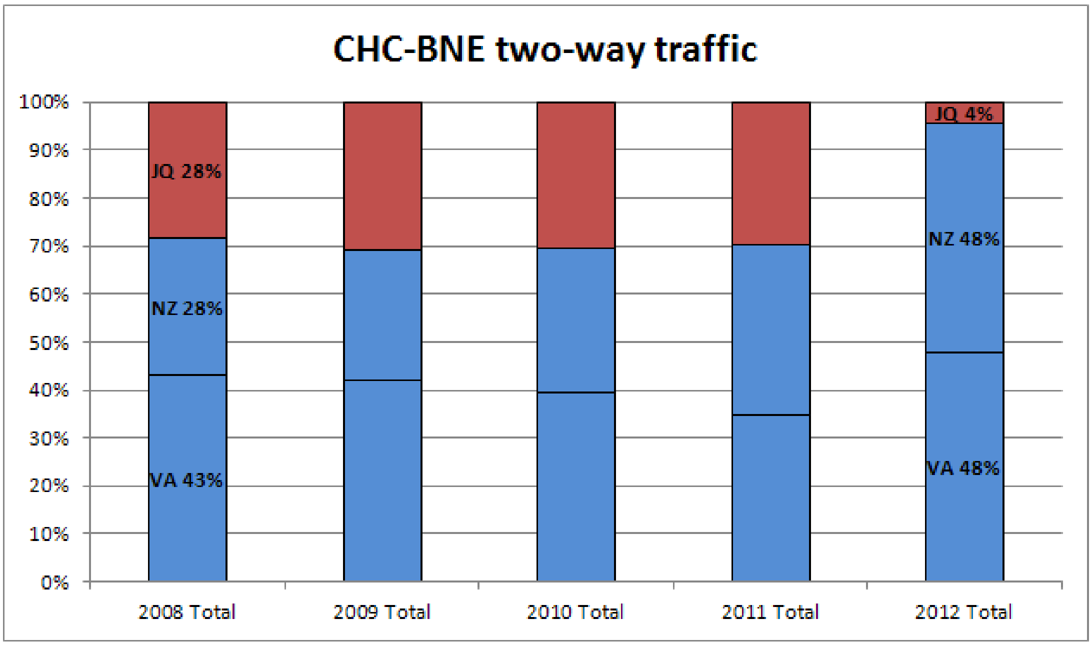




Source: CIAL

CHC-BNE[7]

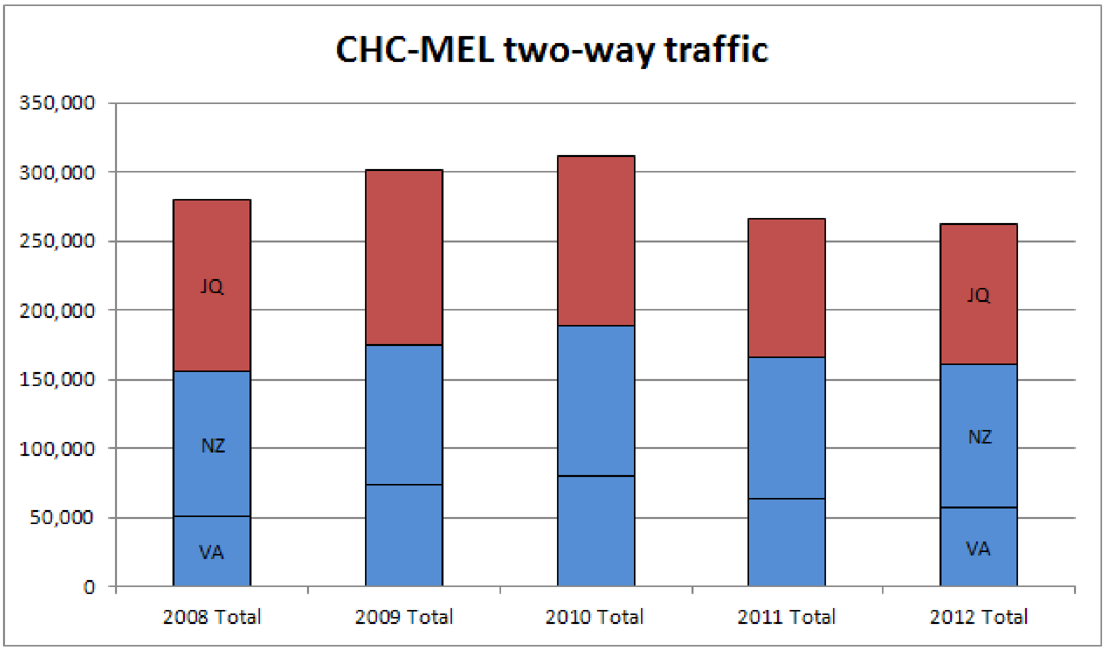


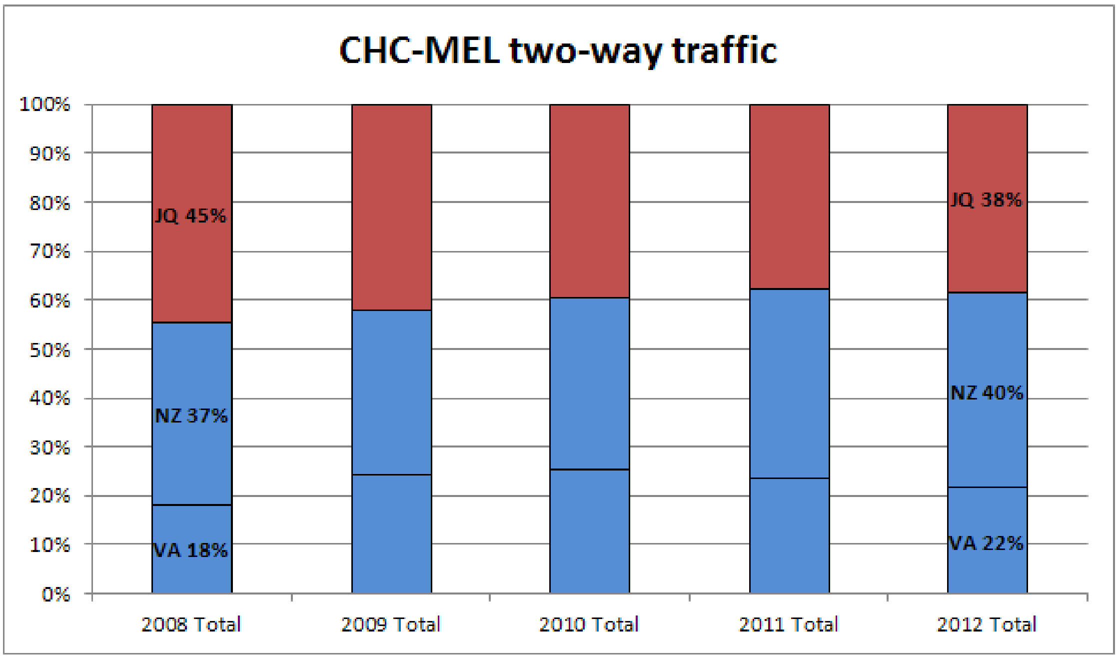


Source: CIAL

[7] Note that Jetstar withdrew from CHC-BNE in March 2012.

CHC-MEL





Source: CIAL