February 4, 2003

The Chairman
Commerce Commission
Private Bag
Wellington

Dear Sir

Ref Yr J5633 – 19 December 2002

SUBMISSION ON THE AIR NEW ZEALAND–QANTAS APPLICATION TO IMPLEMENT A STRATEGIC ALLIANCE ARRANGEMENT

BACKGROUND TO SUBMISSION

As a user of domestic air services from a regional airport, I am opposed to the proposed Alliance between Air New Zealand and Qantas because of its inevitable impact on the cost of flying. An improved quality of service and lower airfares were the consequences of competition in the past and I would not like to see these gains eroded.

Having worked as a consultant to Europe's then largest charter airline in the 1980s (*developing budgets, new aircraft cost/benefit evaluations and implementing an improved management information system*), I have a good understanding of airline economics and the need to balance the multitude of factors required to have a viable business. This submission is therefore made with the benefit of understanding the issues.

THE NATURE OF THE PROPOSAL

Air New Zealand and Qantas are in effect asking the Commerce Commission to permit them to operate within a protected environment – protecting themselves from one another.

When announcing its qualified approval for the Alliance, allowing an application to be made to the competition authorities on both sides of the Tasman, the Government stated (presumably based on information from Air NZ) that "The alternatives were found to be much less attractive in terms of revenue generation, cost savings and protection of Air New Zealand's competitive position"[1].

This seems to be stating the obvious - that an arrangement with a business's strongest competitor is likely to enhance the revenues of both parties.

Secondly, from the same press release came this statement, "The reality is that Air New Zealand's overall profitability is heavily dependent on the profitability of its domestic services. Its long haul services, with one exception, are not profitable." (2).

It has always been claimed by both parties that the proposed alliance is predominantly to gain benefits for the domestic and Trans-Tasman markets (although the Joint Airline Operations, to which the Application applies, covers the global networks) and that competition between the two will remain on long haul routes. For the purposes of considering the Application, I submit that the Commission should look at each of the two markets in isolation.

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[1] From the ministerial press statement announcing that the proposal had conditional Government support dated 18/12/02. See Appendix (1).

Air NZ has obviously made a business decision to operate its long haul routes regardless of the fact that they are unprofitable. This commercial decision should be a matter between the company and its shareholders.

If profitability is deemed by the Commission to be a factor "for the benefit of the public", only the markets to which the components of the Application apply should be considered. I submit that there is no place for the Commission to support a mechanism by which monopoly profits in one market are transferred to operations in another where a competitive environment exists to "balance the books".

Finally, in analysing the nature of this proposal, one must look at the commercial reality of the expectations of a $550m investor. Regardless of the assurances and under-takings given to get approval for the proposed alliance, it defies commercial logic to believe that Qantas is going to allow Air New Zealand to benefit at its expense. It would be reasonable in the circumstances for the Air NZ Board and management to tread very carefully, not wanting to upset Qantas, a 22.5% shareholder, with its ability to terminate the Agreement at any time and put severe competitive pressure on Air NZ. (Given Dr Cullen's letter to Air NZ Chair Mr Palmer about ensuring Air NZ can extract itself from the Agreement at any time, one can only assume the same rights apply to Qantas.)

In looking at the rationale from the Qantas viewpoint, given Air NZ's assessment that , "… if the [proposed Strategic] Alliance was rejected, …… Qantas would enter a war of attrition against Air NZ which Air NZ would be hard-placed to win." (3), what would Qantas achieve? I suggest that the "prize" for Qantas is that the Alliance would prevent another major airline (such as Singapore Airlines) from forming a strategic alliance with Air NZ and thereby exerting some real competitive pressure on Qantas. Qantas has presumably taken a view that this "protection" is the justification for its $550m investment and any return by way of extra revenues and dividends the "icing on the cake".

FOR BENEFIT TO THE PUBLIC

With regards to a national airline, there seems to be two components to what may be claimed by that airline as being of "benefit to the public".

The first of these is an emotional issue; the desire by nationals, and probably more importantly politicians of all countries to see "their" airline in airports around the world. While this was probably central to the Government's decision to "bail-out" Air NZ, I submit it has no place in these deliberations by the Commission because, as previously mentioned, a long haul alliance is not being emphasised and therefore should not be central to the consideration of this Application.

The major factor in the second more substantive component is "what would happen if Air NZ couldn't operate on all the routes it wanted to fly?

Tourism is regarded as being a very important and growing contributor to the New Zealand economy. The *country* has recently been put forward as being the world's most popular destination for 2003, with remoteness from world turmoil being sited as one of the reasons. I don't believe that any condition was put on this view such as "*but only if people can fly to NZ on Air NZ*".

It is likely to be argued by Air NZ that its marketing efforts have been instrumental in creating awareness and therefore stimulating demand for NZ as a destination. That may be so but it is its *marketing* activities that are achieving this not its flying per se. Modern commercial orthodoxy suggests that where there is a demand there will be a business prepared to offer that good or service. In other words it is unlikely that there will be no airline available to fly people to NZ if Air NZ itself cannot. The marketing of NZ as a destination will continue to be undertaken by anyone operating a service to NZ as well as the Tourist industry in NZ. The fact is that the Government is the greatest earner (GST, PAYE on sector wages, etc) from Tourists so has a vested interest in promoting NZ.

Given the importance of the current account (ie the difference between what NZ buys and sells overseas and capital flows) Air New Zealand's contribution to this is relevant.

The acquisition of aircraft, the purchase of fuel and other imported consumables are net outflows to the current account. So is the money spent by NZ citizens when they travel overseas, carried out of the country by all airlines, including Air NZ.

The positive factor is the tourists coming into NZ but the question has to be asked "would they stay away if Air NZ was not flying?" If the real "love affair" was with Air NZ and not the NZ the country, overseas passengers would be inclined to fly from their own countries to whatever destination Air NZ was operating! This, I submit, is highly unlikely.

In summary, looking at the overall contribution that Air NZ's flying operations make to the current account, I suggest that over the long term a net outflow is likely. This cannot be view as "of benefit to the public".

If, in the Commission's view, there are valid "of benefit to the public" arguments, I respectfully submit that it is incumbent upon the Commission to consider other mechanisms by which the claimed elimination of duplicated costs can be achieved. Only after these have been considered and discounted should the Commission contemplate approving this Application in its current form.

A METHOD OF PERMITTING THE ALLIANCE AND CREATING A COMPETITIVE ENVIRONMENT

There is a notion within the airline industry that competition must be in the skies. I wish to challenge that notion and suggest that competition can also be created in the aisles and cargo holds of dominant operators.

My suggestion is that Qantas and Air NZ be required to make 40% to 50% of their NZ domestic and Trans-Tasman capacity (seats and freight) available for sale to third parties at wholesale prices. These would be sold in sector/time-slot blocks for periods of between 3 and 24 months, with a tendering process if demand exceeded supply.

These wholesale prices would be determined by reference to bench-marked aircraft operating costs (eg fuel consumption, per flying hour related air-frame and engine repairs and maintenance etc). Load factor assumptions could be built into the pricing mechanism with a proviso that if the airline reduced its average airfares on a given sector below a marker price, the wholesale price charged for that month will also be reduced. This eliminates the ability of the airline to undercut its wholesalers.

A further refinement of the concept is to create a spot secondary market for seats [available (say) within 48 hours of the day of flying], using a system akin to that operated by the NZ Stock Exchange detailing bids and offers on a daily basis.

While I have designed a model I believe allows this concept to work, the details are not relevant to this submission. The Commission needs to be cognisant of the fact that there may be a way of achieving the cost efficiencies claimed by the Applicants while putting a mechanism in place that minimises the ability of the parties to benefit from monopoly profits. I believe that the Commission itself has suggested that the wholesaling of local loop capacity by Telecom might be imposed if reasonable access rates cannot be negotiated.

CONCLUSION

New Zealand companies have an abysmal performance record in the global market-place. In some cases it is a lack of size, in others it is unwise acquisitions (*remembering that to purchase a company/business you have had to be prepared to pay more than anyone else*) and lastly, many companies have failed to recognise that regardless of ownership, most markets will only accept their nationals as the face of the company.

Air NZ is attempting to operate in one of the most difficult industries in the world (*I once heard it said that the total airline industry, since its inception, has made cumulative losses*). Not only that, NZ is as far away from the rest of the world as it is possible to be with one of the OECD's smallest economies.

If the Government wishes to fund a long haul airline because it believes that seeing the Koru at major airports around the world is important, that is a political decision and should be funded accordingly. If the tourism industry believes that the existence of Air NZ is fundamental to its existence, that industry should be a major contributor to the subsidy needed to keep Air NZ flying long haul.

None of these considerations have any place in the Commission's deliberations regarding this Application.

It would be a very sad day for NZ and the economic reforms of the last 17 to 18 years if the threat by an off-shore company to force a NZ company out of business if an alliance was not permitted was sufficient argument for the Commission to feel obligated to approve such an arrangement.

PERSONAL NOTE

This submission is not made because of any personal animosity towards Air NZ (or Qantas, for that matter). My preference within NZ is to fly Air NZ. I lived in the UK for nearly 14 years and on my numerous trips home I usually flew Air NZ by choice.

My submission has been made because I see this proposal as the "thin end of the wedge" with regard to competition in structurally important sectors in NZ.

QUESTIONS REQUIRING CLARIFICATION

1. What assurance has Qantas given about its long term commitment to first the domestic and secondly the trans-Tasman markets in the event of this proposal being approved?

2. Has Qantas given any indication of its position if the Commission approved the proposal only on the basis that Air NZ's two business components, (Australasia and International) were to be separated with separate Boards and Qantas had representation only on the former Board?

3. If the answer to Q2 was that that would be acceptable "but?", the but is likely to be that the $550m investment would be inappropriate in just the Australasian operation. The question that then needs to be asked is, given that Air NZ has repeatedly stated that its strengthened capital base is needed for the purposes of aircraft acquisition, is Qantas prepared to invest by way of providing Air NZ with aircraft on a revenue share basis?

4. Notwithstanding its expressed confidence is the Commission (see Press Statement, 4), has the Government, (given its ownership of publicly listed shares in Air NZ which are likely to trade at well above its buy-in price in the

event of this proposal being approved), given the Commission any undertaking that it will not seek to reverse a decision to decline the Application?

5. If the Air NZ Board and management do not believe they can run a viable long haul business, has anyone considered the idea of putting up for International tender a proposition of managing the Air NZ brand. (The Garunda brand was established successfully under the management of Dutch Airline KLM without many people outside the industry knowing about it**.**

I look forward to receiving comments in due course.

Yours faithfully

Harvey Bell

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Appendix

http://www.beehive.govt.nz/PrintDocument.cfm?DocumentID=15773
Printed from http://www.beehive.govt.nz/

Hon Trevor Mallard

19 December 2002

Govt approves Air NZ Qantas proposal proceeding to Commerce Commission

The government today agreed to Qantas taking a 4.99 per cent stake in Air New Zealand and gave conditional support to a strategic alliance between the two airlines. It has reserved final approval until the completion of inquiries by competition authorities on both sides of the Tasman.

Under the proposal the two airlines enter a Joint Airline Operation to be managed by Air New Zealand including all Air New Zealand's flights and all Qantas' flying operations into, out of and within New Zealand. Qantas would end up with a 22.5 per cent shareholding in Air New Zealand. The government would retain a majority 64 per cent shareholding.

In taking this decision, the government has acted to secure Air New Zealand's long term viability as an international airline. The substantial investment by Qantas of over $500 million will give it a powerful reason to ensure that Air New Zealand is a successful airline.

The 4.99 per cent stake is a first instalment and will cost Qantas $98 million. Air New Zealand will retain that money even if the rest of the deal fails to achieve the necessary consents.

The government is aware that the proposed alliance will reduce competition in New Zealand and across the Tasman and has made it very clear to the airlines that they will need to get authorisation from both the New Zealand Commerce Commission and the Australian Competition and Consumer Commission.

Applications were lodged with these organisations on 9 December. The hearings are expected to run well into next year.

The Ministers leading the government's response to the Air New Zealand – Qantas proposal are: Finance Minister Michael Cullen as holder of the Crown's 82 percent shareholding in Air New Zealand, Transport Minister Paul Swain as holder of the Kiwi Share, and Associate Finance Minister Trevor Mallard.

4 "The government is concerned at the potential impact on consumers of any reduction in competition but has confidence in the ability of the Commerce Commission, and of the regulatory framework in which it works, to deal effectively with these matters.

"In our previous term, we introduced a number of reforms to strengthen New Zealand's pro-consumer and pro-competition law and are satisfied that we now have one of the toughest regimes in the world," the Ministers said.

As principal shareholder, the government had to assess whether the Qantas alliance was in the best commercial interests of Air New Zealand going forward. This involved measuring it against other options which might be available to Air New Zealand, and against likely scenarios should the deal fail.

"Our advice from officials, supported by First New Zealand Capital which was employed by the Treasury to advise it on this issue, was that the Air New Zealand/Qantas proposal would not only deliver significant benefits to the company and its shareholders but would also be the best option for Air New Zealand to secure its position as an international airline.

1 "The alternatives were found to be much less attractive in terms of revenue generation, cost savings and protection of Air New Zealand's competitive position. This was particularly true given Air New Zealand's assessment that the most likely scenario, **3** if the alliance was rejected, was that Qantas would enter a war of attrition against Air New Zealand which Air New Zealand would be hard-placed to win," the Ministers said.

2 "The reality is that Air New Zealand's overall profitability is heavily dependent on the profitability of its domestic services. Its long haul services, with one exception, are not profitable.

"There is a risk in the long term that Air New Zealand would shrink to being merely a domestic airline with little long haul capacity.

"There would also be a real risk that the government as the principal shareholder would be called on for further substantial funds, diverting government expenditure away from higher priorities in health and education.

"The second perspective from which the government had to judge the proposal was as Kiwi Shareholder and guardian of the national interest. The considerations we used to guide this judgement were:

· maintenance of effective control of Air New Zealand by New Zealand nationals;
· continuation of Air New Zealand's ability to exercise New Zealand's existing and future air rights;
· preservation of the unique New Zealand identity of Air New Zealand;

· provision of effective channels for international tourism and travel;

· provision of a durable domestic air services network; and

· preservation of New Zealand based employment.

"On balance, we considered the proposal cleared these hurdles. The criterion which proved most problematic, and which caused considerable difficulty to the government, was the first one.

"The proposal provides that the Air New Zealand board will retain absolute authority over Air New Zealand and manage the day to day operations of the joint venture. Qantas will have significant influence principally through the Strategic Alliance Advisory Group [which will comprise three representatives from each company]. Qantas will recommend two appointees to the Air New Zealand Board and Air New Zealand will recommend one appointee to the Qantas Board.

"Joint ventures typically provide for such power sharing and consultative structures, and they are to be expected given the size of the investment Qantas is proposing and the fact that it would have to hand over 15 per cent of its air network to Air New Zealand to manage.

"But the government needs to be satisfied that the governance arrangements will preserve Air New Zealand's autonomy and welfare.

"Air New Zealand considers the best way to achieve this is to protect the company's ability to quit the alliance at minimal cost.

"The government agrees with that assessment. It has agreed that Dr Cullen, as the shareholding minister, should reinforce the message by setting out his expectations in a letter to the chair of Air New Zealand, John Palmer.

"We are putting that letter on the public record by releasing it today," the Ministers said.

"The airlines are claiming that the alliance will create public benefits through scheduling efficiencies, new trans-Tasman services, increased tourism and improved freight operations and that these benefits will outweigh the anticipated reduction in competition.

"These claims will be submitted to and tested by the competition authorities on both sides of the Tasman.
"The government expects the competition authorities will carefully assess these claimed benefits and costs. That process will allow for public concerns to be heard and considered.

"Only if the proposal gets Commerce Commission and ACCC approval, will we give it final support," the Ministers said. "If it is significantly altered during the competition processes or if significant new information emerges, the government will need to reappraise it."