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26 February 2019

Ms Marlene Tucker
Executive Director
International Air Services Commission
PO Box 630
CANBERRA ACT 2601

Dear Ms Tucker

Re: Qantas Airways' application for variation – Hong Kong route

I refer to my letter of 22 January 2019 regarding the abovementioned subject and the Commission's subsequent invitation to lodge a further submission following the provision of additional information by Qantas Airways in support of its application. Please find enclosed with this letter the public version of Virgin Australia's submission.

Should you wish to discuss any aspect of our submission, please contact me on (02) 8093 7114.

Yours sincerely


Lee-Anne Tomkins
Head of Government and International Relations

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SUBMISSION IN RESPONSE TO QANTAS AIRWAYS' APPLICATION FOR VARIATION OF DETERMINATION [2015] IASC 115 – HONG KONG ROUTE

1 Overview

- 1.1 Virgin Australia objects to Qantas Airways' (Qantas) application to the International Air Services Commission (IASC) for variation of Determination [2015] IASC 115 on the Hong Kong route to permit the introduction of code share services by Cathay Pacific on Qantas' flights on the Brisbane-Hong Kong, Sydney-Hong Kong and Melbourne-Hong Kong sectors.
- 1.2 Qantas's application is a transfer application, as defined under section 4 of the *International Air Services Commission Act 1992* (Cth) (the Act). The Commission must not make a decision varying a determination as requested under a transfer application if it is satisfied that the allocation as varied would not be of benefit to the public (subsection 25(2)). Section 26 of the Act requires that in assessing the benefit to the public of a variation of an allocation of capacity, the Commission must apply the criteria set out for that purpose in any policy statements made by the Minister under section 11.
- 1.3 In response to an invitation from the Commission, Qantas has provided a supplementary submission addressing the paragraph 9 criteria of the *International Air Services Commission Policy Statement 2018* (Minister's Policy Statement). For the reasons outlined below, Virgin Australia is of the view that Qantas has not demonstrated that its application will be of benefit to the public when assessed against all relevant criteria, particularly "the likely impact on consumers of the proposed allocation, including on costs of airfares, customer choice, product differentiation, stimulation of innovation by incumbent carriers, and frequency of service".¹
- 1.4 Qantas and Cathay Pacific currently dominate the Hong Kong route, holding a combined frequency, capacity and passenger share of 89%, 90% and 92% respectively.² While the proposed cooperation will deliver marginal benefits for consumers, it will undoubtedly increase the individual and collective market power of the two carriers, at the expense of Virgin Australia as the only other competitor on the route. This is likely to significantly erode competition in the market for flights between Australia and Hong Kong, to the detriment of the travelling public and Australian tourism and trade. Accordingly, the application should be rejected on the basis that the proposed use of the relevant capacity will not be of benefit to the public, nor will it

¹ *International Air Services Commission Policy Statement 2018*, paragraph 9.

² Bureau of Infrastructure, Transport and Regional Economics, *International Airline Activity*, 12 months ending November 2018.

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promote the object of the *International Air Services Commission Act 1992* (Cth) (the Act) of enhancing the welfare of Australians by promoting economic efficiency through competition in the provision of international air services.

2 Characteristics of the Hong Kong route

- 2.1 Qantas and Cathay Pacific have been serving the Hong Kong route continuously for more than 45 years. Virgin Australia entered the Hong Kong market in July 2017, with the commencement of flights on the Melbourne-Hong Kong sector, followed by the commencement of flights on the Sydney-Hong Kong sector in July 2018. In October 2018, we became the only other competitor on the route, after Hong Kong Airlines exited the Australian market. During the past 20 years, the route has also been served by Ansett Airlines, Australian Airlines (a subsidiary of Qantas) and Virgin Atlantic.
- 2.2 During the Northern Winter 2018 scheduling season, Cathay Pacific is operating a total of 79 services per week (60 of which are operated on the Brisbane, Sydney and Melbourne sectors), Qantas is operating a total of 28 services per week on sectors to/from Brisbane, Sydney and Melbourne, while Virgin Australia is operating 14 services per week on sectors to/from Sydney and Melbourne.³
- 2.3 Nine third country carriers offer code share services on Cathay Pacific's flights on the route, while six third country carriers code share on flights operated by Qantas. Qantas code shares on Cathay Pacific's flights on the Perth-Hong Kong and Cairns-Hong Kong sectors, as well as sectors between Hong Kong and each of Chennai, Colombo, Delhi, Ho Chi Minh City and Mumbai. Qantas also code shares on Cathay Dragon's flights to Bangalore, Da Nang, Hanoi, Kolkata and Yangon. In addition, Qantas code shares on sectors operated to/from Hong Kong by Air France, El Al Israel Airways, Jet Airways and Jetstar Pacific. Cathay Pacific also offers code share services on selected flights across Qantas' domestic network.
- 2.4 Hong Kong Airlines and Virgin Atlantic code share on Virgin Australia's flights on the route, while Virgin Australia places its code on services operated by Singapore Airlines on the Singapore-Hong Kong sector and Virgin Atlantic's flights on the Hong Kong-London sector.
- 2.5 Over the past five years, the Australia-Hong Kong market has recorded a compound annual growth rate of 6.8%.⁴ Higher passenger growth rates of 9-10% occurred in 2014 and 2015, before moderating back to 3-5% in 2017 and 2018.⁵
- 2.6 Capacity and passenger volumes for the Hong Kong route and each of the Sydney-Hong Kong and Melbourne-Hong Kong sectors for the 12 months to November 2018 are shown in the tables below.⁶ Virgin Australia carried an incremental 131,918

³ Department of Infrastructure, Regional Development and Cities, *Northern Winter 2018-19 Timetable Summary*.

⁴ Bureau of Infrastructure, Transport and Regional Economics, *International Airline Activity*, 12 months ending November 2018

⁵ Ibid.

⁶ Ibid.

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passengers on the route during this period, exceeding industry passenger growth of 131,074.

	Seats	Growth vLY	
Sydney-Hong Kong	1,454,974	135,425	10%
Melbourne-Hong Kong	1,025,285	116,196	13%
Total Australia-Hong Kong	3,514,611	266,609	8%

	Passengers	Growth vLY	
Sydney-Hong Kong ⁷	1,131,844	57,235	5%
Melbourne-Hong Kong ⁸	827,336	72,178	10%
Total Australia-Hong Kong⁹	2,806,905	131,074	5%

2.7 Capacity flown for the 12 months ending November 2018 by each of the airlines serving the Sydney-Hong Kong and Melbourne-Hong Kong sectors is shown in the tables below¹⁰.

Sydney-Hong Kong	Seats	Seat share
Cathay Pacific	875,560	60%
Qantas	496,639	34%
Virgin Australia ¹¹	82,775	6%
Total	1,454,974	
Melbourne-Hong Kong	Seats	Seat share
Cathay Pacific	632,360	62%
Qantas	213,900	21%
Virgin Australia	179,025	17%
Total	1,025,285	

2.8 Load factors achieved by Cathay Pacific, Qantas, Virgin Australia and Hong Kong Airlines on the Hong Kong route for the 12 months to November 2018 are shown in the table below¹².

	Load factor	Change
Cathay Pacific	82.1%	-3.2pts
Qantas	80.5%	+1.6pts
Virgin Australia	65.8%	+0.4ps
Hong Kong Airlines	60.7%	-5.5pts
Total	79.9%	-2.5pts

⁷ Excludes Qantas Hong Kong passengers connecting to/from another Qantas international service.

⁸ Ibid.

⁹ Includes Qantas Hong Kong passengers connecting to/from another Qantas international service. For the 12 months ending November 2018, this totalled 29,841 passengers across the Brisbane/Sydney/Melbourne-Hong Kong sectors combined.

¹⁰ Bureau of Infrastructure, Transport and Regional Economics, *International Airline Activity*, 12 months ending November 2018.

¹¹ Virgin Australia commenced services on the Sydney-Hong Kong sector in July 2018. For the five months ending November 2018, Virgin Australia's seat share on the sector was 13%.

¹² Bureau of Infrastructure, Transport and Regional Economics, *International Airline Activity*, 12 months ending November 2018.

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2.9 [Confidential material redacted]

2.10 [Confidential material redacted]

2.11 In addition to their passenger services, Qantas and Cathay Pacific operate dedicated freighter services on the Hong Kong route. In the 12 months ending November 2018, Qantas and Cathay Pacific held a combined share of 89% of all freight and mail carried between Australia and Hong Kong.¹³ Virgin Australia's share was 7%, with freight and mail solely uplifted on our passenger services on the route.¹⁴ Cathay Pacific carried the fourth largest share of Australia's total international freight (behind Singapore Airlines, Qantas and Emirates), carrying 6.8% of all freight and mail.¹⁵ The Sydney-Hong Kong sector recorded the fourth largest volume of freight during the period (behind Melbourne-Singapore, Sydney-Singapore and Sydney-Auckland).¹⁶

2.12 Virgin Australia's entry to the Melbourne-Hong Kong sector in July 2017 stimulated intense price competition between all three operators. Since the announcement in March 2017 of our intention to enter the Hong Kong route, sale fares at discounts of up to 40% off structural fare levels have been available in the market. This discounting was also observed on the Sydney-Hong Kong sector during this period, as both Cathay Pacific and Qantas offer the same price points on both sectors. As a result, Virgin Australia's entry to the route has driven a significant decrease in airfares on both the Sydney-Hong Kong and Melbourne-Hong Kong sectors.

2.13 Competition on the Hong Kong route from third country carriers is extremely limited, with 90% of passengers travelling on non-stop services operated by Cathay Pacific, Qantas and Virgin Australia.¹⁷ While the one-stop flights operated by Singapore Airlines offer the shortest elapsed journey time of the third country carriers on the route, these itineraries via Singapore extend trips to Hong Kong from both Sydney and Melbourne by around three hours compared to non-stop services.

2.14 During the 12 months ending November 2018, Australian residents accounted for approximately 45% of travellers on the route.¹⁸ For Australian Resident Returns, the main reason for travel was split primarily across holiday (46%), visiting friends and relatives (31%) and business-related reasons (19%).¹⁹ Visitor Arrivals were predominantly for the purpose of holiday (53%), followed by visiting friends and relatives (28%) and business-related reasons (10%).²⁰

3 Australia-Hong Kong air services arrangements

3.1 Under the Australia-Hong Kong air services arrangements, carriers of both countries are entitled to operate up to a total of 72 flights each week between the four major

¹³ Bureau of Infrastructure, Transport and Regional Economics, *International Airline Activity*, 12 months ending November 2018.

¹⁴ Ibid.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ IATA DDS Estimate.

¹⁸ Department of Home Affairs, Overseas Arrivals and Departures data.

¹⁹ Includes reason for travel Business, Convention/Conference, Employment and Exhibition.

²⁰ Ibid.

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Australian gateway airports and Hong Kong. Cathay Pacific is currently utilising all of the capacity available to carriers of Hong Kong for its services to Brisbane, Sydney, Melbourne and Perth. Capacity to/from the major gateways remains available for allocation to Australian carriers.

3.2 *[Confidential material redacted]*

3.3 *[Confidential material redacted]*

3.4 *[Confidential material redacted]*

4 Commercial performance of Virgin Australia's services on the Hong Kong route

4.1 *[Confidential material redacted]*

4.2 *[Confidential material redacted]*

4.3 *[Confidential material redacted]*

4.4 *[Confidential material redacted]*

4.5 *[Confidential material redacted]*

5 Response to Qantas' application addressing the paragraph 9 criteria

5.1 The individual and collective strength that Cathay Pacific and Qantas currently have on the route presents a challenging competitive landscape for Virgin Australia and prospective entrants. This dominance is exercised at both ends of the route. If granted, the variation will enhance Cathay Pacific's selling proposition, by giving it the ability to market more services between Australia and Hong Kong. At the same time, this will drive more passengers onto Qantas' flights, strengthening their commercial performance. This will inevitably alter the competitive forces in the market, by cementing the dominance of the two key players at the expense of Virgin Australia and other potential future competitors.

5.2 Notwithstanding that Qantas has sought to carve out point-to-point itineraries between Australia and Hong Kong from its proposed code share cooperation with Cathay Pacific, Virgin Australia is of the view that any further concentration of the market power held by Cathay Pacific and Qantas on the route will ultimately have a detrimental impact on competition, tourism and trade, and therefore would not benefit the public and be wholly inconsistent with the object of the Act.

5.3 As outlined above under paragraph 2.4, extensive code share cooperation is already in place between Qantas and Cathay Pacific. Passengers wishing to travel under the Qantas code to Hong Kong from each of Brisbane, Sydney and Melbourne, and subsequently beyond Hong Kong to points in India, Sri Lanka, Vietnam and Myanmar, already have the option to do so. It is important to note that the variation requested by Qantas is not required to give effect to such itineraries and relates solely to flights operated by Qantas on sectors which Cathay Pacific operates in parallel.

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Competition criteria

- 5.4 *Subparagraph 9(a) of the Minister's Policy Statement requires an assessment of the desirability of fostering an environment in which Australian carriers can effectively compete with each other and foreign carriers.*

Although the proposed variation is likely to assist Qantas to boost the performance of its services on the Hong Kong route, any benefits in this regard will be more than offset by the corresponding detriment to Virgin Australia's services. As a relatively new entrant, the proposed variation would significantly inhibit Virgin Australia's ability to build our presence on the route and compete with both Qantas and Cathay Pacific over the medium to long term. Given Cathay Pacific and Qantas' combined passenger market share of 92%, the exclusion of point-to-point itineraries will not negate the detrimental impact that the proposal will have on competition on the route.

- 5.5 As Virgin Australia's international network footprint is smaller than those of Cathay Pacific and Qantas, reducing our ability to compete effectively on the Hong Kong route will have a proportionately larger impact on our sustainability as an Australian international carrier. This will also limit our ability to both facilitate and capitalise on the projected growth in international inbound tourist arrivals to Australia.
- 5.6 The proposed variation would give Cathay Pacific a strategic advantage in the Australia-China market, by allowing it to increase the number of frequencies on which it could offer multi-sector journeys, entirely under the Cathay Pacific code, between points in Australia and points in China via Hong Kong. This would directly benefit Qantas, by feeding additional passengers from China onto Qantas' flights on the Hong Kong route. *[Confidential material redacted]*
- 5.7 *Subparagraph 9(b) of the Minister's Policy Statement requires an assessment of the number of carriers operating on the route and the existing distribution of capacity among Australian carriers (including through code sharing and other joint international air services).*
- 5.8 While Virgin Australia's capacity allocations on the Hong Kong route have been varied to allow the use of such capacity for code share services with both Hong Kong Airlines and Virgin Atlantic, neither of these airlines operates their own flights on the route. In contrast, Cathay Pacific is utilising all of the capacity available to Hong Kong carriers under the Australia-Hong Kong air services arrangements for services to the four major Australian gateway airports. If granted, the proposed variation will allow Cathay Pacific to access even more capacity to the gateway airports via code share services with Qantas, on routes which the carriers operate in parallel. This will distort competition on the route and over time may jeopardise the sustainability of our services, which may see the market return to a duopoly. The absence of a competitor would see the route effectively shared by two carriers in a strong commercial relationship and would likely see airfares increase and service options diminish.
- 5.9 The impact of the combined market power of Cathay Pacific and Qantas is likely to have played a factor in Hong Kong Airlines' decision to withdraw from the route in October 2018. It is also relevant that Hong Kong Airlines' ability to compete in the

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market was restricted due to the fact that it was not able to serve the major gateways, due to Cathay Pacific's full utilisation of Hong Kong's capacity entitlement. Under the current bilateral restrictions, Virgin Australia is likely to remain the only other source of competition on the route for the foreseeable future, subject to our ability to compete against Cathay Pacific and Qantas. The competition we bring to the route would, however, be placed at risk if the proposed variation was granted.

- 5.10 *Subparagraph 9(c) of the Minister's Policy Statement requires an assessment of the likely impact on consumers of the proposed allocation, including on the costs of airfares, customer choice, product differentiation, stimulation of innovation by incumbent carriers and frequency of service.*
- 5.11 The only discernible benefit to be delivered to consumers by the proposed variation is the ability for Cathay Pacific Marco Polo Club members to earn more points on the additional code share services. As stated in Qantas' supplementary submission, eligible customers will continue to receive standard oneworld alliance benefits when travelling on either carrier, including lounge access, priority check-in and boarding, priority baggage, increased baggage and tier status recognition.
- 5.12 Most importantly, the proposed variation does not, of itself, unlock any route options on Qantas and Cathay Pacific's behind and beyond networks. Code share services on sectors behind and beyond Hong Kong and each of Brisbane, Sydney and Melbourne have already been implemented by the carriers. The introduction of additional behind and beyond sector code share options by the carriers is not dependent on approval of the proposed variation. Accordingly, Qantas' assertion that its application will result in an "expansion of customer choice through providing more route options on each carrier's respective behind and beyond networks" is tenuous.
- 5.13 The minimal consumer benefits of the proposed variation must be assessed against any potential consumer detriment. This includes the possible impact on consumers if approval of Qantas' application jeopardises the ability of Virgin Australia to remain competitive and sustain a presence on the route. The risk of withdrawal from the route is not theoretical, as evidenced by the exit of Hong Kong Airlines last year.
- 5.14 Virgin Australia is the only other competitor and, as stated under paragraph 2.12, our entry has seen fares between Australia and Hong Kong fall dramatically, benefiting consumers, tourism and trade. In Virgin Australia's view, our services have been the catalyst behind the product and service innovation of Cathay Pacific and Qantas on the route, including the deployment of new aircraft types and retiming of flights. Granting the variation will reduce incentives for the carriers to innovate in the future and is unlikely to lead Qantas to introduce new services or additional frequencies on the route. In fact, it could also lead Cathay Pacific and Qantas to rationalise capacity on the route in the future.
- 5.15 Regardless of the fact that the proposed variation seeks to exclude point-to-point itineraries on the route, Qantas is seeking to use its allocation of capacity to support the introduction of code share services on overlapping sectors which it operates in direct competition with Cathay Pacific. The Commission has consistently expressed

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concerns regarding code share arrangements in markets dominated by two carriers and before the case on the Papua New Guinea route in 2016 concerning Qantas and Air Niugini, it had never before approved any proposal which would permit two carriers in a dominant position on a particular route to offer code share services on overlapping routes (except for such arrangements encompassed under integrated alliances which have been granted authorisation by the ACCC).

- 5.16 The decisions in 2016 on the Papua New Guinea route were subsequently reversed by the Commission in Draft Decisions 2018 IASC 210d and 211d, based on the finding that the proposed code share arrangement between Qantas and Air Niugini would reduce competition and risk the withdrawal of Virgin Australia from the market. In those draft decisions, the Commission stated that:

“By operating parallel services and selling seats on each other’s services the code share partners are able to improve their offering in terms of frequency and passenger convenience, making it more difficult for competing airlines to enter or remain in the market”.²¹

- 5.17 The commercial performance of Virgin Australia’s services on the Papua New Guinea route deteriorated dramatically following the implementation of revised code share arrangements between Qantas and Air Niugini between November 2016 and 30 June 2018, as permitted by Decisions [2016] IASC 220, [2016] IASC 221 and [2016] IASC 222. This highlights the risk to competition associated with approving variations which allow increased cooperation between the two strongest carriers on a route, each of which dominates one end of the route. Accordingly, the proposed variation should not be approved, even on a short-term basis, given the impact this would have on our ability to sustain services on the Hong Kong route, particularly as a relatively new entrant.

- 5.18 Support for our view is also found in Decision [2002] IASC 218 on the Japan route, which was issued in response to an application by Qantas to vary decisions to enable Japan Airlines to code share on its new services between Melbourne and Tokyo. Japan Airlines did not serve that route and while the Commission approved Qantas’ application in that case, it noted that:

“the code share arrangement is not proposed to apply to the Sydney-Tokyo leg of the three weekly northbound services. Sydney-Tokyo is a major route on which Qantas and Japan Airlines are established direct competitors and it is difficult for the Commission to foresee circumstances where code sharing on this route would be anything but anti-competitive with little public benefit”.²²

- 5.19 It remains the case today that Qantas and Japan Airlines do not code share on each other’s parallel services between Sydney and Tokyo.

²¹ Paragraph 7.12, [2018] IASC 210d and [2018] IASC 211d.

²² [2002] IASC 218, paragraph 4.5.

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- 5.20 On the South Africa route, it is also notable that the code share arrangements previously in place between Qantas and South African Airways did not apply when both carriers operated on the Sydney/Perth-Johannesburg route in parallel.
- 5.21 The rationale underpinning the decisions made by the Commission on the Papua New Guinea, Japan and South Africa routes concerning proposed code share cooperation by Qantas must be taken into account as directly relevant precedent in assessing the merits of the application against the competition criteria.
- 5.22 The Qantas supplementary submission states that the proposed variation, “will not impact the ability of Cathay Pacific to sell and ticket on Virgin through its interline relationship, particularly given that Virgin services some destinations in Australia to which Qantas or Jetstar do not operate”. Given the existing commercial relationship between Cathay Pacific and Qantas, Virgin Australia is not aware of any incentive that Cathay Pacific would have to ticket any domestic connections on flights operated by Virgin Australia. It should also be noted that the only domestic ports which are served by Virgin Australia, but not Qantas and Jetstar, are Kununurra and Onslow.

Tourism and trade criteria

- 5.23 *Subparagraph 9(h) of the Minister’s Policy Statement requires an assessment of the level of promotion, market development and investment proposed by each of the applicants.*
- 5.24 Qantas’s supplementary submission does not contain any information as to the specific promotion, market development and investment proposed by itself and Cathay Pacific to support the realisation of the tourism benefits that Qantas claims the variation application would deliver.
- 5.25 *Subparagraph 9(i) of the Minister’s Policy Statement requires an assessment of route service possibilities to and from points beyond Australian or foreign gateways.*
- 5.26 Qantas’ supplementary submission illustrates the route service possibilities of the variation application using the example of Cathay Pacific offering a Chicago-Wagga Wagga journey via Hong Kong and Sydney under its own code. Cathay Pacific could offer this journey without the proposed variation, by carrying passengers on its own flights between Sydney and Hong Kong, and subsequently onto a code share service on a domestic flight operated by Qantas to Wagga Wagga. The variation is not required to enable Cathay Pacific to introduce code share services to additional destinations across Qantas’ domestic network. Accordingly, the proposal itself is not necessary to open up this particular routing.
- 5.27 Similarly, the variation application has no bearing on Qantas’ ability to market a Sydney-Mumbai-Sydney journey via Hong Kong/Singapore under its own code. Qantas already has the ability to offer its passengers this itinerary under code share services with Cathay Pacific, supporting the growth of inbound tourism from markets such as India and Sri Lanka. Therefore, the variation itself does not give rise to any additional tourism or trade benefits.

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- 5.28 *Subparagraph 9(j) of the Minister's Policy Statement requires an assessment of the availability of frequent, low cost, reliable air freight movements for Australian importers and exporters.*
- 5.29 Hong Kong is a key destination for Australian importers and exporters, including small and medium-sized Australian businesses seeking access to Chinese growth markets. As noted above under paragraph 2.11, Cathay Pacific and Qantas dominate the Hong Kong freight market, together carrying 89% of cargo on the route in the 12 months ending November 2018.
- 5.30 To the extent that the proposed variation jeopardises our ability to retain our current level of capacity on the route, it is likely that the cost of transporting freight between Australia and Hong Kong will increase. This will reduce the competitiveness of Australian importers and exporters.
- 5.31 *[Confidential material redacted]*

6 Conclusion

- 6.1 In order for the Commission to make a decision varying the relevant determination so as to give effect to the variation requested by Qantas, the Commission must be satisfied, after conducting a review of the application, that the proposed variation, as a whole, would be of benefit to the public.
- 6.2 Virgin Australia is of the view that the material provided by Qantas to support its application for variation is insufficient to demonstrate that it would be of benefit to the public or promote the object of the Act. This submission outlines how any marginal benefits to be delivered by the application would be completely offset by the corresponding detriment to competition, tourism and trade that would occur through permitting code share services on routes operated in parallel by the dominant carriers on the route. Relevant precedent on the Papua New Guinea, Japan and South Africa routes provides clear support for this view. Accordingly, there are insufficient grounds to justify the variation of Determination [2015] IASC 115.