

22 AUGUST 2003

## PRESENTATION BY INFRATIL (cont)

**CHAIR:** Good morning ladies and gentlemen. Can I please ask everyone to be seated.

I'd like to welcome everyone to the fifth day of the Commerce Commission's Conference being held in relation to the application by Air New Zealand and Qantas Airways who are seeking authorisation to enter into a Strategic Alliance Agreement and related agreements, and the application by Qantas Airways seeking authorisation to subscribe for up to 22.5% of the voting equity in Air New Zealand.

Last night when we adjourned we were in the middle of a presentation on behalf of Infratil by Professor Hausman, and I propose at this time to return to that presentation. So, Mr David?

**MR DAVID:** Just a brief procedural matter. Two of Professor Hausman's slides not the ones coming up immediately, but part of the way through his presentation deal with confidential material, that is the NECG tourism effect on the confidential counterfactual. The slides themselves don't provide for any detail, I've provided or shown copies of the slides for counsel for the Applicants; they're happy for Professor Hausman to continue his presentation in open session, but if we do inadvertently stray into figures, then I'm sure counsel will jump up and indicate.

**CHAIR:** Please, it's very easy for it to happen, so I would appreciate an immediate warning as possible, if that happens.

1 **MR DAVID:** We'll try, thank you.

2 **MR P TAYLOR:** Madam Chair, just from our perspective, I'm happy  
3 with the slides as they stand, but I would be disturbed if  
4 we start getting into figures; because any figures are going  
5 to -- we can't help them -- come from the confidential  
6 session in relation to those slides.

7 **CHAIR:** If we need to have a discussion on figures, we will do  
8 that just before morning tea and have a confidential  
9 session, but let's see how we go on that. Okay.

10 **PROF HAUSMAN:** I'll try to be very careful.

11 Okay, when I broke off last evening I was on this last  
12 slide or last bullet point; that, you know, there's been a  
13 change in the sense that United has exited from Los Angeles-  
14 Auckland, so there's been a change in economic conditions,  
15 and market conditions suggest the alliance will turn things  
16 into a merger to a monopoly from Auckland-Los Angeles.

17 Absent the alliance, a duopoly between Air New Zealand  
18 and Qantas on this route would seem likely to persist for  
19 the foreseeable future. It would be very unlikely for a VBA  
20 to enter; everyone has agreed to that.

21 Okay, I'm now going to turn to my next topic and that is  
22 the effect of uncertain outcomes; the importance of option  
23 value. So, I was trying to think about this from the  
24 Commission's point of view, or from the public policy point  
25 of view, and I think it's quite clear that there is a  
26 significant degree of uncertainty about what might happen.  
27 That almost always goes with mergers; you're forward-looking  
28 and you're trying to predict the future. So, I'm trying  
29 here just to put this into a framework that might be  
30 helpful.

31 So, Dr Tretheway in his testimony concluded:

*Infratil (cont)*

1           "The factual and counterfactual eventually have the same  
2 outcome. The only issue is the path to get there: Slow and  
3 painful without the alliance, or quickly while maintaining  
4 and enhancing both the Air New Zealand and Qantas marketing  
5 brands."

6           Now, I'm speaking here of course in terms of consumers  
7 in my view and, you know, the overall national welfare --  
8 social welfare, not from management's point of view about  
9 what might be slow and painful.

10          I think it's correct to say that there are differing  
11 views as to what the future might bring, and that of course  
12 creates significant uncertainty.

13          Now, it turns out that the business and economics  
14 literature in the past 15 years have emphasised the value of  
15 options. I've written numerous papers in telecommunications  
16 on this, which I will not bring up in front of the  
17 Commission this time -- perhaps some time in the future, but  
18 not this time. However, it turns out that what we find when  
19 we do this research is that, with sunk costs, options turn  
20 out to be very important.

21          And, just to remind people; a sunk cost is, when you  
22 make an investment that, if you exit the business, you  
23 cannot recover your investment, or not recover very much of  
24 it.

25          And, when Dr Tretheway is talking about "brand names"  
26 and marketing brands, that's typically seen as a sunk cost;  
27 there is investment over many years, you want your customers  
28 to recognise your brand, and there are other sunk costs in  
29 airlines as well in terms of route structures and all.

30          In fact, back in the early 80s there was literature on  
31 contestability which assumes no sunk cost, and they're a

*Infratil (cont)*

1 primary example, if there was one of, the real world was the  
2 airline industry. But by the early 1990s everyone realised  
3 that that contestability literature did not really apply to  
4 airlines, that sunk costs were quite important.

5 So, I'm going to take it as a given that there are  
6 important sunk costs in the airline industry; I don't think  
7 that's really a very arguable proposition.

8 So, the Commission should then realise the value of the  
9 Air New Zealand option because, if the alliance is permitted  
10 to go ahead, no chance will exist for re-entry by another  
11 New Zealand based FSA in the future. So, in other words, if  
12 the alliance goes forward and you have a merged entity, I  
13 think it would be very unlikely in the future we would see  
14 another New Zealand based FSA, full service airline.

15 However, if the alliance is not permitted to form, then  
16 the Commission can gain further information regarding the  
17 performance of Air New Zealand rather than assuming its  
18 demise.

19 So, that's another lesson that we learned from the  
20 options literature is, if I'm a firm, I could do the  
21 investment today. I mean, by "today" I mean this year. But  
22 there could be a lot of uncertainty about what's going to  
23 happen to prices, to demand, to factor input prices. So one  
24 of the things that it turns out is that it's often  
25 worthwhile to wait and the value of waiting is called the  
26 value of the option, to see what's going to happen because  
27 you may learn a lot of information in the meantime.

28 So, Air New Zealand has claimed, or at least  
29 Dr Tretheway has claimed, that in his view Air New Zealand,  
30 as I quoted in this above paragraph, is likely to die.

31 Now, I can't say that he's wrong; as I said earlier, I

*Infratil (cont)*

1 don't think he took into account the changes in economic  
2 conditions, but I don't think he can claim that he knows for  
3 sure that's gonna happen either.

4 So, here's then my last point, that the immediate and  
5 long-term value of this option to consumers in New Zealand  
6 is significant. Because, so long as competition remains,  
7 consumers get lower prices; they're made better off, but if  
8 you allow the alliance to form, just for example, you have a  
9 monopoly in between New Zealand and the US, and New Zealand  
10 consumers who want to fly to North America -- and maybe even  
11 to a lesser extent London but I'll just focus on  
12 North America -- will definitely be made worse off, so the  
13 value of the option to them as citizens of New Zealand is  
14 significant.

15 **CHAIR:** Can I just ask you; isn't it -- I understand the point  
16 that's being made, but presumably the value of that option  
17 is picked up in the welfare analysis that's been done?

18 **PROF HAUSMAN:** I would respectfully disagree, because I heard, I  
19 think it was Mr Ergas testify yesterday, that he agrees that  
20 there's significant uncertainty, but they're using the most  
21 likely outcome, and so, since they do not take the  
22 uncertainty into account, they have not valued the option  
23 whatsoever. I mean, unless it's somewhere in the model and  
24 I've missed it, but I very much think not.

25 **CHAIR:** In the NECG model?

26 **PROF HAUSMAN:** Yes. So, when they've done the welfare  
27 comparisons, they have not taken into account the option  
28 value.

29 **CHAIR:** What about the other models that have been used to look  
30 at this?

31 **PROF HAUSMAN:** I don't think any of them have, but I will say

*Infratil (cont)*

1 that I have not studied the Commission models at all  
2 closely. The only model I studied closely was really the  
3 NEEG model.

4 But, I mean, the way to think about this if there's  
5 uncertainty on both sides; on one side things work out and  
6 they keep going, on the other side they die, but if you  
7 allow the alliance to go forward in my view it's like  
8 allowing them to die, so you haven't taken into account that  
9 the good things might have happened and they could have kept  
10 going.

11 So, therefore, if Dr Tretheway is wrong in his  
12 prediction in the future, by declining the application the  
13 Commission would have met its statutory purpose; I won't  
14 quote back to you your own language. However, if  
15 Dr Tretheway proves correct then, by declining the  
16 application, the Commission would have ensure that consumers  
17 benefitted from competition in the interim. So, in my view,  
18 in either case consumers are better off if the applications  
19 are declined when one takes into account the option value.

20 I'm now going to turn to my reply to Dr Winston. As I  
21 said, Dr Winston -- Cliff to me, he's an old friend, he was  
22 at MIT; I actually predated him a little bit, and he's now  
23 at Brookings in Washington and we've remained friends, so I  
24 would like to be very careful in what I say -- so,  
25 Dr Winston does a fare regression and finds a negative  
26 effect of Virgin Blue.

27 I asked counsel to get the data for me and it was  
28 provided by the Commission. When I rerun Professor  
29 Winston's -- or Dr Winston's I guess it is -- results, I end  
30 up with 1429 observations, when I fit it into a computer  
31 programme. So, I end up with 22 more observations than the

*Infratil (cont)*

1 Morrison-Winston paper. I asked Dr Winston why that could  
2 be, and he was not able to tell me why, but 22 observations,  
3 you know, out of 1400 really should not matter that much but  
4 I would like to say I want to be somewhat cautious here  
5 because I was not able to replicate his results exactly.

6 But my findings -- I guess for those two Commissioners  
7 who don't know me, I'm a pretty well-known econometrician  
8 and I'm going to talk about something called a Hausman  
9 Specification Test, which I invented.

10 I found his results are very sensitive to specification,  
11 and in fact when I put in year effects -- this is a term of  
12 ours -- I found demand GDP to be significant. If you go  
13 back and look at the Morrison-Winston paper, they do not  
14 find demand to have a significant effect, which is in my  
15 view a bit odd. So, by changing the specification I was  
16 able to do that, and Professor Winston, or Dr Winston had  
17 Mr Morrison back in Boston -- Professor Morrison back in  
18 Boston do it, and he confirmed to me that when they did it,  
19 followed my thing, they also found it to be significant.

20 However, the other thing that I did, which they did not  
21 do in their model, which is more important is, in the  
22 database there are other airlines as well. So, if you  
23 remember back to the regression specification, they had only  
24 Ansett, Virgin and of course Qantas is always there. But I  
25 put in the other airlines as well, and I found them to be  
26 statistically significant and negative, so that means that  
27 the presence of other airlines drives down the price in  
28 addition to whatever effect that Ansett and Virgin Blue had.

29 When I do that, I now find that the Virgin Blue and  
30 Ansett effects are not statistically different; I find that  
31 they have about the same effect. When Dr Winston had

*Infratil (cont)*

1 Professor Morrison rerun it using a specification, he found  
2 that the Virgin Blue effect decreased by 30%, so that goes  
3 from 11% to about 8%. So I think putting in these other  
4 variables has an effect, and by the time Virgin Blue gets  
5 down to 8% it's a lot less, of course, and something like  
6 the 20% that you typically find for Southwest in the  
7 United States.

8 So, when I do a specification test, the Hausman  
9 Specification Test, I find these other variables to be very  
10 important, and the coefficient on Virgin Blue to be  
11 significantly affected.

12 **CHAIR:** Did you try any other variations to the regression?

13 **PROF HAUSMAN:** Not really. I mean, I did some things with the  
14 auto regression and things like that, but this is a very  
15 limited data set; this was a data set that was given to me  
16 and there weren't other many variables.

17 I think I did try one other thing, which was mean  
18 income, which I don't think mattered but, as usual, I was  
19 sitting at the back of a Conference room running regressions  
20 while Dr Winston was testifying, so...

21 Okay, so what are the conclusions from this? Well, as I  
22 said yesterday, I think that it's well-known in the US that  
23 three or more airlines lead to lower fares than when two  
24 competitors exist. So, in other words, adding an additional  
25 airline does lead to lower prices. So, I used Dr Winston's  
26 data to test for the effects in Australia and I found the  
27 presence of an additional airline led to significantly  
28 negative effects beyond Ansett and Virgin Blue.

29 Now, without the alliance you will have Air New Zealand,  
30 Qantas and Virgin Blue, so in other words you will have  
31 three airlines, but with the alliance you'll have the merged



*Infratil (cont)*

1 airline, which I'm calling Air New Zealand -- I guess I  
2 should have put Air New Zealand Star -- and Virgin Blue.  
3 Now, I can't say for sure what will happen in New Zealand  
4 because you haven't run that experiment yet, but to the  
5 extent that the Australian and US results apply, airfares  
6 will be significantly higher in New Zealand if you allow the  
7 alliance, and my estimated effect is about 4 to 5% higher  
8 fares.

9 **MS BATES QC:** Can I just ask you something.

10 **PROF HAUSMAN:** Sure.

11 **MS BATES QC:** Because we have situation in Australia where  
12 presumably we know what the position was before Ansett  
13 exited and what the position was after Ansett exited the  
14 Australian market, and now, maybe that doesn't do anything,  
15 but at least you've got an example of a three going to a  
16 two, but do you know that in fact the prices declined?

17 **PROF HAUSMAN:** Well, I think you would mean to ask me whether  
18 they increased after Ansett?

19 **MS BATES QC:** I mean increased; yes, sorry, I did mean that.

20 **PROF HAUSMAN:** I don't know that. I think there was a paper  
21 that I saw cited in some Australian Transport Journal that  
22 speaks to that, and I'll let staff remind me when they ask  
23 me questions, I don't remember, but I think it might cover  
24 that topic.

25 **MS BATES QC:** What would you expect to be the position?

26 **PROF HAUSMAN:** I think they probably are not going down as fast  
27 as they would have otherwise. In other words, as Virgin  
28 expands, I would expect fares to come down, but if Ansett  
29 had been there I would have expected them to come down  
30 faster. Because, again, remember in the US what you usually  
31 find is, when a VBA comes in, prices go down 20%, and

*Infratil (cont)*

1 Dr Winston's regression has Virgin Blue at 8%, and I have it  
2 even somewhat lower than that at about 5%. So, in my view  
3 the proposed authorisation is anti-competitive and further  
4 harms consumers.

5 The one point I'd like to make which I think the  
6 Commission said yesterday -- Ms Rebstock said yesterday,  
7 which I agree with, but I'm not trying to put words in her  
8 mouth of course -- Dr Winston testified that competition  
9 should be allowed to take place undistorted by promises to  
10 the Commission not to compete too much, and I want to  
11 emphasise when I'm making this point about going from three  
12 to two, I think it would be a very bad idea, and I think  
13 Professor Willig also agreed with this, to have the  
14 authorisation depend on promises made by the alliance not to  
15 put too much capacity on. I think, you know, that harms  
16 consumers; maybe it will help Virgin Blue but, of course,  
17 everybody at the front table knows you're supposed to be  
18 helping consumers, not competitors. I just wanted to end  
19 with that point.

20 Okay, I move on now to Professor Willig and Ms Geurin-  
21 Calvert. I say the same thing, I've known Bobby Willig for  
22 30 years, and Meg Geurin-Calvert probably for 20, so I want  
23 to be, again, careful. They claim the alliance opens  
24 opportunities for airlines to provide on-line itineraries  
25 and co-ordinate schedules. They also claim the consumer  
26 benefits reduce prices on inter-line services by 21 to 25%  
27 and you'll spread flights over the day rather than wingtip  
28 flights.

29 The primary difficulty I see with their analysis is -- I  
30 haven't been able to go back through and check, but there is  
31 this whole thing about using business fares and all, which I

*Infratil (cont)*

1 question. But also, they're assuming that dominance does no  
2 harm. We could do this for any networked airlines in the  
3 United States, and why not just let the whole country merge  
4 in a monopoly? Well, we know that what happens when you  
5 have dominance, the prices are going to go up. So, I think  
6 they've only looked at one side of the equation, not the  
7 other side. When all at once they combine, to a lot of  
8 these places where there's already competition, there are  
9 already on-line flights -- I think Ms Bates gave some  
10 examples, I don't know the names of the towns in New Zealand  
11 well enough to be able to give some examples, but there's  
12 already competition between on-line and inter-line flights -  
13 - once you have the alliance that competition will cease,  
14 and of course prices are going to go up. That was never  
15 mentioned so far as I could see in the Willig Geurin-Calvert  
16 presentation. And this also ignores long haul routes with  
17 little prospect of VBA entry.

18 While the Commission of course, in my view, should  
19 presume that dominance harms consumers, the alliance market  
20 share will be 100% on most routes where you currently often  
21 have competition. Of course, there's a question of how much  
22 VBA like Virgin will come in and offer service to these  
23 small places; I can't predict that, but I doubt they'll  
24 cover the country nearly as much as the current airlines do.  
25 That's not been their operation model.

26 So, most competition models would have prices increasing  
27 where the alliance replaces current competition and,  
28 furthermore, rivalry drives service innovation over time,  
29 and that will cease as well; that was discussed yesterday.

30 So, competition authorities are very wary of same route  
31 alliances. The Department of Justice in the US generally

*Infratil (cont)*

1 oppose network overlap mergers. So the most recent one they  
2 rejected in that sense was the United-US Air merger in which  
3 there was an extensive overlap, there was overlap in two  
4 hubs but, you know, despite the consumer benefits claimed in  
5 all the inter-line -- on-line benefits claimed since US Air  
6 has extensive routes to smaller cities and towns in the  
7 eastern US, which United doesn't by-in-large, the merger was  
8 turned down.

9 Similarly, the European Commission is concerned where  
10 mergers between only the competitors on particular routes.  
11 So, alliances aren't necessarily bad, but what you need to  
12 have is enough competition from other airlines, you know, to  
13 keep prices from rising. In my view this alliance is the  
14 wrong type of alliance because you won't have sufficient  
15 competition to constrain prices.

16 **CHAIR:** Can I just stop you there for a second,  
17 Professor Hausman. I did note in your introduction  
18 yesterday that you made a fairly strong statement that no  
19 antitrust authority would approve such a merger, as what you  
20 see this alliance creating, and I guess the question  
21 really -- I wonder if that can really be stated in that way.

22 Would you be supposing their merger laws and their  
23 market environment, or would you make that statement in the  
24 context of the law under which this decision has to be made  
25 in this environment here?

26 **PROF HAUSMAN:** No, what I'm saying is -- and by "no", I meant  
27 the US and European, I wasn't speaking of the rest of the  
28 world.

29 **CHAIR:** But by applying their laws to this --

30 **PROF HAUSMAN:** By apply their laws, yes.

31 **CHAIR:** Because we aren't even looking at this strictly under

1 the merger test; this is an authorisation process. And so,  
2 to be helpful to us, I think we need to look at it under the  
3 test that is to be applied here.

4 **PROF HAUSMAN:** Right. Well, I'm getting there. I thought that  
5 perhaps Professor Willig and Ms Geurin-Calvert gave the  
6 impression -- but I don't again want to put words into their  
7 mouth -- that the US authorities might look favourably on  
8 this type of merger, and I'm saying I would disagree with  
9 that respectfully, and then I'm going to get on to your  
10 authorisation procedure very shortly.

11 **CHAIR:** Okay. I was also interested though in the case you  
12 mentioned yesterday that had been put forward several times  
13 and rejected in the US. So, even though I'm saying to you  
14 we need to apply New Zealand law, I am interested to hear  
15 the details of why that particular merger was rejected.

16 **PROF HAUSMAN:** Oh, the reason that that -- that wasn't a merger,  
17 that was actually an alliance between British Air and  
18 American, and the reason why it's been rejected numerous  
19 timings is that American and British Air have a very high  
20 concentration from the East Coast to Heathrow. It's not to  
21 say that there are not other airlines that fly to Heathrow;  
22 United does, Virgin does, but nevertheless it's been  
23 determined a number of times that that would lead to a  
24 lessening of competition and has been stopped. And so, in  
25 fact the model that Professor Willig talked about, that  
26 Professor Ordover had done had been used in that proceeding,  
27 but nevertheless it was turned down.

28 Okay, so I just have a quote here from a Transportation  
29 Research Board paper saying that the DOJ will allow mergers  
30 or carriers where there's not significant overlap. American  
31 bought Reno; more recently American bought TWA which I think

*Infratil (cont)*

1 again is headed for its third or fourth bankruptcy, but  
2 there was very little overlap. However, it's generally  
3 opposed mergers where networks overlap.

4 Okay, now I'm going to turn to the models and hopefully  
5 this will get into the authorisation procedure. So, I  
6 believe that the approach that NECG have taken is  
7 fundamentally incorrect. So, they use the assumption of the  
8 Cournot model, and I'm going to try to explain, I believe  
9 this is inconsistent with both the facts and the testimony.

10 So, what does Cournot do? It assumes a homogeneous  
11 product with no differentiation. So, the classic example  
12 that I use of Cournot when I teach my students is, Cournot  
13 is cement. In the US we have the ASTM Standards, and grades  
14 of cement have to be made to those standards; I'm sure you  
15 have something similar in New Zealand. Nobody cares about  
16 the brand of cement, and cement is cement; that's what we  
17 mean by "homogeneous product". And, the price will be same,  
18 because if you try to charge a little bit more for your  
19 cement no-one will buy it, and vice versa, and there are  
20 really no essential product differences. That's not to say  
21 there aren't two different types of cement, but for a given  
22 type of cement it will be homogeneous.

23 Now, I think in the airline industry that once upon a  
24 time Cournot might have been a reasonable assumption,  
25 because you had different FSAs but their prices were  
26 essentially the same and they were offering a very similar  
27 product. Now that's changed more recently with things like  
28 alliances and frequent flyers and all, but it might still  
29 have been a reasonable approximation.

30 But now with VBAs I think the differentiation is very  
31 important for FSAs to exist. I may have the wrong name for

*Infratil (cont)*

1 this airline here, but I listened to Dr Tretheway's evidence  
2 regarding the differences between Air Canada, where he had a  
3 seat that he could use his computer, and I may have this  
4 name wrong in this airline, it was Canada West, it was a  
5 budget airline, and he went on and on about that and, of  
6 course, I agree.

7 We also have the importance of frequent flyer programmes  
8 and alliances such as the Star Alliance which was discussed  
9 yesterday, and actually Ms Geurin-Calvert also testified the  
10 differentiation between FSAs and VBAs. We know we have to  
11 have differentiation because VBAs typically offer a lower  
12 priced product, and if you don't have differentiated  
13 products there's no reason for FSAs to exist.

14 The other thing which I found very interesting is, the  
15 Applicants have emphasised the importance of brand name. On  
16 and on, "we're going to build the brand name". Well that  
17 means differentiation, because there is no role for brand  
18 names in Cournot models; period.

19 Models with product differentiation behave very  
20 differently; there is not as much competition typically. So  
21 this is called Nash-Bertrand rather than Cournot. Nash, of  
22 course, is the noble prize winner, then they made the movie  
23 about it, and Bertrand was another economist in the 19th  
24 Century.

25 Nash-Bertrand is used for differentiated products -- I'm  
26 not going to go into great detail here about them; as I  
27 said, I published numerous papers on the subject, perhaps  
28 the first being competitive analysis with differentiated  
29 products, and this approach has been adopted by the US DOJ,  
30 and FTC, and actually also by the Europeans as well, and  
31 Australians, I've done mergers in Australia.

*Infratil (cont)*

1           Now, what do these models mean? Well, in differentiated  
2 product markets certain products are more closely  
3 competitive than others. So, I'm going to use an automobile  
4 example and beer example; I've looked at both of those.

5           But, for automobiles we know that Saabs and Volvos are  
6 considerably closer competitors than a Cadillac is. If I'm  
7 using cars people don't know about, tell me and I'll switch  
8 examples. I haven't seen any Cadillacs in New Zealand,  
9 so that shows good taste on someone's part. But, in terms  
10 of beer, which I've written papers about, Budweiser -- I'm  
11 going to mention some US beers so you can cringe --  
12 Budweiser and Miller are much closer competitors than  
13 Milwaukee's Best, which is a budget beer.

14           So, what you expect here is that Air New Zealand and  
15 Qantas are what in the US Merger Guidelines under the  
16 Competitive Effects section -- and you may have a similar,  
17 one I couldn't find it on the web -- are called "closest  
18 competitors". That means that they have a higher cross-  
19 price elasticity than with VBAs. So that's why, you know,  
20 historically you see the FSAs charging the same price,  
21 because they both have high levels of service, but the VBAs  
22 can come in with a lower price and everybody still can exist  
23 in the market, especially for business travellers; you know  
24 this is what has been discussed.

25           And from my papers -- and other people; I mean, I'm not  
26 the only one who's worked on this by far -- Nash-Bertrand  
27 models demonstrate the price effect of a merger is higher  
28 with closer competitors. So, I contend therefore that the  
29 anti-competitive effect of allowing the alliance is  
30 considerably higher than the NECG model assumes with  
31 Cournot. So, to that extent it is not conservative as has



1       been claimed.

2           I think this is actually quite important because I  
3       listened for a long time yesterday, and it was claimed time  
4       and time again that the model was conservative, and in this  
5       very important respect I don't think it is, and the various  
6       kluges to the model, by putting in a hedonic or whatever,  
7       doesn't really capture this effect at all, that's just  
8       mucking around with cost; that's not correcting any cross-  
9       price elasticities.

10   **CHAIR:**   Can I just ask you: I do understand that the comment  
11       about whether the NEEG approach with the Cournot model was  
12       conservative, but nevertheless the result is still  
13       ambiguous, isn't it. We don't know whether the net -- just  
14       on an a priori basis, you don't necessarily know whether the  
15       overall impact will be positive or negative at this point?

16   **PROF HAUSMAN:** I can't say that, but what I can say is, to the  
17       extent they claim a positive effect, it will be less  
18       positive if you take into account differentiation, and I'm  
19       still getting there in terms of what their net effect is, so  
20       you will not be disappointed.

21   **CHAIR:**   All right.

22   **PROF HAUSMAN:** I hope. Any other questions, or I guess the  
23       staff can ask me questions later.

24           Okay, now what I'd like to demonstrate, I'm an  
25       econometrician who looks facts, so I believe that the  
26       Cournot assumption is inconsistent with the facts. It turns  
27       out that under Cournot, with different costs, share is  
28       inversely related to costs. So, I'm now going to discuss  
29       that.

30           So, here is the pricing equation under imperfect  
31       competition; there can be no disagreement with this, and

1 what I'd like to do is go up here.

2 [Approaches overhead]

3 So what this says is that, for firm 1, its price is  
4 equal to its marginal cost, which is  $C_1$  times its own price  
5 elasticity,  $\eta_1$ , and I always put minus signs in front of  
6 elasticities, but you can do it either way, it's sort of  
7 just convenience. Divided by  $\eta_1 - 1$ , so that comes out of the  
8 profit maximisation position, so I'm assuming profit  
9 maximisation here very much like Professor Willig claimed.  
10 He and I certainly agree on that.

11 Under Cournot it turns out that this elasticity is equal  
12 to the market elasticity -- you can see that I have taken  
13 away the subscript -- divide by the share.  $S_1$  stands for  
14 the share for firm 1. And then the denominator is  $\eta - S_1$  over  
15  $S_1$ . So now doing some arithmetic you can see that these  
16 cancel and is equal to the marginal cost,  $C_1$ , the market  
17 elasticity  $\eta$  divided by  $\eta - S_1$ .

18 Okay, now remember under Cournot the prices are equal,  
19 so  $P_1$  is going to be equal to  $P_2$ . So, if that's true, I can  
20 just divide the right-hand side and I get,  $C_1$  over  $C_2$  is  
21 equal to  $\eta - S_1$  over  $\eta - S_2$ . So, under Cournot the firm with  
22 lower costs will have the higher share. So, if you want  
23 just to think about this very easily, you could set  $\eta$  equal  
24 to 1. So, if you set  $\eta$  equal to 1, it's  $C_1$  over  $1 - S_1$  and  
25 you can see that marginal cost is inversely related to  
26 share. So, this is not controversial, I think, amongst  
27 economists.

28 [Returns to presenter's table]

29 So, where does this lead? Well, it was claimed in  
30 Australia that Qantas had about 80% share. Now, maybe it's  
31 only 70%; you know, we could change these numbers, it really

*Infratil (cont)*

1 doesn't matter much, but I used 80% because that's what I  
2 heard when I was sitting in the back of the room, and Virgin  
3 Blue has about 20%. So, with a market elasticity of  
4 approximately 1 for example -- I mean, you could put  
5 whatever market elasticity in you'd like; it shouldn't be  
6 too high though because that would be incorrect -- Qantas'  
7 cost should only be about 25% as high as Virgin Blue's.  
8 That's just filling in the blanks in the equation.

9 Now, we know that things are exactly the opposite, that  
10 Qantas has much higher share than Virgin Blue and also much  
11 higher cost. You know, I don't know exactly how much higher  
12 the costs are, but for instance 25% is a number that's often  
13 thrown around. So, you can see that the Cournot model leads  
14 to the wrong conclusion.

15 How can somebody with higher costs have greater share?  
16 Under Cournot that couldn't happen because the product's  
17 homogeneous and you always do better. Well, Michael Porter  
18 who's a very famous professor at Harvard Business School  
19 always says in his books on competitive analysis, "There are  
20 two ways to compete; you're either low cost or you  
21 differentiate". Well, Qantas certainly isn't low cost  
22 compared to Virgin Blue, but it does differentiate; that's  
23 how they keep going.

24 So, Qantas offers a differentiated product which is not  
25 the same as Virgin Blue, as you heard yesterday and you've  
26 heard from Mr Webster, and you've heard many times, this is  
27 also true in the US and Europe.

28 So, the point I'd like to end up with here is that  
29 travellers have heterogeneous preferences and needs which  
30 lead to differentiated products. This is what makes  
31 economics interesting from my perspective; if everybody were

*Infratil (cont)*

1 the same, it would be a boring world indeed. You wouldn't  
2 need econometricians, you could just do everything in terms  
3 of theory, but because you have heterogeneous preferences  
4 you have different needs, and then you get these  
5 differentiated product situations.

6 **MS BATES QC:** Could I just ask you something which is puzzling  
7 me, as a non-economist.

8 **PROF HAUSMAN:** Sure.

9 **MS BATES QC:** When I asked Professor Ergas why in the factual he  
10 said prices would rise, and taking that into account when  
11 VBA entry was likely, he said that for the purposes of the  
12 factual he'd assumed that VBA would not enter, and I'm  
13 wondering how that affects what you're telling us?

14 **PROF HAUSMAN:** If you didn't have VBA entry at all, then using  
15 Cournot might be okay.

16 **MS BATES QC:** That's not really my question.

17 **PROF HAUSMAN:** I'm sorry, then I misunderstood you.

18 **MS BATES QC:** That's not really my question. He said that he  
19 hadn't assumed VBA entry, and in that respect that his model  
20 is conservative. Now, unless I've picked him up entirely  
21 wrong, that's what I thought I heard him say, and I'm asking  
22 you how that affects what you're telling us now?

23 **PROF HAUSMAN:** Okay. To the extent that VBA -- he did not have  
24 VBA in the model that he was talking about, that would lead  
25 it to be conservative. But what I am saying is that, if you  
26 think about going from three to two here, that you need to  
27 take into account the two that you are letting go together  
28 are each other's closest competitors. So, that would be my  
29 answer.

30 **MS BATES QC:** Yeah, I do understand that point, but to the  
31 extent that he didn't take into account a differentiated

1 product for his assessment of the detriments, then isn't he  
2 right in saying he was conservative?

3 **PROF HAUSMAN:** Yes. If in his model he didn't take into account  
4 VBA, I would agree that he's been conservative.

5 **MS BATES QC:** You say you reviewed the model yourself; did you  
6 notice whether he took VBA into account?

7 **PROF HAUSMAN:** I thought that he did, but. [**Pause**]. We'll have  
8 to check and get back to you.

9 **MS BATES QC:** Yes, I'd like you to, thank you.

10 **PROF HAUSMAN:** Okay, thanks.

11 Okay, now I'm going to get into the balancing and into  
12 the authorisation. So, what I'm going to do is to look at  
13 the effects on prices and tourism. So, North America is a  
14 substantial source of tourists; they spend for instance  
15 considerably more than tourists from Australia; it's about  
16 2:1. And I couldn't totally verify this, but I think it's  
17 likely they're the largest source of tourist revenue in  
18 New Zealand.

19 As I testified yesterday, Auckland-Los Angeles is the  
20 only US route to New Zealand -- I mean, you can of course  
21 fly through London-Singapore, but that takes about 1 2 hours  
22 longer and is considerably more expensive going round the  
23 other way. Presumably, you could also fly to Japan or  
24 Australia, but that's going to be more expensive and longer  
25 as well. So, currently you only have Air New Zealand and  
26 Qantas, you'll have a mergered monopoly in this market and,  
27 as I testified yesterday, in my view it's very unlikely in  
28 the near to medium run that you'll have US entry.

29 The alliance representative, whose name I didn't catch,  
30 claimed that UA would enter in year 3, seems to me to be  
31 pure speculation, and is contrary to United's current

1 financial position. Certainly United, so far as I know,  
2 never said that they're never coming back.

3 So now what I'm going to do is, I'm going to try to  
4 quantify what's going to go on. Okay, so I'm now going to  
5 use the Cournot model that NECG used -- their very own  
6 model, because I want to be able to put things into their  
7 context; not saying that I agree with it, but I'm going  
8 there.

9 **CHAIR:** Are you only going to look at the one route?

10 **PROF HAUSMAN:** Well, it's many routes, but yes, I am. I mean,  
11 many routes come to Los Angeles, but yes, that's what I'm  
12 going to look at.

13 **CHAIR:** You're only going to look at that segment?

14 **PROF HAUSMAN:** Yes.

15 **CHAIR:** And what's the justification for that?

16 **PROF HAUSMAN:** Next page, the next slide.

17 So, economics predict -- oh, I mean, I don't want to be,  
18 you know, a smart Alec here. The reason you only look at  
19 one, that's a separate market -- I don't think there'd be  
20 any disagreement that North America to New Zealand's a  
21 separate market. You know, origin-destination, it's not --  
22 people from the US don't go other ways in sufficient --

23 **CHAIR:** No, I understand that in terms of looking at the impact  
24 of the alliance on this particular market, but this goes  
25 back to my earlier question: Even if we found there was a  
26 substantial lessening in one particular market, we can still  
27 look at the overall net benefits.

28 **PROF HAUSMAN:** That's the next slide.

29 Okay, so you use the Cournot model and economics  
30 predicts that prices will increase by about 42%. I used a  
31 market price elasticity of 1.7 which is consistent with the

*Infratil (cont)*

1       NECG assumption -- this is for tourists, and it's also  
2       consistent with the literature.

3               So, what's the price effect on US tourist demand? Well,  
4       tourism from the US on LAX-Auckland will decrease by about  
5       45%. Now, as I say, this could be partly offset by  
6       increased promotion; you'd have higher profit margins which  
7       increase economic incentive for promotion, but I don't think  
8       it's going to come close to offsetting the price increase,  
9       and we know that the airline advertising for New Zealand is  
10      only a small amount of the total.

11              So, just so you don't think these are crazy numbers from  
12      an economist; if the average tourist fare is \$800 to New  
13      Zealand from the US. It could easily go up to \$1,200; it's  
14      been at \$1,200 in the recent past, you know, it's gone up  
15      and down over time. So that's a 50% increase, so I'm not  
16      talking about anything that we haven't seen conceivably  
17      before.

18              Now, I heard an NECG person, whose name I didn't catch,  
19      say that they assumed prices would not increase, and  
20      increase by only a small amount in year 3 -- this is also in  
21      their model, I should say. He said something, that tourists  
22      were price elastic; so he didn't think they could raise  
23      prices. Well, this is completely unheard of in economics  
24      and merger monopoly. It assumes that Air New Zealand and  
25      Qantas are economically irrational, that they're not  
26      behaving in their stock holders' best interest. It's also  
27      inconsistent with their own Cournot model.

28              So, in other words, when you go from two firms to one,  
29      all economics says that you will raise prices, because  
30      that's how you increase your profits. So, it would be  
31      inconceivable to me that an economist can say that I'm going

*Infratil (cont)*

1 to assume for two years prices will stay the same, and in  
2 year 3 they will only go up 10% when you're going from two  
3 to one firms on a route.

4 Okay, so now -- this is the answer to Ms Rebstock; I  
5 should have said "two slides forward" -- I'm now going to  
6 quantify the effect on tourism.

7 **MS BATES QC:** There's a question I wanted to pursue with you  
8 before we move on to this, and just a slide back, effect on  
9 prices, you say North America is a substantial source of  
10 tourists. Do you know what percentage out of the 2 million  
11 tourists it accounts for?

12 **PROF HAUSMAN:** Yes, umm.

13 **MS BATES QC:** It will be helpful for us, that's all.

14 **PROF HAUSMAN:** I think the number's on two slides forward, but  
15 if not I'll get it to you; okay?

16 **MS BATES QC:** So, that will be answered, and --

17 **PROF HAUSMAN:** Yes, it's between 10 and 20%, I can see a number  
18 right here, but remember, North America spent twice as much  
19 as Australia, so in terms of the effect on the New Zealand  
20 economy, it's quite a bit bigger.

21 **MS BATES QC:** And what was the source of the data?

22 **PROF HAUSMAN:** That's the data from --

23 **MR MURRAY:** International visitor arrivals from Statistics  
24 New Zealand.

25 **MS BATES QC:** Okay, and that gives what the spending is as well,  
26 does it?

27 **MR MURRAY:** No. Statistics New Zealand gives the breakdown of  
28 tourist arrivals, on the spend I've used the same numbers  
29 that are in NECG's report, and they're from -- I'll check  
30 the source. [**Pause**].

31 **MS BATES QC:** Just go on.



1 **PROF HAUSMAN:** I'm just using what NECG used.

2 **MR PJM TAYLOR:** I'm looking at the top of the -- it's the next  
3 slide; that one, up the top there where you say the price  
4 effect is almost a 50% increase --

5 **PROF HAUSMAN:** Umm, decrease.

6 **MR PJM TAYLOR:** Sorry, the price goes up, the volume goes down.  
7 Presumably you're assuming that the airlines continue to fly  
8 the same number of planes?

9 **PROF HAUSMAN:** Umm, no. In fact, they'll contract the number of  
10 planes, that's how you get the price to go up.

11 **MR PJM TAYLOR:** So capacity goes down, which is the missing  
12 link?

13 **PROF HAUSMAN:** Yeah.

14 **MR PJM TAYLOR:** Thank you.

15 **PROF HAUSMAN:** Are we all set? Okay. So, now I'm going to  
16 quantify this. Air New Zealand is at the heart of the  
17 New Zealand tourism industry. Somebody said you were  
18 longitudinally challenged, but I did once check and  
19 Wellington is the furthest capital south in the world, so  
20 there's some truth to that. Importance of tourism industry  
21 to New Zealand, and I understand it's among the largest  
22 export dollar earners.

23 Okay, so this is to answer Ms Bates: There are 260,000  
24 North American tourists per year out of 2 million, and they  
25 spend on average \$3,900 which is, as I said, twice as much.  
26 This is actually -- I think it's probably even higher than  
27 this; they didn't break down just to North American.

28 So, you get a reduction in the number of tourists and  
29 the reduction would be between 60,000 and 117,000. The 117  
30 is what comes out of the model; I say, well, you could have  
31 additional promotion, some of these are dual visitors, I

*Infratil (cont)*

1       tried to put some statistics together, sort of, back of the  
2       envelope; maybe it would fall by as much as half.

3               So then you need to use a multiplier, so I again used  
4       the NECG multiplier of 1.0 for the effect on the social  
5       welfare, and you get a reduction in social welfare of  
6       \$228 million to \$456 million.       So, in answer to  
7       Ms Rebstock's question why I only looked at one, this just  
8       shows what a huge effect this is, and I think this turns  
9       their model from positive to negative.    You know, if you  
10      change it from \$456 million per year, I'm pretty sure things  
11      become negative.

12 **MR DAVID:**   If I could comment, Commissioner Rebstock; the reason  
13      we asked Professor Hausman to confine himself to one was  
14      economy of effort, and also, we wanted him to focus on the  
15      market that he would be most familiar with himself.    It's  
16      intended to be illustrative, not exhaustive.

17 **PROF HAUSMAN:**   Now, one might question whether a multiplier of  
18      one is correct, but of course NECG wants to use a large  
19      multiplier, it helps them because they have the -- oh, is  
20      that a confidential number?    Am I allowed to say the  
21      additional number of tourists?    Well, in their model they  
22      have a lot more tourists coming in because of Qantas  
23      Holidays, and so they -- the large multiplier leads to  
24      greater benefits.

25 **MR MURRAY:**    The increase in tourist numbers that arise from  
26      Qantas Holidays is a public number, it's not a confidential  
27      number.

28 **PROF HAUSMAN:**    Oh, so I think they had 50,000 if I remember  
29      correctly.    However, if I use the multiplier of 0.5 of  
30      course things go down by half, so I would still find a range  
31      of \$114 million to \$228 million welfare loss, so these are

1 very very large numbers on the scale of what's being done in  
2 the authorisation.

3 **CHAIR:** I just want to stop for a second because I just want --  
4 I'm having trouble thinking through what would happen if you  
5 had done the analysis for all routes, not just this.

6 Is it not possible to conceive that in some of the other  
7 routes the benefits may have been even higher than what have  
8 been estimated? And so, therefore, we would need to do the  
9 analysis across all the routes?

10 **PROF HAUSMAN:** It's possible. I can't say what the answer would  
11 be. I don't have the resources or the data to do it across  
12 all routes but, you know, I could look at other routes as  
13 well, like going to London. You know, it was claimed that  
14 they might have more because of Qantas, but they would also  
15 have less because of the monopoly going through the US.

16 I don't think you actually need to do it for all. I'm  
17 just saying, the NECG model has been put forward; whatever  
18 they claimed, they claimed. I'm saying they left this out.  
19 They assumed that there's zero effect; that has to be wrong  
20 as a matter of economics. No respectable economist in the  
21 world would stand up and say I'm going from two firms to one  
22 in a market and the price isn't going to change.

23 **CHAIR:** I understand that point, and I imagine you'll tell me  
24 you're coming to it, we still have to decide what the  
25 overall impact is. We have to make that link.

26 **PROF HAUSMAN:** Okay, and what I'm saying is, to the extent that  
27 you want to base anything on the NECG model, you should  
28 subtract out about -- you know, between 200 and  
29 \$400 million.

30 **CHAIR:** That goes to my earlier question: If we accept your  
31 point, it seems to me we should be using a different

*Infratil (cont)*

1 modelling approach and not simply using one model to sort of  
2 subtract something out of another. I mean, that doesn't  
3 seem to me to have a great deal of reliable sense.

4 **PROF HAUSMAN:** I'm going to disagree with that and I'll explain  
5 why. Professor Willig said you should do sensitivity  
6 analysis on models. I agree. So, my sensitivity analysis  
7 on the NECG model is to say, I'm going to change one  
8 assumption. They assume there's a zero price effect; that  
9 doesn't make economic sense, but I'm just going to do a  
10 sensitivity analysis changing that one assumption and, when  
11 I do, this is what happens. It's a sensitivity analysis;  
12 you get a very large change.

13 Now, I agree with you, if I had a lot of resources and I  
14 wasn't going to start to teach the day after Labour Day,  
15 maybe I could sit down and do a model but you know that  
16 wasn't, as the lawyers say, "my brief". I don't have the  
17 resources and I don't have the time to do that. But, I'm  
18 just saying this is a sensitivity analysis; this is what  
19 happens.

20 **CHAIR:** Okay, thank you.

21 **PROF HAUSMAN:** Sure. Okay, now I'm going to look a little bit  
22 more at the NECG tourism effect, and I may not be able to  
23 remember all these different counterfactuals, but this is a  
24 confidential counterfactual. So, the NECG model assumes  
25 that you have immediate retrenchment of Air New Zealand from  
26 long haul and other routes, and you have a disproportionate  
27 reduction in promotional expenditure and, therefore, they  
28 then go and estimate the welfare effect of reduced tourism.  
29 And they conclude that it's in the interest of the economy  
30 and social welfare to keep Air New Zealand flying long haul  
31 routes.

*Infratil (cont)*

1           So, I have some difficulties with their analysis. I  
2 think that retrenchment from cash positive routes is  
3 implausible. We had a representative from Air New Zealand  
4 saying, I think, that they maintain routes where they're  
5 cash positive. And again, given that factors have changed  
6 in the US, United has gone, I would be somewhat surprised if  
7 they remained independent, that they're going to pull off a  
8 US route merely to the extent that NECG assumes.

9           It's also a partial analysis; they did not deduct the  
10 savings, and I think they end up with the wrong policy  
11 conclusion. It's really an argument for direct Government  
12 funding of promotion in my view, if it's needed, not for  
13 bending the competition rules.

14           Okay, now I'm going to look at their effect for the non-  
15 confidential counterfactual. They have an increase in  
16 capacity under the counterfactual but reduced tourists due  
17 to a price increase and capacity reductions in the factual.  
18 But this is more than offset by the 50,000 plus 13,000  
19 tourists found by Qantas Holidays, and then they apply the  
20 multiplier to estimate the benefit.

21           Okay, I might say, I'm not -- I don't want to make too  
22 big a point of this, but the 50,000 plus the 13,000, that's  
23 basically what I would call a "hard wired" number. You  
24 know, it's a figment of somebody's imagination; I'm not  
25 saying the person's wrong. I do find it a little strange,  
26 if there's that much of a profit potential, that some  
27 entrepreneur has not seized upon it. New Zealand is pretty  
28 much a deregulated economy, you seem to be doing pretty  
29 well. Economists typically or a little bit wonder why that  
30 doesn't happen; I mean, it's not as if there aren't a lot of  
31 IT platforms out there. There are very sophisticated ones

*Infratil (cont)*

1 in the United States that you could buy. By anyway, I want  
2 to point that out, that seems to me a hard wired number --  
3 would be a lot to base authorisation on a number such as  
4 that in my view.

5 Okay, difficulties with the analysis. The likely price  
6 increase on major tourist routes is understated. NECG  
7 assumes 0% for two years and 10% thereafter. This is  
8 inconsistent with economics and with the Cournot model which  
9 they themselves used.

10 So, therefore the detrimental impact of the alliance on  
11 tourism is understated, and I find the net additional  
12 tourists by Qantas Holidays implausible.

13 Then I turn to the Qantas Holidays stretch target; you  
14 have a 35% increase in package tourists to New Zealand in  
15 year 1, 6% increase in Qantas Holidays revenue. You know,  
16 one could argue this is outside Qantas Holidays' core  
17 expertise since out-bound from Australia is 50% of their  
18 revenue. And further, the owner has conflicting incentives,  
19 does better whether Qantas Holidays sells trips to Australia  
20 on Qantas, so you know, you think in terms of employee  
21 incentives, they're gonna want to tilt things towards  
22 Australia, not to New Zealand.

23 Also, it assumes increases on routes where prices  
24 increase and capacity reduced relative to the  
25 counterfactual, which seems a bit strange to me.

26 **MR CURTIN:** Can I just ask you about the owner having  
27 conflicting incentives. I hear what you say and normally  
28 they might make more one if they provide the airfare on  
29 their airline and all the rest of it, and they might have  
30 other reasons over and above the pure profit from doing it  
31 themselves rather than giving it to someone else, but as an

*Infratil (cont)*

1 empirical issue they do get an override on this to sales  
2 Commission, if you like, on anything that Air New Zealand  
3 does.

4 It seems had to me that whether they have a conflicting  
5 incentive or not is very much an empirical issue depending  
6 on how much they make on their own package as opposed to how  
7 much they might make on someone else's if they've got a  
8 revenue override on that one.

9 **PROF HAUSMAN:** I agree, although if their owner is at all with  
10 it, it will make sure that the overrides are bigger, you  
11 know, to always be in better shape to do that. So, I mean I  
12 agree, you can always think of some compensation package  
13 which will turn things around, but as it stands it would  
14 seem to me that this would be my conclusion, not that it  
15 can't be changed.

16 Okay, now just one or two more topics and I'll be done.  
17 I'd like to turn to predictive inefficiency. In my view the  
18 alliance will lead to dynamic productive economic  
19 inefficiency. So one of the things that I started with  
20 yesterday is, when you think about full service airlines,  
21 you have to remember that they came out of a regulated  
22 environment in which labour unions had a very strong  
23 position, which to a large extent they've been able to  
24 maintain, because by going on strike and putting the airline  
25 on the ground given the cost of the planes, the dead cost,  
26 it's been able to stay in a pretty strong position; that's  
27 not to say that things aren't changing.

28 Of course in the United States one of the reasons that  
29 people like United have gone bankrupt is to actually reform  
30 the labour contracts. Now, just to give you a number which  
31 has always struck me as an amazing number, and it's not to

*Infratil (cont)*

1 say this applies to Australia and New Zealand, I don't know  
2 what the numbers are, but a senior pilot on United Airlines  
3 gets paid \$500,000 New Zealand per year, and works about  
4 30 hours a month, okay. Now, to an academic that's a lot of  
5 money and, you know, you might wonder how this has been  
6 maintained.

7 Now, the value based airlines, you know, they're much  
8 lower, typically one fifth as much, one fourth as much, and  
9 so labour costs turn out to be very important -- I mean,  
10 that's generally agreed that that's one of the important  
11 factors. So, we have these airlines and they have a lot of  
12 rent that they're getting -- and this isn't true only for  
13 the airline industry, I mean this is true of a lot of  
14 oligopoly industries historically. The auto industry, auto  
15 workers capture a lot of the rent, there've been a lot of  
16 economic papers, the steel industry and so on.

17 So, what you have is rent capture and rent protection  
18 expenditures by labour unions, and in my view this is  
19 economic waste under the assumption of full employment,  
20 which is usually the way you think about these type of  
21 things.

22 So the higher cost of FSAs are importantly affected by  
23 labour costs, and it's not just labour costs, it's  
24 restrictive work rules as well.

25 Again in the US, United, they have a mechanics person  
26 flag the plane in when it comes in and that person gets paid  
27 a lot of money. Southwest, you know, has a non-union, much  
28 lower paid person doing that type of thing.

29 Now, in my view over time the market outcome's gonna fix  
30 this problem one way or the other, this productive dynamic  
31 inefficiency. You know, may be difficult, but it's going to



*Infratil (cont)*

1 be fixed. But in my view the alliance is going to have  
2 market power, and this is going to be captured through rent  
3 by the labour unions.

4 So, in other words, this argument that yield is going to  
5 increase, the prices are going to increase; well, labour  
6 unions, their wages might still go down but they're going to  
7 be higher than they otherwise would be, and in my view this  
8 is rent capture.

9 And I'll just give you an example here, again during  
10 these hearings I believe it was a Qantas executive said  
11 "competitive response required cost to decrease by 20% when  
12 fares dropped", and he said that, "Qantas required the  
13 unions to become more productive". Well, that means that --  
14 you know, when there was less competition you were less  
15 productive. That's not to say that Qantas hasn't become  
16 more productive over time, I don't disagree at least with  
17 the NECG study, but that's also not to say that there isn't  
18 a lot of room for continuing improvement.

19 In my view, that statement -- and it's not only him, but  
20 it's what's going on in the US as well -- demonstrates the  
21 absence of productive efficiency, so it's not just the  
22 wages, but it's also these work rules that need to be  
23 reformed; you know, a pilot only flying 30 hours a month,  
24 you know, a lot of them will hold second jobs. You know,  
25 it's a demonstration of productive inefficiency.

26 Okay, so with that I'm going to conclude. What's my  
27 conclusion? You'll have a substantial lessening of  
28 competition even if Virgin Blue enters. Prices will be  
29 significantly higher in New Zealand; that's based on  
30 Australian experience and economics, and also possibly  
31 Trans-Tasman. I'm somewhat less sure about the Trans-Tasman

1 since we don't have the data to check that.

2 Prices will be significantly higher in one of the most  
3 important markets, Auckland-Los Angeles for tourists, and  
4 this is merger to monopoly.

5 This has a significant negative effect on tourists from  
6 the US and, therefore, even under your procedure, if you  
7 were to take the NECG model and subtract off, for instance,  
8 the \$400 million, you'll end up with a negative amount, and  
9 I think that should -- that's a correction that should be  
10 made to their model.

11 Lastly, in my view the US would never allow this type of  
12 merger. I realise you have a different procedure here,  
13 you're looking at different things, but many of the problems  
14 that arise in terms of lessening of competition also arise  
15 here, and I do not see the calculation and the benefits when  
16 looked at correctly to be large enough to overcome the  
17 substantial lessening of competition. Thank you.

18 **CHAIR:** Thank you for that, Professor Hausman, and we'll take  
19 some further questions now.

20 **DR PICKFORD:** Professor Hausman, I've got four questions. The  
21 first one concerns your finding that when there's merger  
22 duopoly on the Auckland-Los Angeles route, prices would  
23 increase by 42%. I think the Applicants would claim to  
24 counter that; that when prices increase by such a large  
25 amount, then new entry is almost inevitable. I wonder what  
26 you're views would be on that?

27 **PROF HAUSMAN:** Well, remember, I'm only looking at tourism; you  
28 know, it's a question of what would happen in business  
29 because fares are very important there. But, I don't  
30 actually see new entry happening even for that amount,  
31 because I'm United and I'm thinking of coming back in.

*Infratil (cont)*

1 Well, when I come back in what I expect is for prices to  
2 fall back to what they were when I was here because now I'm  
3 back to three firms rather than two, you know, it's the  
4 energy problem, you're going to end up flying a 747 each  
5 day. So, this is what I was discussing to some extent  
6 yesterday. It would seem to me that entry is unlikely.  
7 You've just run the experiment, United pulled out March  
8 29th; it hasn't been long, and you know I don't see things  
9 have changed much. Kerosene prices have gone up if  
10 anything; they haven't gone down. You know, that's not to  
11 say that things couldn't change.

12 The other thing I thought about was, who are the obvious  
13 entrants? Well, they're United and they're American, but  
14 they're both codeshare members with the two current  
15 competitors. So, you know, I think it's unlikely that they  
16 would -- not impossible, but unlikely. They're also the two  
17 airlines that have the major hubs at LA and San Francisco,  
18 which of course are the demarcation points to New Zealand.

19 So, I just think it's quite unlikely. You know, you  
20 just can't enter, as I said yesterday, with a half a 747 a  
21 week, and presumably United could have said, well, I'm gonna  
22 cut down from seven planes a week to two or three planes a  
23 week but, you know, with the fixed costs and all, that just  
24 wasn't worthwhile, so they pulled out all together.

25 **DR PICKFORD:** Another question is concerning the question I  
26 raised with Professor Willig about his submission yesterday,  
27 that he was discussing consumer on-line benefits from the  
28 alliance, where consumers can go from inter-line to on-line  
29 and that generates a benefit and a convenience which he  
30 measured by the decrease in the on-line fare compared to the  
31 inter-line fare.

1 I suggested to him that really what he was measuring was  
2 a transfer rather than a welfare gain to society as a whole.  
3 He disagreed with that, but I'm wondering what your view was  
4 on that matter?

5 **MR HAUSMAN:** I think I have a view in between, because I don't  
6 think he took into account that prices would go up, and  
7 that's one of the points I made today. I think in a sense  
8 you're both right; you know, if you take his assumption and  
9 you only look at what he's looking at and nothing else,  
10 perhaps he could be right. But I take your point, I think  
11 you're right as well, and so, you can't do partial  
12 equilibrium here, you need to do general equilibrium and say  
13 what's gonna happen to fares, and fares are gonna go up and,  
14 you know, that's the correct way to do it.

15 So, hopefully I'll stay on both of your right sides by  
16 doing what I -- you know, saying what I think the correct  
17 way to do it would be.

18 **DR PICKFORD:** As you said, NECG used the Cournot model, but yet  
19 you say that their results were inconsistent with the  
20 Cournot model. I wonder if you've had enough time, I know  
21 you've only recently received it, to try and tease out why  
22 it is that, despite using the Cournot model, their results  
23 are not Cournot like?

24 **PROF HAUSMAN:** I think the point that was made yesterday, I  
25 think by you -- I'm always sitting in the back of the room  
26 so I can't always see people -- but somebody made the point  
27 about Cournot capacities and Cournot models, and I believe  
28 it was you -- [**Dr Pickford points to Mr Peters**] -- oh,  
29 sorry -- I think that's a correct point, so this is in some  
30 sense a hybrid Cournot model which is assuming Cournot  
31 pricing, so I think that's what's going on. I haven't been

1 able to work through it in great detail, but that's what my  
2 economic intuition says.

3 **DR PICKFORD:** And the last point is on this business of rents  
4 and productive inefficiency. NECG have argued that, while  
5 they accept that rents may accrue or occur as a result of  
6 the alliance, that this really is just a transfer, but it  
7 doesn't have any bearing on the measurement of social  
8 welfare. Could you comment?

9 **PROF HAUSMAN:** That's just incorrect. So the unions go on  
10 strike and shut down British Airways at Heathrow for one  
11 day; that's rent protection. Under full employment that's a  
12 complete social waste. All the trips that were missed, all  
13 the businesses that were missed, you know, all the social  
14 welfare that would have come out of that, the fewer people  
15 that would go to the UK because of that in the future, so  
16 when you have rent protection you have social waste.

17 So, it's not just a transfer -- if there were a free  
18 transfer he'd be right of course, but there's not a free  
19 transfer, and in fact people like Judge Posner, I have a  
20 famous article, pointing out that, you know, people try to  
21 capture the monopoly rents and by doing so they expand a lot  
22 of resources, and that's a waste.

23 **DR PICKFORD:** Is there any way of working out what the social  
24 waste is attached to rent seeking? Could you use the  
25 measure of rents transferred as a measure of the true social  
26 cost, or is it something different?

27 **PROF HAUSMAN:** Not to put words in his mouth, I think that's  
28 what Judge Posner would do. I think you'd need to look at  
29 the particular situation, but I mean it's a very tough  
30 situation in airlines, because I said yesterday, Mr Cardy  
31 said, and I agree with him, that if the unions can put the

1 planes on the ground for two weeks, we're gone. You have  
2 highly geared corporations that have to meet their debt  
3 payments, so the unions are in a very very strong position.

4 You know, with data I think this would be an interesting  
5 research project -- of course, that's what academics always  
6 like to do -- would be to study what's been going on in the  
7 US and perhaps the UK to see that; I think you might be able  
8 to estimate it.

9 **PROF GILLEN:** I have a couple of questions. First, your  
10 discussion of the Cournot model is, you don't like the  
11 Cournot model, or you don't like the fact that that product  
12 differentiation is not included in the Cournot model,  
13 because in our work it is and in the work by Professor  
14 Hazledine, which we'll see later on today, it's also  
15 included as well.

16 **PROF HAUSMAN:** I admit to not having studied those models, so to  
17 the extent that it is, my complaints would not apply.

18 **PROF GILLEN:** I confirm that. Looking at the work that  
19 Dr Winston did, did you try a September 11 dummy in your  
20 specification? Because, when you look at the fare data, we  
21 saw this yesterday, there was just this huge hit on fares?

22 **PROF HAUSMAN:** I did put in a year dummy, but I did not put in  
23 September 11th -- actually, that's the reasonable idea. The  
24 year dummies when I put them in were significant though, and  
25 that's what led demand becoming significant as well.

26 **PROF GILLEN:** That's actually my next question. When you put in  
27 time, some sort of time specification, you have some sort of  
28 interpretation tool, whether there's technical change going  
29 on or something else. How would you, in a sense, justify  
30 the inclusion of those time variables?

31 **PROF HAUSMAN:** Oh, here I think it's pretty clear, it's that

*Infratil (cont)*

1 Virgin Blue was expanding; you know, they didn't start up  
2 one day with a fully flung network and people were becoming  
3 more aware of them over time, and so, you don't start off in  
4 equilibrium in this data set, and so you expect to have time  
5 effects; you know, that was the first thought that went  
6 through my mind. They were a new entrant, they have to  
7 establish themselves in the market.

8 **PROF GILLEN:** Okay. The third question on Cliff's work: When  
9 you look at the change in the number of competitors in the  
10 market, we know from both Dr Morrison and Dr Winston's work  
11 as well as some work by Dresner and Wendell in the  
12 United States that who is in the market really matters, it's  
13 not just the numbers. And so, isn't the real question that  
14 we want to know is, what is the impact on fares of Air New  
15 Zealand being in the market, being in or out of the market  
16 knowing that Virgin Blue is there?

17 **PROF HAUSMAN:** Yes, but that is what I tested because, if Ansett  
18 was in the market -- I figured that Air New Zealand's a lot  
19 better than Australia and Ansett was; that's just speaking  
20 from personal experience -- when they were both in together  
21 Ansett still had a significant effect of 4 to 5% beyond  
22 Virgin Blue, and so did other airlines as well.

23 **PROF GILLEN:** I find that result a little surprising in the  
24 sense, and I'd like your comment on this, that we know that  
25 as you approach the end of the data series, because I  
26 believe it ends in June of 2002, we know that Ansett is  
27 becoming less and less effective. So in a sense their  
28 provision of capacity, in a sense they're a weak competitor,  
29 they're not the same type of competitor, and yet the way  
30 that they're characterised in the model is simply a 01  
31 dummy, so it implies that their presence is equally

1 effective over the entire series when they're in the market.

2 **PROF HAUSMAN:** Well, I would look at it a little differently.  
3 You're just calculating their average effect over the time  
4 period -- you know, you could assume it's the same, but  
5 you're not. I also looked at it a bit and broke it up into  
6 different years, and you still find an effect across  
7 different years, but I take your point.

8 **PROF GILLEN:** Okay, thank you. The final question is, if you  
9 were going to try and include this notion of uncertainty,  
10 the option of value into a Cournot model, have you seen it  
11 done, or if you were going to try and do it, how would you  
12 do it?

13 **PROF HAUSMAN:** I've done it for differentiated product markets,  
14 and I've done it for telecomm markets, which are pretty  
15 close to Cournot, although some people claim now they have  
16 become differentiated, and what you do is, you go to a  
17 partial equilibrium model, you know competition, and you  
18 assume things like constant elasticity, demand curves.

19 The key thing is, you also have to make an assumption  
20 about how -- what type of uncertainty you have, so I usually  
21 use a Weiner process, and then you solve. You can't solve  
22 analytically, you have to do it on a computer, but I  
23 published a paper in November of 2002 in the Journal of  
24 Regulatory Economics which does it for railroads, and can  
25 see it. It's just, once you set up the model, you assume a  
26 Weiner process and then you do stochastic simulations but,  
27 you know, with modern Intel computers it's not difficult to  
28 do. So, this is all doable.

29 I've never seen it done in the airline business. It  
30 would be very interesting to do it in airlines, I think you  
31 should do it, because you have a barrier as well due to



1 bankruptcy, and in my railroad stuff I have a barrier model  
2 and that makes it a good deal more interesting than just  
3 straight Weiner.

4 **PROF GILLEN:** Okay, thank you.

5 **MR PETERS:** Okay, Professor Hausman --

6 **PROF HAUSMAN:** I'm sorry, I didn't give you the credit for the  
7 Cournot model.

8 **MR PETERS:** You said that you've had the opportunity to look at  
9 the NECG model, so I have a number of questions on your  
10 views on that. Notwithstanding what you've said regarding  
11 the use of Cournot given that in the NECG model  
12 counterfactual capacities, factual capacities and costs are  
13 input to the model, and the model uses Cournot formulated to  
14 determine the price differences between the counterfactual  
15 and the factual. Given this, might their model be best  
16 described as a model that assumes Cournot pricing rather  
17 than a Cournot model?

18 **PROF HAUSMAN:** That was the point I made. Yeah, I think that --  
19 I would call it a hybrid Cournot, not pure Cournot, you  
20 know, we could label it, but yeah, I think that's a relevant  
21 point.

22 **MR PETERS:** Regarding --

23 **MR P TAYLOR:** Madam Chair, sorry to interrupt, there's been a  
24 significant breach of confidential -- not by the speakers,  
25 but a paper has been distributed which has attached to it a  
26 very confidential piece of information of Air New Zealand's  
27 and as a result we must try and get them all back. It's  
28 been distributed.

29 **CHAIR:** It has been distributed? Could you just come forward  
30 for a minute, please. [**Pause**].

31 I'm going to take a five minute break, but I'm going to

1 ask that no one leave the room until we sort out this issue,  
2 please. So, we'll adjourn for five minutes.

3

4 **Adjournment taken from 9.23 am to 9.36 am**

5

6 **CHAIR:** Can I ask everyone to please be seated.

7

8 As you will have heard at the end of the last session,  
9 it has been brought to our attention that some confidential  
10 information has, in error, been made available. This  
11 occurred yesterday evening. There was a paper which was  
12 distributed appropriately entitled "Response by Tim  
13 Hazledine to An Economic Assessment of Professor Tim  
14 Hazledine's Model of the Proposed Alliance Between Qantas  
15 and Air New Zealand", and it goes on to list several dates,  
16 and I'm sorry there's no other date on that particular  
17 document.

17

18 Attached to that document, which is not confidential,  
19 was accidentally a document that is headed up "Confidential  
20 to Air New Zealand". That particular page is confidential  
21 and is clearly marked that, so anyone who has received it  
22 should have immediately been aware of its confidentiality  
23 status.

23

24 What I would like to emphasise at this point is that  
25 that material remains subject to a confidentiality order  
26 under s.100 of the Commerce Act. Anyone who has obtained  
27 this confidential information cannot use that information  
28 for any reason, and I would ask that anyone in the room who  
29 has that information now return it to the Commission staff  
30 who will collect it.

30

31 I'd also like to indicate that the Commission is  
presently contacting all media who were here at any time

1 during the proceedings and we'll ensure that the information  
2 is not used in any way, and that the documents are returned.

3 So, with that said, I'll ask the staff to collect those  
4 documents, and I do wish to apologise to the Applicants for  
5 this, and I have asked the staff to inquire with each of the  
6 media sources whether the information has been used in any  
7 way, and I would ask that if anyone else has used the  
8 information in any way, that they advise the Commission. If  
9 that has happened, Mr Taylor, I will bring it to your  
10 attention immediately.

11 **PROF HAZLEDINE:** Could you make it clear that that page did not  
12 come from me.

13 **CHAIR:** It had nothing to do with the professor, it was an error  
14 that happened in photocopying and it was an error made by  
15 Commission staff. So, I absolutely want to be clear that it  
16 had absolutely nothing to do with the Professor.

17 [Pause]. Apparently not all copies had the document  
18 attached to it, so if you are searching for it and you know  
19 you've got the covering document, you may not have received  
20 that particular document.

21 Okay, are there any further questions on that matter at  
22 this time?

23 **MR P TAYLOR:** No, that's fine. Thank you.

24 **CHAIR:** Then we will return to questions, and someone will have  
25 to remind me who was questioning, because I've lost track.  
26 Okay, David, please.

27 **MR DAVID:** Madam Chair, before we do, could I just say that,  
28 while obviously we sympathise with the Applicants for any  
29 inconvenience that has happened as a result of the  
30 inadvertent disclosure, we also empathise with the  
31 Commission and the Commission staff over that. It's one of

1 the trade-offs; if we're going to have an expeditious  
2 process, then inevitably you run the risk of unfortunate  
3 disclosures and, while it's very regretful, it's  
4 understandable.

5 **CHAIR:** Thank you for that, Mr David. If I seem particularly  
6 concerned, it's because the Commission has always been very  
7 careful to protect confidential information, and we take it  
8 very seriously for obvious reasons, so thank you for that.

9 Now, David, please.

10 **MR PETERS:** Professor Hausman, you may not have had the chance  
11 to explore this aspect of the NECG model fully. This is  
12 regarding the negative relationship between welfare and  
13 capacity, and you will have heard how we attempted to change  
14 the schedules to test the NECG model.

15 Can you comment on this aspect of the model and what  
16 your response would be to a model that produced outcomes  
17 like this?

18 **PROF HAUSMAN:** Well, you're correct that I haven't had the  
19 opportunity to explore the model in detail to understand how  
20 this happens, but my response -- I have some suspicions but,  
21 you know, they haven't been verified. But my response would  
22 be, I'd be very very worried about using the model if it  
23 produces those type of results, and I would want to study  
24 the model sufficiently to understand what's the source of  
25 that before I actually depended on the model.

26 **MR PETERS:** This is a similar question, but you may recall it  
27 mentioned yesterday that there is an unexplained disconnect  
28 in the NECG model between price and capacity variables, and  
29 on several routes there appears to be a substantial increase  
30 in capacity in the factual and yet there is a significant  
31 price increase in the factual over the counterfactual.

*Infratil (cont)*

1           Again, you may not have had a chance to explore this,  
2           but can you comment on what effect this might have had on  
3           the model's ability to predict even, in its own expressed  
4           framework, the effects of the proposal?

5 **PROF HAUSMAN:** Well, again, that seems to me quite surprising  
6           and, you know, before depending on the model you'd want to  
7           understand it. I'll just give my suspicion of what's going  
8           on and, as I said, I haven't verified this.

9           As I understand the NECG model, they never put in what  
10          the actual costs of the airlines are. They solve for that,  
11          given shares and prices, and since they're not using real  
12          costs and if you remember my slide from before and my  
13          discussion, the actual costs and the shares just have the  
14          wrong direction, we know, in what actually goes on in  
15          airline markets. So that's my suspicion; they're not using  
16          real costs or an approximation to real costs, they're  
17          estimating costs in a way which is just wrong on the facts.  
18          So, that's actually my suspicion but, you know, you don't  
19          expect to have more capacity; holding other things equal,  
20          maybe they're not, and getting this inverse relationship.

21          I do want to point out that I understand that when they  
22          do the cost savings they're doing it in a different way, I'm  
23          not speaking of that, but I'm talking about the relationship  
24          in your question that you asked me about.

25 **MR PETERS:** One last question. You've done some work with Chris  
26          Vellturo and Gregory Leonard on market definition and price  
27          discrimination. Given that this practice is common in air  
28          travel, what are your views regarding the market definition  
29          in this case, in particular whether there should be separate  
30          markets for business and leisure travellers?

31 **PROF HAUSMAN:** My general view about market definition is that

*Infratil (cont)*

1 it should not drive the results. That it's not a precise  
2 science, and if you do the economic analysis right, you  
3 should end up pretty much with the same conclusions.  
4 Really, the only reason you define markets, in my view --  
5 and this may be heresy in front of a Competition  
6 Commission -- but the only reason you do it is to calculate  
7 shares. The grown-ups don't usually use market shares to do  
8 serious economic analysis, so that's been my view for 25  
9 years. I've said it in public before, so this is hardly the  
10 first time.

11 So, to answer your question, I think you can do it one  
12 of two ways. One is, you can allow for differentiated  
13 products, business travellers -- this is the point I tried  
14 to make; business travellers want a different product,  
15 they're willing to pay a different price. Or, if you want  
16 to do it with a homogeneous product, then perhaps having  
17 different markets would be better.

18 So, there are two different ways to get to it, but if  
19 you did it right hopefully you'd end up, not with exactly  
20 the same answer in doing competitive effects, but broadly  
21 the same answer.

22 **MR PETERS:** Okay, thank you.

23 **MR CASEY:** I'm interested in -- I guess this follows on from a  
24 discussion that was occurring yesterday about the principles  
25 of decision-making used by the Commission, but I'm  
26 approaching this more from a general perspective of public  
27 finance, and I'm interested in what you had to say about  
28 real options as the approach to valuing effects. I was just  
29 interested in, if you had a comment about the use of options  
30 theory as opposed to the Commission's present method in  
31 valuing tourism benefits and other benefits?

*Infratil (cont)*

1 **PROF HAUSMAN:** Yes, my view is here, because of the sunk costs  
2 involved with airline and brand name and all, that you can't  
3 say, well, I'm taking the middle number and, you know, the  
4 positive balances out the negatives. I think that was a  
5 claim that was made yesterday which I would disagree with  
6 because of the sunk costs.

7         So, I think you could do one of two things; you could  
8 try to explicitly model this as I've done before, you know,  
9 in my academic work and some regulatory work I've done in  
10 the United States. Or, the Commission, if it doesn't have  
11 the time or resources to do that, could recognise that going  
12 in one direction kills the option. If you form the  
13 alliance -- it's not impossible, but I think it's quite  
14 unlikely that you'd ever have a FSA in New Zealand again,  
15 but if you go in the other direction you keep the option  
16 open; can gain more information about whether the  
17 Applicants' claim is true, that there's going to be a war of  
18 attrition. You know, anyone can have a view on that. So,  
19 in making a decision you would take into account, even if  
20 you couldn't quantify exactly the value of the option.

21 **MR CASEY:** Here the options also relate to whether the tourism  
22 industry has the benefits of access to a distribution  
23 network and a promotion network, or whether the same  
24 services can be provided by Governments and other  
25 organisations. Is the same method applicable here?

26 **PROF HAUSMAN:** To some extent, although here the sunk costs  
27 might be a bit less, because I presume you can contract for  
28 these type of services in some part. In other words, it  
29 would be unlikely that you would have to build all your own  
30 software, you know, to do the IT for this. But, no, to some  
31 extent you could look at the tourist effect and the effect

1 on tourism and think about the options there as well.

2 **MR CASEY:** Thanks.

3 **MR CURTIN:** I had just one question. You mentioned in passing,  
4 you made a reference to the Willig/Geurin-Calvert study of  
5 the benefits of going on-line rather than inter-line where  
6 they had a go at quantifying that. And, I think we're all  
7 aware, they used Business Class tickets for data  
8 comparability reasons as they explained, but you mentioned  
9 along the way that you had some reservations or feelings  
10 about that and I just wondered if you'd care to amplify on  
11 what your thinking was?

12 **PROF HAUSMAN:** Yes, I agree with Professor Willig that this is  
13 difficult to do when you look at cheap fares, but it's been  
14 my experience and my observation that that dispersion, the  
15 25% -- I've never looked at this in New Zealand or  
16 Australia, I'll be the first to admit, but I did look at  
17 something similar in the US this past summer -- and I think  
18 most of the studies we've referred to before were before the  
19 days of very wide web fares, Expedia, Travelocity, airlines  
20 using the web, and I found that the dispersion had decreased  
21 significantly, even after controlling for mean fare or  
22 median fare. And I think what has happened is, we have  
23 tremendous increased transparency -- you know, again in the  
24 US, but I don't see any reason why it's not here in terms of  
25 searching -- and so the type of gap that you had before,  
26 which was partly due to price discrimination, which was  
27 brought up by David just a minute ago, I think has been  
28 lessened now, so I would just question whether 21 to 25% is  
29 actually the correct amount.

30 But I'll be the first to say, I have not done a study  
31 for New Zealand to say that they're wrong.



*Infratil (cont)*

1 **MS BATES QC:** Professor Hausman, I just want to clarify  
2 something about VBA entry that I took up with you much  
3 earlier in the session. From checking with our staff it  
4 seems I might have got the wrong end of the stick, and no  
5 doubt I'll be corrected if they have.

6 What I'm told from staff is that the NECG model took VBA  
7 entry into account in both the counterfactual and in the  
8 factual on the Tasman market and in the factual in the  
9 New Zealand domestic market.

10 **PROF HAUSMAN:** That's what I sort of thought, but I wasn't sure,  
11 and I didn't want to argue with you unless I was sure. I  
12 think that's correct, yes.

13 **MS BATES QC:** I think I might have misinterpreted an answer that  
14 Professor Ergas gave to me, but I'll check the transcript.

15 **PROF HAUSMAN:** Okay. And then my point will be that, because of  
16 a differentiation between FSA and VBA, they're not  
17 conservative. That was my point.

18 **MS BATES QC:** Thank you. I'm sorry that I --

19 **PROF HAUSMAN:** No, no, my students correct me all the time.

20 **MS BATES QC:** Well, you're correcting me in this case, but there  
21 you go.

22 **PROF GILLEN:** In a Cournot model how would you introduce product  
23 differentiation in this particular case if you were going to  
24 do it?

25 **PROF HAUSMAN:** I haven't worked that out so I would rather not  
26 speculate on that. I think it should be done and I heard  
27 you say that the staff's model and Professor Hazledine has  
28 done it, and so, that sounds great to me, but it should  
29 definitely be done. But I don't sit here and have an  
30 approach that I would say would be the best approach now.  
31 I'd have to sit down and do some thinking and research on

1 it. Sorry about that.

2 **DR PICKFORD:** Just following on from David's question; would you  
3 then prefer to use a Bertrand type model for this model  
4 rather than Cournot with product differentiation adjustment?

5 **PROF HAUSMAN:** I think it's a combination of both. Life is  
6 always more complicated than we like it to be. So, you can  
7 have Bertrand with elements of Cournot or Cournot with  
8 elements of Bertrand. I'm not saying that either is correct,  
9 but no matter which approach you use, if you are going to  
10 use Cournot I think you need to build in some product  
11 differentiation because otherwise we have a difficult time  
12 explaining why the VBAs don't have all the share and also  
13 why FSAs continue to exist.

14 **CHAIR:** Thank you for that. I would like to ask Professor  
15 Hausman if the regression analysis, or the modelling,  
16 sensitivity testing that you have done, if we can have that  
17 made available to the Commission and other interested  
18 parties? Is it in a form that you can provide that to us?

19 **PROF HAUSMAN:** Not now, but toward the end of next week I hope,  
20 would be enough time, I could do it. Or maybe the beginning  
21 of next week, I'll be flying back, I can do it on a plane.

22 **CHAIR:** I suspect that the Applicants would need it this week in  
23 order to respond to it on Monday.

24 **PROF HAUSMAN:** Okay, what I'll do is, I'll just e-mail the  
25 results to someone, so somebody on the staff can give me  
26 their e-mail address and I'll go back to the hotel and e-  
27 mail it. I can't write it all up, I just don't have time,  
28 but I can send the results.

29 **CHAIR:** If we can get the results and the specification and  
30 everything, I think that would be sufficient at this stage.  
31 If that's what you have, then we can't ask for more than

1 that at this point.

2 And you could do that today, could you?

3 **PROF HAUSMAN:** Well, I'm leaving noon tomorrow, so I'll have it  
4 done by the time I leave.

5 **CHAIR:** Okay, all right, thank you for that. It's my proposal  
6 now to break for morning tea; after I locked everyone in the  
7 room, I think everyone probably could use a short break.  
8 So, I'd like to suggest that we reconvene this session at 10  
9 past the hour. Thank you very much.

10

11 **Adjournment taken from 9.54 am to 10.18 am**

12

13 **CHAIR:** I'd like everyone to please be seated.

14 I'd like to reconvene this session. I want to check one  
15 last time if there are any further questions for Professor  
16 Hausman at this time? [**No questions**].

17 Thank you for that, Professor Hausman, I suspect we're  
18 all your students now, and we don't even have to pay  
19 tuition, but that was very useful for us, so thank you for  
20 that.

21 We now, I believe, have a presentation by Dr Stone, and  
22 I would ask that you begin your presentation when you're  
23 ready. Thank you.

24 **MR DAVID:** Thank you Madam Chair, but before Dr Stone does; in  
25 relation to Professor Hausman and as the one who does have  
26 to pay for the tuition, to the extent that there have been  
27 limitations -- and I hesitate to use the word in relation to  
28 Professor Hausman -- it applies generally to our  
29 presentation.

30 As I said, at the outset we don't regard the process as  
31 adversarial, we don't see ourselves as here to prove every

*Infratil (cont)*

1 point in the Draft Determination, that's not our function.  
2 We have simply tried to bring to bear experience and  
3 expertise in those areas where we think we can help.  
4 Indeed, it's not the function of the Commission to  
5 positively prove every point in the Draft Determination, and  
6 that's probably a good point to raise the question, or to  
7 deal with the issue of onus that the Applicants have raised  
8 in their paper, opening submission, where they say:

9 "It's submitted that the exercise is indeed a relatively  
10 straightforward one and the Applicants need only establish  
11 likely outcomes to a balance of probabilities standard."

12 Irrespective of what the appropriate standard is -- and  
13 I don't want to actually enter into that debate -- it is for  
14 the Applicants to positively demonstrate the outcomes that  
15 they're claiming, and in relation to the economic outcomes  
16 that they're claiming, what we do say that Professor Hausman  
17 has helped demonstrate is that the model employed by the  
18 Applicants was inappropriate, that it was inadequately  
19 applied, and that it doesn't survive the kind of sensitivity  
20 testing that Professor Willig suggested it should. Dr  
21 Stone.

22 **DR STONE:** Thank you. Madam Chair, I should just mention that  
23 the version of the slides that is on the screen is slightly  
24 different from the one that has been circulated. The  
25 substance is the same; the order is a little different.

26 I think it will be appropriate, Madam Chair, for me to  
27 commence with a brief outline of my qualifications to  
28 comment on the applications by Air New Zealand and Qantas  
29 for authorisation of their alliance and equity proposals. I  
30 am not an economist, my PhD from the Australian National  
31 University is in history and politics, but with over 14

*Infratil (cont)*

1 years involvement in international aviation I do have a  
2 reasonable degree of familiarity with the industry. So,  
3 although I shall steer clear of the arcane world of economic  
4 modelling, happy to leave this to Professor Hausman.

5 I am concerned with an empirical look at the underlying  
6 assumptions. For 8 years I held the position of Head,  
7 International Air Services in the Ministry of Transport and  
8 in that capacity, among other duties, I participated as  
9 principal adviser and later as leader of the New Zealand  
10 delegation in over 60 bilateral air rights negotiations with  
11 27 countries, including the earlier negotiations with  
12 Australia on the single aviation market.

13 I conducted a major in-house review of New Zealand's  
14 International Air Transport Policy that led to the updating  
15 of that policy announced by the Ministry of Transport in  
16 1998. That policy, which is strongly pro-competitive, is  
17 still current. I took the lead role in devising the simpler  
18 and more efficient regulatory regime for international  
19 airlines set out in the Civil Aviation Act.

20 In these various roles I liaised on a regular basis with  
21 senior executives of Air New Zealand. For the past six  
22 years I have been an independent consultant and writer on  
23 aviation issues. My consultancy clients during that time  
24 have included the Government and regional authorities,  
25 airports and airlines, including Air New Zealand.

26 In the present proceeding I have been asked to comment  
27 on the counterfactual put forward by the Applicants as  
28 compared with that adopted by the Commission in its Draft  
29 Determination. A review of the counterfactual seems  
30 particularly warranted because of the detriments the  
31 Applicants claim would ensue if authorisation for their

1 alliance proposals were denied.

2       However, before addressing that issue and given my past  
3 involvement in the negotiation of bilateral air rights,  
4 including with the United Kingdom, I hope I may be excused  
5 for drawing attention to an error made by the Air  
6 New Zealand representative when referring on Tuesday to the  
7 capacity constrained nature of the rights the airline may  
8 exercise on the Auckland-Los Angeles-London route.

9       Contrary to his presentation on this matter, as I'm sure  
10 he has realised since, Air New Zealand is entitled to  
11 exercise and does exercise Fifth Freedom rights between Los  
12 Angeles and London, Heathrow. As the Auckland-London route  
13 is probably the longest in the world and given also its high  
14 seasonality, it will be difficult indeed to operate the  
15 route viably without the rights to carry OD traffic between  
16 London and Los Angeles.

17       Now to the Applicant's counterfactual. The Applicants  
18 claim that their proposals would result in net benefits  
19 compared with the alternative scenario without the alliance.  
20 That is the counterfactual under which Air New Zealand would  
21 face a capacity battle with Qantas. This is the war of  
22 attrition, the airline's phrase, that has gained such wide  
23 spread currency over the past year, a war Air New Zealand  
24 could not win.

25       Instead the airline would suffer they say a more or less  
26 gradual decline which could ultimately lead to its demise.  
27 There have been varying estimates of how long this downward  
28 spiral would take, but the latest pointer was provided  
29 earlier this week by Air New Zealand's CEO Ralph Norris who  
30 suggested, and I think I quote him correctly, 3 to 5 or 6  
31 years. But however soon, the Applicants have stuck by their

*Infratil (cont)*

1 doomsday prediction. In my view their counterfactual is  
2 flawed and I will put forward four basic reasons for this  
3 view.

4 For a start, I believe it would be demonstrably  
5 irrational for a major listed company to embark on a course  
6 that it had insistentlly predicted beforehand would lead to  
7 its destruction. I think it defies belief that such a  
8 course could be justified by reference to the past habitual  
9 practice of full service airlines elsewhere in the world  
10 when that sort of commercial conduct, resulting in gross  
11 over-capacity, has been a significant contributor to the  
12 current state of financial crisis that has befallen so many  
13 full service airlines.

14 Although not limited to the United States, the problem  
15 has been particularly evident in that country. There's an  
16 element of irony in this because the US aviation industry of  
17 course also gave birth to a very pertinent innovation in the  
18 form of a value based airline.

19 Air New Zealand's low cost subsidiary, Freedom Air was I  
20 think preceded only by Southwest, Ryanair and perhaps just  
21 by easyJet. More recently and to its credit Air New Zealand  
22 has also been to the fore with its innovative Express  
23 product, a concept some have called "VBA Plus". In the  
24 process Air New Zealand has demonstrated the direction in  
25 which it could have options other than a fatal war of  
26 attrition.

27 My second reason for thinking the Applicant's  
28 counterfactual is flawed relates to the likelihood of Virgin  
29 Blue's early entry into the Tasman and possibly the  
30 New Zealand domestic markets. As there is no room, they  
31 claim, for two full service airlines and a value based

*Infratil (cont)*

1 airline in the New Zealand market in particular, they  
2 predict an outcome in which Air New Zealand will be squeezed  
3 between the bigger FSA, Qantas, and the VBA, Virgin Blue.  
4 In my view, however, the circumstances suggest that Qantas  
5 could well be more vulnerable than Air New Zealand to impact  
6 from Virgin Blue.

7 New Zealand is Air New Zealand's home market; a claim  
8 most New Zealanders would not concede to Qantas. But  
9 popular feeling aside, even Qantas' New Zealand subsidiary,  
10 JetConnect, employing staff on New Zealand conditions, will  
11 not, we understand, operate Tasman routes from Auckland;  
12 much the biggest New Zealand aviation market and only later  
13 will extend to the domestic market. Qantas' overall costs  
14 will therefore remain above those of Air New Zealand.

15 In addition, and a factor that as far as I'm aware has  
16 been largely overlooked, Virgin Blue's entry will inevitably  
17 siphon off domestic Australian feed to the Tasman that since  
18 Ansett's demise has been monopolised by Qantas.

19 In these circumstances I think it would be fallacious to  
20 argue that the competition between Air New Zealand and  
21 Qantas will come down simply to the issue of which has the  
22 deepest pockets. Indeed, last week, and in the wake of what  
23 turned out to be correct predictions of a second half year  
24 loss by Qantas, a Macquarie Equities analyst suggested that  
25 money Qantas would save if the alliance proposals were  
26 declined should be spent on upgrading Qantas' short haul  
27 fleet. The clear implication was that the airline would  
28 lack the funds for such a move if the investment in Air  
29 New Zealand went ahead. As I note later, Air New Zealand's  
30 financial position has moved in the opposite beneficial  
31 direction.



*Infratil (cont)*

1 My third reason for resisting the doomsday prediction is  
2 that the extent of competition on the Tasman from Fifth  
3 Freedom carriers has been in my belief overstated by the  
4 Applicants. In this regard I would note that all so far  
5 operate only to and from Auckland, they do not operate with  
6 the frequency of Air New Zealand, nor in some cases at  
7 similarly convenient times.

8 Although they all carry through traffic, which of course  
9 reduces the amount of -- number of seats available for just  
10 Tasman passengers, the Applicants have emphasised capacity  
11 share rather than market share apparently in order to make  
12 the threat seem greater than it is. And again, due to costs  
13 differential the impact of the Fifth Freedom carriers is  
14 quite likely to be felt more directly by Qantas.

15 The Applicants have also been unrealistic in listing all  
16 the foreign airlines that could theoretically access Fifth  
17 Freedom rights on the Tasman, implying that they might elect  
18 to exercise them. The list they have presented to the  
19 Commission includes airlines that formerly operated on the  
20 Tasman but withdrew, airlines that once operated separately  
21 to Australia or New Zealand, not across the Tasman, but also  
22 withdrew long ago, and some airlines that have never  
23 operated at all in this part of the world.

24 While Fifth Freedom carriers do have some impact, the  
25 Tasman nevertheless has been an unstable aviation market.  
26 Airlines have come and have gone, as was demonstrated only  
27 last month when Malaysia Airlines withdrew some flights via  
28 Brisbane in favour of operating to Auckland non-stop from  
29 Kuala Lumpur.

30 I've gone too far with the slides, I'm sorry. Finally,  
31 the assertion by the Applicants that Air New Zealand would

*Infratil (cont)*

1 be forced to pull off its international routes would be  
2 counter-productive in that it would deprive the airline's  
3 domestic services of substantial international origin  
4 traffic.

5 Given Air New Zealand's advice that it carries 40% of  
6 all in-bound traffic to New Zealand, and given that it  
7 withdrew from all international routes, excluding the Tasman  
8 and the South Pacific, and based on international arrivals  
9 in the year to June 2003, the airline would lose potentially  
10 up to 500,000 passengers on an annualised basis on its  
11 domestic services.

12 Now, the Commission's counterfactual. The Commission on  
13 the other hand has posted a counterfactual under which Air  
14 New Zealand would continue to compete effectively and remain  
15 in a position to evaluate other commercial opportunities as  
16 they arise. It is my view that this counterfactual is the  
17 more credible and for a number of reasons which I shall now  
18 outline.

19 First, Air New Zealand's financial position is greatly  
20 improved and been stabilised, thus in an Australian TV  
21 interview on the 3rd of August, just two weeks ago, Ralph  
22 Norris was able to say, and I quote:

23 "There's no doubt that Air New Zealand's financial  
24 position is looking a lot better. We have got a significant  
25 pool of cash in the bank, we've paid off all of our  
26 unsecured bank debt and we have been strongly cashflow  
27 positive, and we're going to turn a profit."

28 Accordingly, in a statement to the Australian and New  
29 Zealand Stock Exchanges on 31 July Air New Zealand  
30 reconfirmed that its profit before unusuals and tax for the  
31 year ending June 2003 "would exceed the forecast announced

*Infratil (cont)*

1 at the Air New Zealand's annual general meeting last  
2 November. Mr Norris advised that the final result, due to  
3 be announced next week would be "comfortably on the positive  
4 side of \$200 million".

5 Air New Zealand has argued that this financial  
6 improvement is short-term and that the longer term outlook  
7 is much less encouraging. It says that the current  
8 financial situation has been assisted by benign exogenous  
9 conditions such as the high New Zealand dollar and low fuel  
10 prices. But such conditions are cyclical and as the ACCC  
11 has pointed out, do not provide a basis for special  
12 treatment.

13 Moreover, by gaining its first profit on Tasman routes  
14 for five years through reducing capacity revealed by  
15 Mr Norris in a Sydney speech on 30 July, Air New Zealand has  
16 shown that throwing additional capacity on a route may not  
17 be as rewarding, nor necessarily as damaging to a competitor  
18 as the Applicants assert.

19 Air New Zealand has managed to reduce its costs since  
20 its recapitalisation, including through the successful  
21 introduction of its Express service on domestic routes which  
22 will soon be extended to the Tasman and possibly other short  
23 haul flights in the South Pacific.

24 Referring to the airline's cost-effectiveness; in his  
25 Australian TV interview, Mr Norris said Air New Zealand was  
26 "operating near to world best practice for a network  
27 airline". This is of interest in the context of the  
28 applicant's claim that there is no room for two full service  
29 airlines in the New Zealand domestic market.

30 Air New Zealand's Express Class has brought the airline,  
31 or those aspects of it nearer to a VBA as noted earlier, a

*Infratil (cont)*

1 kind of VBA Plus, especially when account is taken of the  
2 modifications that Virgin Blue has made to its business  
3 model.

4 If Express Class has enabled Air New Zealand to expand  
5 the domestic market by 20%, it will be relevant to note  
6 whether a similar result can be achieved on the Tasman.

7 Air New Zealand's position on the Tasman will be further  
8 strengthened with the introduction of the new Airbus 320  
9 aircraft from October onwards and later on domestic routes  
10 with a consequent operating cost savings, we are told, of  
11 15% compared with the current Boeing 737s. Meanwhile the  
12 retention of Freedom Air provides Air New Zealand with a  
13 continuing low cost operation to ward off or at least make  
14 it very difficult for competitors to enter the secondary  
15 Tasman routes.

16 Air New Zealand's experience with these two lower cost  
17 variations could possibly point the way to further  
18 development of a strongly competitive option in the future.

19 Owing to the orientation of its international network,  
20 Air New Zealand has also largely avoided the adverse impact  
21 of wars and tensions in the Middle East and neighbouring  
22 areas that have seriously set back other airlines, even if  
23 temporally, including Qantas, an advantage that will  
24 continue along with the perception of New Zealand as a safe  
25 tourism destination. This has been reflected, for example,  
26 in the fact that even with the impact of SARS, New Zealand  
27 has enjoyed a higher relative rate of short-term  
28 international arrivals than Australia.

29 Thus for the year ended June 2003 there was an increase  
30 of 8.6% over the 2001 year -- the year I've chosen because  
31 it was prior to the events of 9/11 -- arrivals from our top

*Infratil (cont)*

1 five tourism markets, those exceeding 100,000, all increased  
2 most notably an astonishing 18.3% in the case of the  
3 United Kingdom.

4 Finally, if the alliance with Qantas were to proceed,  
5 Air New Zealand would be able to -- sorry, if the alliance  
6 with Qantas were not to proceed, Air New Zealand would be  
7 able to retain its membership of the Star Alliance and  
8 thereby continue to gain the benefits of membership of the  
9 world's largest international alliance -- airline alliance  
10 by a number of benchmarks, that is in terms of revenue  
11 passengers per kilometre, total passengers carried and total  
12 revenue earned as well as the number of individual  
13 destinations and countries served. Moreover, as this  
14 suggests, New Zealanders would continue to benefit from the  
15 worldwide competition between the Star and One World global  
16 alliances that is presently available to them.

17 For these reasons, Madam Chair, it is my view that the  
18 Commission's counterfactual remains more credible than that  
19 put forward by the Applicants, and that developments since  
20 the release of its Draft Determination have added weight to  
21 the Commission's initial assessment. Thank you.

22 **MR PJM TAYLOR:** Just a couple of questions about Fifth Freedom  
23 rights, please Dr Stone. Could you just explain, the number  
24 of passengers or number of passengers that can be flown from  
25 Los Angeles to London under the bilateral rights, or Fifth  
26 Freedom rights compared with the number of passengers that  
27 can be flown from Auckland to Los Angeles?

28 **DR STONE:** I don't have the data immediately available for that  
29 question, to answer that question. I'm sure the gentlemen  
30 behind me do, but it has been well-established over a number  
31 of years now that that route would not have been reliable

*Infratil (cont)*

1 but for the ability to pick up and put down passengers  
2 between Los Angeles and London.

3 There are, of course, many more flights between Auckland  
4 and Los Angeles than go on to London. As was mentioned the  
5 other day, that is a constrained route from Los Angeles  
6 onwards to a daily service. New Zealand has been making  
7 consistent attempts over the years to engage the  
8 United Kingdom authorities and to negotiating and upgrading,  
9 preferably an open skies arrangement, but at least a double  
10 daily service; but it's still restricted to daily and looks  
11 likely until the scrap between the US and the UK is sorted  
12 out -- as was mentioned the other day, but to compare 7  
13 flights a week between Los Angeles and London and 14 or 17  
14 if Air New Zealand have put back the extra three flights  
15 between Auckland and Los Angeles.

16 **MR PJM TAYLOR:** Yes, that's how I understood the argument went  
17 the other day. Thank you.

18 You mentioned about Fifth Freedom capacity into Auckland  
19 as compared to market share. Would the additional capacity  
20 in excess of current market share, would that be available  
21 as a constraint in the excessive price rises by the  
22 alliance, do you think?

23 **DR STONE:** The seats that are not available to Trans-Tasman  
24 passengers, which is the price you're talking about, these  
25 are seats which would be occupied by passengers going on to  
26 Bangkok in the case of Thailand and Kuala Lumpur and so  
27 forth. I'm not sure that the through price would have any  
28 relevance to the price offered to fill the seats across the  
29 Tasman that was available.

30 **MR PJM TAYLOR:** Yeah, I wasn't so much talking about the through  
31 price, I was talking about capacity that would be available

*Infratil (cont)*

1 on the Tasman being available to constrain any price  
2 increases that the alliance might.

3 **DR STONE:** There's been quite a lot of discussion on this point,  
4 hasn't there, during these proceedings?

5 **MR PJM TAYLOR:** Yes, there has.

6 **DR STONE:** Clearly, there has been some constraint, but much of  
7 it has been related to discount fares, which have not been  
8 continuously available, and is also constrained by the  
9 number of seats; there's not full planes that they're able  
10 to fill between Auckland and Sydney and Auckland to  
11 Brisbane.

12 **MR PJM TAYLOR:** Okay, thank you. One last question. There's  
13 been comment and counter-comment, shall I say, that the  
14 Fifth Freedom pricing into Auckland would constrain pricing  
15 into Wellington and Christchurch. What's your view?

16 **DR STONE:** I doubt if the full extent of the discounts that have  
17 been offered by some of the Fifth Freedom carriers would in  
18 fact be a constraint in any case even in Auckland. There's  
19 been -- in my observation as much as a \$100 a gap. Against  
20 that, it has been Air New Zealand's practice over as long as  
21 I can recall to try and common rate their fares out of  
22 Auckland, Wellington and Christchurch, but not, I would  
23 think, at the lowest or cheapest discount fares that are  
24 occasionally offered by Fifth Freedom carriers.

25 **MR PJM TAYLOR:** Thank you.

26 **MS BATES QC:** Notwithstanding the improvement in Air  
27 New Zealand's position, the argument was put to us that the  
28 rate of return wasn't sufficient to -- for Air New Zealand  
29 to attract the capital investment that it says it requires  
30 in particular to upgrade some of its services and aircrafts.  
31 Have you got any comment on that?

1 **DR STONE:** It's been a constant comment I think from the  
2 Applicants about the inability of Air New Zealand to achieve  
3 a return that will cover their cost of capital. What  
4 they've not said is that this is not at all unusual in the  
5 aviation industry. There would be few airlines that could  
6 make that claim, and yet they continue to attract  
7 investment.

8 **MS BATES QC:** There's been some comment on that too, it's fair  
9 to say. So, that's your response, is it?

10 **DR STONE:** Yes, it is.

11 **MS BATES QC:** That investment will come to it regardless of the  
12 return?

13 **DR STONE:** Well, I think Air New Zealand apparently is of that  
14 belief, because it announced -- I can't remember whether it  
15 was at the annual general meeting in November or before  
16 that, that it intended to implement a rights issue. It was  
17 initially stated that that would take place in the first  
18 quarter of the year. A later announcement indicated that it  
19 might be in the first half. We haven't heard any more, nor  
20 have we heard anything from Air New Zealand to indicate that  
21 it would not proceed with the rights issue.

22 So, in the absence of such a statement, I think one can  
23 only assume that at some point which the airline itself  
24 considers judicious, it will proceed.

25 **PROF HAUSMAN:** If I could, can I make one remark on that please?

26 **MS BATES QC:** Yes.

27 **PROF HAUSMAN:** You know one thing that surprised me this whole  
28 week, this began with Dr Tretheway, is that one of the  
29 reasons that value based airlines in my view have been able  
30 to have a much larger presence and this would also go to Air  
31 New Zealand, is competition between Airbus and Boeing. You



*Infratil (cont)*

1 know, once upon a time there was Boeing and there was  
2 McDonald Douglas but there wasn't a lot of competition then  
3 Airbus came in.

4 So in terms of what you need to get to buy new  
5 airplanes, it's changed really quite a bit in terms of  
6 discounting. And so when you're talking about getting your  
7 cost of capital there's a difference between looking  
8 backwards, what you might once have paid for a plane and  
9 carried on your books and what you'd have to pay for a plane  
10 going forward, especially nowadays when both Boeing and  
11 Airbus are pretty hard up for orders.

12 So, I don't want to get into an accounting debates,  
13 that's not my speciality nor my interest, but I do know that  
14 companies often do things on an historic basis and  
15 economists do things on a forward-looking basis. So, I  
16 think you just want to keep that in mind.

17 **MS BATES QC:** Can I follow up with you, Professor Hausman. In  
18 the United States is there this problem with the perceived  
19 lack of return on capital in the airline industry?

20 **PROF HAUSMAN:** For sure. Up until the late 90s, and maybe 2000,  
21 they were doing quite well and their stock prices were  
22 higher and then we went into the recession and then we had  
23 9/11 and so they were mainly canceling aircraft orders,  
24 which means there are even more aircraft out there that  
25 Airbus or Boeing would be glad for you to take off their  
26 hands, but the airline industry is very interesting. I  
27 mean, I agree, it's a basket case but it keeps going.

28 **MS BATES QC:** So, despite all the problems in the US, are  
29 investors continuing to invest?

30 **PROF HAUSMAN:** The Southwest stock price is very robust.

31 **MS BATES QC:** That's a VBA though isn't it?

1 **PROF HAUSMAN:** Yeah, sure, the FSA's a combination of bankruptcy  
2 or in pretty poor financial shape, but there's been much  
3 less contraction than you would expect on "rational economic  
4 grounds", it's a usual thing. I think one thing you have to  
5 realise with the airline industry is, let's think back a few  
6 years. If you look at 97/98/99, beginning of 2000 in the US  
7 the airline stocks were great -- I mean, people can agree  
8 with me or they remember -- now hopefully 9/11 is never  
9 gonna happen again, but you can't say. The airline industry  
10 has always been cyclical. I don't think you want to take  
11 the point where things are really bad and necessarily make  
12 irreversible decisions at that point in time. You know, if  
13 we were talking about 98 or 99 in the US, it was great, and  
14 there's a bit of that going on here, you know, in my view.

15 **MS BATES QC:** Okay, thank you.

16 **CHAIR:** Any further questions from the staff?

17 **DR PICKFORD:** I'd just like to ask Dr Stone a question about the  
18 Star Alliance issue, the notion that if the alliance were to  
19 proceed then Air New Zealand might leave Star and go to One  
20 World, and the Applicants haven't been able to confirm that  
21 one way or the other. I just wondered whether you could  
22 comment on the practicalities of them continuing -- the two  
23 participants to continue to operate in different world  
24 alliances?

25 **DR STONE:** It is true that the Applicants have steered clear of  
26 this topic, although the papers released by the Government  
27 earlier this year, which covered the discussions with the  
28 airlines last year leading up to their application,  
29 indicates that the airlines had said that they would be  
30 reaching a decision prior to the next annual general meeting  
31 of Air New Zealand, which is timed before the end of this

*Infratil (cont)*

1 year. I believe that that announcement when it comes, if it  
2 comes, will indicate that this is what will happen.

3 I don't think it is at all practicable for two airlines  
4 which are entering into such a strongly integrated and co-  
5 ordinated arrangement as is indicated in the Strategic  
6 Alliance Agreement, could possibly belong successfully to  
7 opposing global alliances.

8 **DR PICKFORD:** Are you aware of the potential costs on Air  
9 New Zealand from switching from one alliance to the other?

10 **DR STONE:** I didn't catch the last part of that question, I'm  
11 sorry.

12 **DR PICKFORD:** Are you aware of what cost Air New Zealand would  
13 face if they were to switch from Star Alliance to One World?

14 **MR P TAYLOR:** Excuse me, Madam Chair, that's part of the  
15 confidential information and I'm aware that the witness has  
16 not been party to that information.

17 **DR STONE:** For that reason, Madam Chair, I wasn't going to be  
18 able to answer in terms of anything which Air New Zealand  
19 may have revealed. What I can say is that there has been  
20 speculation within the industry, and that has been that  
21 there will be a penalty payment. And speculative as it may  
22 be, that penalty payment has been estimated to be anything  
23 between 25 and 50 million.

24 **DR PICKFORD:** Just one last question on Fifth Freedom operators.  
25 It's been claimed by the Applicants that although they  
26 currently operate only into Auckland, they could fairly  
27 easily switch to operating from Wellington or Christchurch.  
28 Has there been any prior experience of this happening and do  
29 you think it's likely in the future?

30 **DR STONE:** I'm glad this question is being asked. There has  
31 been very little interest in Fifth Freedom to Wellington or

*Infratil (cont)*

1 Christchurch. Air Pacific and Polynesian have both very  
2 briefly and with very small capacity attempted to achieve  
3 this successfully.

4 I should mention with regard to Christchurch and talk a  
5 little bit about Christchurch in particular because some  
6 publicity was given to the fact that an executive Emirates  
7 had referred to the future possibility of operating to  
8 Christchurch.

9 It has been very difficult indeed to attract any  
10 international airline into Christchurch. There have been a  
11 number; all have withdrawn after a brief time, with the  
12 exception of Singapore Airlines. It's long enough ago now I  
13 think for me to say without any concern about official  
14 secrets or whatever, that when Singapore Airlines entered  
15 into that market it did so because of negotiations with  
16 New Zealand -- Singapore's bilateral negotiations with  
17 New Zealand and when they wanted more capacity, the  
18 New Zealand answer was, well yes you can have more capacity  
19 if you put it into Christchurch.

20 Now, it turns out that it's been quite a successful  
21 operation because Singapore Airlines, it would appear, have  
22 put far more effort into marketing than any of its  
23 successors who have all gone in and withdrawn.

24 It has been very difficult, in my experience as a  
25 bilateral rights negotiator, to attract any foreign airline  
26 to operate to Christchurch rather than to Auckland  
27 irrespective of the incentives held out in terms of  
28 increased capacity.

29 It's difficult to understand quite why this is. The Air  
30 New Zealand people may well be able to go into chapter and  
31 verse, because empirically you look at what the major routes

*Infratil (cont)*

1 are for a tourist coming in and at Auckland, Rotorua,  
2 Christchurch, Queenstown sort of thing, spend much of their  
3 time in the South Island, but there's been a very distinct  
4 reluctance of foreign airlines to operate to Christchurch  
5 either directly either on a Fifth Freedom basis. Certainly  
6 less so, of course, Wellington where there are aircraft  
7 constraints as well for landing.

8 **MR CASEY:** Just in terms of what you said, particularly about  
9 the bilaterals with the United Kingdom. Do you see that an  
10 alliance with Qantas network would allow New Zealand an  
11 important tourism asset in terms of access to bilaterals  
12 that way?

13 **DR STONE:** I'm not sure that the alliance would -- how much  
14 difference the alliance would make. Qantas has a huge  
15 advantage in respect to the market in New Zealand in that it  
16 is what is sometimes termed a "Sixth Freedom carrier", that  
17 is it is located geographically between New Zealand and  
18 New Zealand's major tourism markets.

19 So, like Singapore Airlines, Qantas can bring people in  
20 through Sydney or Melbourne or where ever, Brisbane and on  
21 to New Zealand. That Sixth Freedom position has been very  
22 successfully exploited by Qantas over a number of years now,  
23 in particular since the mid-90s. It is able to bring as  
24 much traffic as it likes, as it judges profitable into  
25 New Zealand now without the alliance.

26 **MR CASEY:** Will the alliance allow --

27 **DR STONE:** Sorry, you were talking about the United Kingdom,  
28 weren't you?

29 **MR CASEY:** Yes, I was.

30 **DR STONE:** Yes, well, it would be through that route, yes.

31 **MR CASEY:** And what about more generally, is that --

*Infratil (cont)*

1 **DR STONE:** Well, the same would apply to any of the Asian  
2 routes. Air New Zealand, for example, does not operate to  
3 China although we've had a rather good bilateral arrangement  
4 China since 1992, and yet when you look at the greatly  
5 rising number of Chinese arrivals, and some of them of whom  
6 Air New Zealand will be carrying through interconnection to  
7 Hong Kong no doubt, but a great many obviously are coming  
8 through other airlines, and I would think that Qantas would  
9 be at the head of those, and the same would go from any  
10 other Asian destination to a much more limited extent from  
11 North America.

12 **MR CASEY:** Thank you.

13 **MR PJM TAYLOR:** The pricing on the London, or the UK Qantas  
14 routes into New Zealand via Asia; would they act as any form  
15 of constraint on the pricing on Air New Zealand from  
16 Auckland through to London via Los Angeles?

17 **DR STONE:** Well, it has much more limited capacity via  
18 Los Angeles. It also doesn't operate itself beyond Los  
19 Angeles, it codeshares on British Airways.

20 **MR PJM TAYLOR:** I understand that, it's just the question of the  
21 headline prices.

22 **PROF HAUSMAN:** I can speak to that I think. Let's take Chicago  
23 from the United States, that's halfway in the country. So,  
24 going from Los Angeles it's approximately 14 to 15,000 miles  
25 round trip to Auckland, frequent flyer, you know, that kind  
26 of thing.

27 On the other hand, if you go through London from Chicago  
28 through Asia round trip it will be 24, 31,000, so it's just  
29 about 2 to 1 in terms of miles, and it's also significantly  
30 more expensive as I can confirm to you as of two weeks ago.

31 **MR PJM TAYLOR:** Sure, I was actually talking about the UK-

*Infratil (cont)*

1 New Zealand route either eastbound or westbound and whether  
2 the Qantas -- the Qantas flights and their pricing would  
3 impact on the pricing through to London of Air New Zealand;  
4 not suggesting anybody coming from in the middle of the  
5 United States.

6 **DR STONE:** The answer to that is, it is not just Qantas. I  
7 calculated just a few years back that I think there were 11  
8 ways in which New Zealanders could fly to London and no  
9 doubt vice versa. There is considerable competition on that  
10 route, or between those two points by a number of routes. I  
11 mean, Japan Airlines, for example, at one point was the  
12 price leader, even although it didn't operate itself to  
13 Auckland, but it codeshared on Air New Zealand. So, it  
14 would not be just Qantas.

15 **MR PJM TAYLOR:** But you think they act as a constraint on Air  
16 New Zealand?

17 **DR STONE:** Qantas alone?

18 **MR PJM TAYLOR:** No, no, I've overlooked the other flights, but  
19 all these flights, do they act as a constraint on Air  
20 New Zealand?

21 **DR STONE:** As far as price is concerned? Yes, I think they act  
22 as a constraint upon each other, they must do.

23 **MR PJM TAYLOR:** But particularly on Air New Zealand?

24 **DR STONE:** I don't see why Air New Zealand more than any other.  
25 A lot of these other airlines have daily services to  
26 Auckland, even if it's by connection through Hong Kong,  
27 Singapore or wherever, just the same as Air New Zealand does  
28 using its own equipment.

29 **MR PJM TAYLOR:** Thanks, you've answered the question.

30 **DR PICKFORD:** Just one more question on the Fifth Freedom  
31 operators. Are there any constraints in terms of the

*Infratil (cont)*

1 bilaterals under which they operate in terms of limiting  
2 their capacity on the Tasman?

3 **DR STONE:** There are no constraints on the capacity on the  
4 Tasman between Australia and New Zealand. Is that -- do you  
5 mean for Australian and New Zealand operators?

6 **DR PICKFORD:** No, no, for the Fifth Freedom operators? Are they  
7 constrained in any way?

8 **DR STONE:** I'm not privy to the nature of the individual  
9 bilateral agreements that Australia has, for example, with  
10 the Thailand or Singapore and the like -- sorry, Singapore  
11 doesn't come across, Thailand and Indonesia, for example,  
12 that they appear to be operating daily, I suspect that is  
13 the limit of their, beyond rights that have been made  
14 available to them, but I can't vouch for that.

15 **CHAIR:** Thank you for that, Dr Stone. We did wonder if we could  
16 have the copy of your overheads, because I think there was a  
17 bit more information on the overheads than what we were  
18 given and we'd be grateful if we could have that version of  
19 it.

20 **MR DAVID:** Yes, Madam Chair, we'll provide them directly after  
21 lunch I hope.

22 **CHAIR:** Now Mr David, are we coming to the legal arguments?

23 **MR DAVID:** We're coming to the bit where all sensible people  
24 will probably want to leave.

25 I've tried in the interests of expedition to put them  
26 into three parts. I refer to these parts as the mad, the  
27 bad and the legalistic, some would say they're  
28 indistinguishable.

29 **MS BATES QC:** Which is which? Which is mad and which is bad?

30 **MR DAVID:** The comment on conditions that I distributed last  
31 night or was distributed last night.



*Infratil (cont)*

1 **MS BATES QC:** I know you did, I'm sorry. Yes, here it is.

2 **MR DAVID:** I refer to this as the "mad" because this is the mad  
3 relative in the attic that nobody talks about. It's there  
4 but it's inconvenient. I thought Mr Norris on the first day  
5 had revealed when he said that, basically in response to  
6 your question Ms Bates, that, "Do you agree it would be more  
7 difficult for Virgin to compete with the proposed alliance  
8 than with two full service airlines?" And Mr Norris  
9 replied, yes, he believed that the way in which it  
10 structured the airlines and the undertakings that they put  
11 in place would largely obviate that.

12 And of course there was a lot of comment when the  
13 applications were first made that particularly in Australia  
14 to the extent that there was an anti-competitive potential  
15 from the alliance and from the merger, that this would be  
16 mitigated, if not entirely obviated, by the conditions, the  
17 extensive conditions that the Applicants were proposing to  
18 the competition authorities in both jurisdictions.

19 So what I've attempted to do in my comment on conditions  
20 is to identify the limitations, both the legal limitations  
21 and the practical limitations that there are in respect of  
22 undertakings, undertakings and conditions in this  
23 jurisdiction and the law and practice in New Zealand is  
24 quite different from the practice that has developed in  
25 Australia in this regard.

26 So, very briefly, the law first. Conditions: The  
27 Commission may impose conditions not inconsistent with the  
28 Act in respect of the authorisation for restrictive trade  
29 practices; that is the alliance proposal.

30 However, in relation to the equity proposal, the merger  
31 proposal, the Commission can only accept a written

*Infratil (cont)*

1       undertaking to dispose of shares or assets specified in the  
2       undertaking and there's a particular statutory prohibition  
3       on the Commission accepting behavioural undertakings; it's  
4       undertakings of a kind other than to divest shares or  
5       assets.

6       Now, I've tried, whilst the law seems simple, in fact  
7       there are a number of practical limitations that you have,  
8       and I've tried to summarise those in paragraph 21 of the  
9       paper. That is first of all, as I have said, an undertaking  
10      can only relate to the equity proposal, an undertaking can  
11      only be to divest specified shares or assets within a  
12      specified time. The undertaking must be defined by the  
13      Applicants themselves in respect of the equity proposal and  
14      can't be negotiated with the Commission. In other words,  
15      the Applicants have to say what they are prepared to divest  
16      themselves of, they can't enter into a process of going  
17      backwards and forwards to the Commission.

18      The next one is a very important one that, any condition  
19      that the Commission does impose can only relate to the  
20      alliance proposal.

21      And while the Commission does have a seemingly wide  
22      discretion in relation to the kind of conditions it can  
23      impose, in fact in its previous decisions the Commission has  
24      said that enforceability is a very important consideration.

25      Now, I add to that in addition to enforceability the  
26      notion of procedural fairness in relation to other  
27      interested parties must come into play, in other words,  
28      other parties must have the opportunity to comment on  
29      conditions and the potential effect or claimed effect of  
30      them.

31      The next point that I make is that conditions are less

*Infratil (cont)*

1 readily enforceable than undertakings, and I say that  
2 because the effect of not complying with a condition is more  
3 immediate. If a condition -- sorry, is less immediate. If  
4 an undertaking is breached, an undertaking in respect of a  
5 merger proposal, the Commission has got the immediate  
6 ability to seek a divestment order in respect of the  
7 particular shares or assets, and probably more  
8 significantly, the protection of the authorisation itself  
9 arguably falls away because it's not in terms -- the  
10 acquisition would not be implemented in terms of the  
11 authorisation together with the undertaking.

12 Now, you contrast that with the Commission's ability to  
13 enforce a condition where the Commission must of course, if  
14 a condition hasn't been complied with, hold a hearing and  
15 consider whether or not it's going to revoke or vary the  
16 authorisation. So the consequences of breaching or not  
17 complying with the condition are far less immediate and  
18 arguably less drastic than the immediate consequence if you  
19 don't carry out the divestment in terms of an undertaking.  
20 So for that reason I say that the conditions are much less  
21 enforceable than undertakings and, therefore, are less  
22 effective in mitigating competition concerns.

23 The final point that I make is of course the fact that  
24 our practice and law is quite different from the  
25 Australians, so the fact that your colleagues or your  
26 equivalents in the ACCC may be persuaded to accept any  
27 condition and attach weight to such condition is by and  
28 large irrelevant within this jurisdiction.

29 So, having set out the legal limitations on conditions,  
30 I turn to say that enforceability, which you've properly  
31 identified in existing decisions as an important criterion,

*Infratil (cont)*

1 I agree with you there, I'd say it's not the only criterion  
2 to which regard should be had.

3 The other criteria that I say are important and the  
4 Commission should address is whether or not the condition  
5 that the Applicants are seeking to have imposed upon them is  
6 something that would be more appropriately regulated by way  
7 of specific legislation or indeed something that could be  
8 more properly imposed within another part of the Act itself.

9 There are several of the conditions that they're  
10 suggesting that are effectively saying "impose a form of  
11 price control on us". Now of course there is a specific  
12 mechanism for the imposition of price control under Part IV  
13 of the Act. If the Commission is minded to impose that kind  
14 of constraint on the Applicants in accordance with their  
15 invitation, it shouldn't do so by way of a condition, it  
16 should do so by way of an express statutory mechanism.

17 Another criterion I say is important is whether or not  
18 there's an ongoing resource commitment required by the  
19 Commission. Another one is whether -- and a very important  
20 one of course -- is whether the condition is enforceable in  
21 practice. Then, the one that would seem obvious, the extent  
22 to which the condition, if it is accepted, will in fact  
23 ameliorate the concerns that the Commission has identified  
24 in relation to competition analysis, and last and by no  
25 means least -- and Professor Winston I think was referred to  
26 this himself two days ago -- whether the condition itself  
27 created new competition concerns in other areas.

28 Now, having regard to those criteria I've tried to apply  
29 them, and this is not a work of art, it's a matrix that I  
30 think that the Commission should go through, and indeed I  
31 think the Applicants should have gone through in terms of

*Infratil (cont)*

1 their own presentation to demonstrate whether or not  
2 particular conditions that they are suggesting in fact  
3 comply with those criteria.

4 In other words, is this a condition that would be better  
5 suited to specific legislation or another part of the Act?  
6 Is the condition one that will require ongoing resource  
7 commitment by the Commission? Is it enforceable? To what  
8 extent in practice does it have the capacity to ameliorate  
9 the particular concern which it purports to address, and  
10 then last but certainly not least, the extent to which it in  
11 fact has the potential to give rise to competition concerns  
12 in other markets.

13 Now, I say that that is a process that the Applicants  
14 should have gone through and I certainly say that it's a  
15 process that the Commission itself will need to go through,  
16 not necessarily the same criteria, but criteria of those  
17 kind before it can accept and have regard to and attach any  
18 weight to the kinds of conditions that the Applicants are  
19 proposing.

20 And finally by way of the guidance of past practice and  
21 the precedent effect of this is very important, I've  
22 attached to the back my analysis of the Commission's  
23 previous treatment of restrictive trade practice  
24 authorisations; that is, applications equivalent to the  
25 alliance proposal.

26 You will see there the dates and those few situations  
27 where conditions have been accepted -- and I should say,  
28 I've acted as counsel in a majority of these authorisation  
29 applications so I've got a firsthand familiarity of what the  
30 conditions are and what they were seeking to achieve. In  
31 almost all of them the condition has been immediately

*Infratil (cont)*

1 enforceable. The authorisation, the effect of the  
2 authorisation didn't come into effect until the condition  
3 had been complied with. In none of them is there an ongoing  
4 commitment of resource required by the Commission. In none  
5 of them is the potential to give rise to concerns,  
6 competition concerns in relation to other markets.

7 The only one that does stray from the pack is the post  
8 recent one, the Draft Determination in respect of the  
9 Pohokura application; I won't discuss that in detail there,  
10 but the conditions that are being sought to be imposed in  
11 the context of that Draft Determination do rely very heavily  
12 on the Australian experience; in fact, there's a  
13 considerable passage in the Pohokura Draft Determination  
14 dealing with the Australian experience studying what's  
15 happened there, and I would point out as I said before, the  
16 experience in Australia is quite different; there is  
17 detail -- and I'm sure the Australian lawyers present  
18 behind, or to the side or wherever they are, would be able  
19 to say there are quite detailed guidelines in the ACCC's own  
20 website as to the circumstances in which behavioural  
21 conditions, enforceable conditions can be accepted or will  
22 be accepted or imposed by the Commission.

23 There is on the website a record of all of the  
24 conditions that the ACCC has accepted in practice so, there  
25 is a high degree of transparency in relation to that well-  
26 established practice, it's been on the website or been in  
27 some form I think since 1995. So, there is a well-  
28 established precedent for the Commission there imposing  
29 conditions, that's not a precedent -- that's not a practice  
30 that there's been in this jurisdiction, there are no  
31 guidelines for the imposition of a restrictive trade

*Infratil (cont)*

1 practice authorisation with conditions equivalent to say the  
2 Commission's detailed Merger Guidelines its put out.

3 So, it is very much a stab in the dark. I say that the  
4 Commission ought not to depart from --

5 **MS BATES QC:** A stab in the dark?

6 **MR DAVID:** A stab in the dark for practitioners in terms of what  
7 is likely to be acceptable.

8 **MS BATES QC:** So, what you're saying is, practitioners would  
9 like some guidelines around to assist them in what is a  
10 potentially huge range of circumstances?

11 **MR DAVID:** No, what I'm saying is, basically, the Commission has  
12 got a statutory obligation to disseminate about information  
13 as to how it's going to carry out its functions. If it is  
14 going to depart significantly in the way in which it has  
15 previously carried out its functions in relation to  
16 restrictive trade practice authorisations, in relation in  
17 particular to its treatment of conditions, then there should  
18 be some promulgation of guidelines in that regard.

19 **MS BATES QC:** So it's not a statutory requirement really, is it?  
20 Just give me the reference to the statutory requirement that  
21 we've got to do that?

22 **MR DAVID:** There's a statutory requirement -- [**refers to**  
23 **document**].

24 **MS BATES QC:** I'm not exactly saying you're wrong, but I would  
25 like to be pointed to it.

26 **MR DAVID:** S.25 of the Act. It's an obligation to disseminate  
27 information with respect to the carrying out of functions in  
28 the exercise of its powers under the Act.

29 **MS BATES QC:** Which will make available or co-operate in making  
30 available information. Okay. If that's what you're relying  
31 on, I understand your argument.

*Infratil (cont)*

1 **MR DAVID:** I'm not saying that the Commission is remiss, I'm  
2 saying that if the Commission is going to depart radically  
3 from its established practice then it would be a useful  
4 precedent -- it would be useful to have some guidelines in  
5 place as to how it intends to do so.

6 **CHAIR:** I want to follow-up on that if I can, this notion of  
7 departing from established practice, because it seems to me  
8 that what is appropriate in terms of conditions must relate  
9 to the particular fact situation that you are looking at in  
10 the proposal, and I don't know if I can look at that list  
11 where the Commission has made an authorisation either with  
12 or without conditions and say that it necessarily  
13 establishes what would be the normal practice in this  
14 particular circumstance. So, I'm having some difficulty  
15 really understanding the argument that somehow what we might  
16 do here or what we might have done in Pohokura or anywhere  
17 else somehow departed from Commission practice.

18 **MR DAVID:** I think the point that I'm making Madam Chair is  
19 that, the acceptance of wide ranging conditions by the  
20 Commission would be an evolution, a quite -- a very very  
21 lengthy evolutionary step from what it has done previously  
22 in terms of allowing Applicants to argue that they are  
23 containing the competition effects of the proposal.

24 **CHAIR:** I understand the point and the principle, I do  
25 understand the point. But I also think in terms of the law  
26 the Commission has a very wide discretion. Obviously, we  
27 have to take account of exactly the sort of factors you're  
28 alerting us to, and I don't have difficulty with that, but I  
29 still fail to see how the Commission considering to accept  
30 conditions necessarily departs in any way from past  
31 practice.



1 **MR DAVID:** I think what I'm saying is that, because there have  
2 been no clear guidelines, because there are no clear  
3 guidelines and because what the Commission is contemplating  
4 here is a significant departure from what's happened before,  
5 it should be thinking very carefully about the ongoing  
6 consequences for future applications.

7 **CHAIR:** I'm not even clear that the Commission has signalled  
8 that it is contemplating anything with respect to  
9 conditions. I'm not sure where you see that in our Draft  
10 Determination.

11 **MR DAVID:** It was a reference in the Draft Determination to the  
12 fact that the Applicants had put forward conditions and  
13 there was a specific invitation in the Draft Determination  
14 for parties to comment on the proposed conditions --

15 **CHAIR:** Yes, and I understand that. I was reacting to your  
16 suggestion that somehow the Draft Determination relied in  
17 some way on conditions which, obviously since the Draft  
18 Determination said no to the arrangement that couldn't  
19 possibly be the case.

20 **MR DAVID:** No, I'm not suggesting the Draft Determination or the  
21 conclusions in the Draft Determination rely upon the  
22 conditions. I'm responding to the invitation to comment on  
23 the conditions and indeed any other conditions.

24 **CHAIR:** I understand that. Thank you.

25 **MS BATES QC:** We accept there's an obligation to consult on any  
26 conditions that might be put forward. It should probably  
27 allay your concern, shouldn't it? [**Pause**]. If you have the  
28 obligation to bring to our attention --

29 **MR DAVID:** My immediate concern, yes.

30 **MS BATES QC:** -- any concerns that you have at that point, why do  
31 you need more than that?

1 **MR DAVID:** It's probably a debate that could be carried on  
2 elsewhere. I think I've made the point, with respect,  
3 Ms Bates.

4 **CHAIR:** Can I just see if our legal advisors have any further  
5 questions on this point? No questions.

6 **MR DAVID:** Okay, that's the "bad" dealt with -- no sorry, that's  
7 the "mad". The bad is my concern about the form of the  
8 legal applications, or the legal form of the applications.

9 And this is basically -- this is a concern that the  
10 Applicants have put together their applications, or more  
11 particularly they've put together the benefit and detriment  
12 analysis in relation to their applications as -- and they  
13 have also made reference to benefits that come from the  
14 alliance proposal; there's been a lot of reference to all of  
15 the benefits that come from the alliance. There has been no  
16 reference at all to the benefits that relate to the merger  
17 application, the equity proposal.

18 I say that the statute is quite clear in relation to an  
19 application for authorisation of a business acquisition.  
20 There is a prescribed form, there is a requirement in that  
21 form that the Applicants can't specify the benefits and  
22 detriments that will flow from the particular acquisition,  
23 and that wasn't done by the Applicants. As a consequence of  
24 that not being done, there was an intertwining of the  
25 benefit and detriment analysis in their application; that  
26 intertwining flowed through into the Commission's own  
27 analysis in the Draft Determination.

28 It's not a matter of being picky about it, what I'm  
29 trying to do is say, well, the benefits that relate to the  
30 alliance should be had regard to in relation to the  
31 alliance. In order for the equity proposal to be

*Infratil (cont)*

1 authorised, the Commission has to be satisfied that those  
2 benefits that are claimed for the equity proposal would not  
3 arise but for the equity proposal. That is, for the merger  
4 itself.

5 I'd stress, I'm not saying that the Commission can't  
6 hear those applications together. It would be a cruel and  
7 inhuman punishment for us to have to go through this process  
8 twice. What I am saying is that --

9 **MS BATES QC:** And then put the results together.

10 **MR DAVID:** What I am saying is that, to the extent that there  
11 are express statutory requirements that relate to the equity  
12 proposal on the one hand or on the alliance proposal to the  
13 other, regard should be had to those requirements.

14 To the extent that benefits are attributable to the  
15 alliance that are not attributable to the merger, they  
16 should only be counted in relation to the alliance proposal.

17 To the extent that the conditions that we've just spoken  
18 about mitigate the competition effects, or have the  
19 potential to mitigate the competition effects, those should  
20 only be had regard to in relation to the alliance, because  
21 it's only in respect of the alliance proposal that  
22 conditions can be accepted. The Commission itself has said  
23 quite correctly in its Draft Determination, the conditions  
24 proposed by the applicant are not structural undertakings,  
25 they are conditions. As they are not structural undertakes  
26 to divest shares or assets they shouldn't be -- they can't  
27 be had regard to in relation to the equity proposal.

28 What I've done is attached as an appendix to the paper  
29 entitled "concerns with the manner in which the applicants  
30 have been handled", to our submission, I think it was of the  
31 20th of June where Mr Murray had attempted to segregate the

1       detriments and benefits that were claimed and attribute them  
2       to the appropriate application.

3             By way of anticipating a question along the lines of,  
4       well doesn't the Act allow you to have applications in  
5       tandem like that, there is a provision of the Act that  
6       says -- s.62(7) that says the Commission's allowed to deal  
7       with restrictive trade practice applications dealing with  
8       substantially the same matters put forward by the  
9       same parties in tandem together, and intertwined with the  
10       benefits.

11            I'd point out that that provision is not one that  
12       applies to applications for authorisation of business  
13       acquisitions. Importantly, s.69B(2), which is the provision  
14       that applies the processes and provisions of the Act  
15       applicable to Conferences for restrictive trade practice  
16       authorisations to merger applications doesn't refer to  
17       s.62(7).

18            Now, it certainly doesn't contemplate that a restrictive  
19       trade practice authorisation application and a business  
20       acquisition authorisation application could be dealt with in  
21       an intertwined fashion.

22 **MS BATES QC:** It's silent on it?

23 **MR DAVID:** It's silent -- umm, it's not silent on it, it's just  
24       not there.

25 **MS BATES QC:** Yes, it's silent on it.

26 **MR DAVID:** I think the point is, Ms Bates, it's an expressed  
27       provision in relation to the ability of the Commission to  
28       have intertwined restrictive trade practice authorisation  
29       applications.

30 **MS BATES QC:** I understand.

31 **MR DAVID:** That position doesn't apply to mergers and it

*Infratil (cont)*

1 certainly doesn't apply to the mixing of the species.

2 That concludes my point in relation to the concerns on  
3 the legal form of the applications.

4 **MS BATES QC:** Can I just ask you this; it's just a practical  
5 point really. If you separate them out, do you think you'd  
6 come to a different conclusion than putting them together?

7 **MR DAVID:** I certainly don't think you'd come to a different  
8 conclusion in this case on the basis of the analysis you've  
9 done.

10 **MS BATES QC:** No, different numbers I mean. Would you come out  
11 with sets of numbers which when combined added up to the  
12 same thing?

13 **MR DAVID:** Mr Murray's the one that can answer that question.

14 **MR MURRAY:** It's possible that you could do. What we've tried  
15 to do in just this little quite simple example here was to  
16 say, take the Commission's Draft Determination, not debate  
17 what the numbers are, but say how much you allocate those  
18 between the equity application and the alliance application,  
19 and in some cases it seems relatively straightforward to do.

20 For example, the cost savings would seem to me to arise  
21 because of the ability to co-ordinate between the entities  
22 which arises through the alliance application, but aren't  
23 there in the equity application on its own.

24 Depending on where the numbers come out, as you can see  
25 in the simple table we have at the back, just on that  
26 allocation get a much larger detriment arising through, with  
27 the alliance application than the equity application.

28 Where the Commission comes to when it does its final set  
29 of numbers may under each of those categories have different  
30 sets of numbers, and so they may add in different ways, and  
31 so, in theory yes, you could come out with a decision that

1 one of the applications was approved but the other was  
2 declined.

3 Now, it might be that the Applicants then go on to say,  
4 well, we do not intend to proceed unless we have both  
5 applications approved, but that is a decision for the  
6 Applicants to make.

7 **MS BATES QC:** I understand.

8 **CHAIR:** I'll just ask if either Dr Berry or Mr Rennie have any  
9 further questions.

10 **MR RENNIE QC:** You made the point that in your contention the  
11 equity proposal has not been presented in accordance with a  
12 specified form in the regulations. You would accept that  
13 that's not the position that the Applicants have in relation  
14 to compliance?

15 **MR DAVID:** I understand that, yes.

16 **MR RENNIE QC:** Whether you are right or they are right, does it  
17 matter given that s.60(4) empowers the Commission to proceed  
18 whether or not the correct form has been filled out  
19 correctly?

20 **MR DAVID:** I think my concern is, not that they haven't filled  
21 out the form correctly; I think it's a concern that the  
22 ongoing treatment of the form, once accepted; I'm not  
23 arguing that the Commission, having accepted the  
24 application, shouldn't be dealing with it. I'm saying it's  
25 the subsequent treatment of the application that is my  
26 concern.

27 **MR RENNIE QC:** Indeed. So to put it another way, you accept  
28 that the equity application, or the equity proposal as you  
29 call it, is validly before the Commission and your concern  
30 is not a process issue in the past but a process issue in  
31 the future?

1 **MR DAVID:** Yes.

2 **MR RENNIE QC:** You referred to s.62(7) and the ability of the  
3 Commission in relation to trade practices authorisations to  
4 hold a single hearing and issue a single determination when  
5 in fact there were multiple applications with the same  
6 parties. That provision may simply declare as a matter of  
7 clarification something that the Commission can do anyway in  
8 regulating its process. Would you agree?

9 **MR DAVID:** The existence of the provision, an express provision  
10 to that effect arguably implies the contrary.

11 **MR RENNIE QC:** Except that if you set it against the provision  
12 in relation to flexibility and simple process and so forth,  
13 the restriction that you argue for would really be in  
14 conflict with both the purpose of the Act and the direction  
15 as to process, wouldn't it?

16 **MR DAVID:** No, it wouldn't because that provision to which you  
17 refer allowing for flexibility says, "to the extent that the  
18 Act allows". That says to me, if the Act expressly provides  
19 something to the contrary the express provision overrides  
20 the general discretion as to informality.

21 **MR RENNIE QC:** But I thought I had understood you to accept that  
22 there is no express prohibition in relation to this matter,  
23 in relation to Commissioner Bates' question.

24 **MR DAVID:** I'm not quite sure that I understand what you're  
25 saying.

26 **MR RENNIE QC:** You just put it to me that the reference to  
27 flexibility is stated to be subject to the provisions of the  
28 Act.

29 **MR DAVID:** Yes.

30 **MR RENNIE QC:** You then went on to suggest there was an express  
31 prohibition, and my point to you was I had understood you to

1 accept, in relation to Commissioner Bates' question, that  
2 there was no express prohibition on proceeding in that way?

3 **MR DAVID:** I'm not sure that that's what I said in response to  
4 Commissioner Bates.

5 **MR RENNIE QC:** Well, for the sake of clarity, would you want to  
6 state your position now?

7 **MR DAVID:** I've just stated my position, that an express  
8 provision overrides the general provision as to informality  
9 of process. That is my position. To the extent that it's  
10 inconsistent with something I may have said in response to  
11 Commissioner Bates, that is my position.

12 **MS BATES QC:** I understand your argument this way, is that  
13 there's an express condition -- provision that you can do it  
14 with authorisation, there's -- the position on mergers is  
15 silent and, therefore, you say that means that adds up to,  
16 because it's not expressed, it adds up to the argument you  
17 can't do it?

18 **MR DAVID:** More than that, it's silent in relation to mergers  
19 but in relation to merging mergers with restrictive trade  
20 practices authorisations, where you're talking about  
21 different things, where there is a --

22 **MS BATES QC:** Sorry you're quite right --

23 **MR DAVID:** -- an express provision in the Act that applies some  
24 of the provisions across --

25 **MS BATES QC:** So, the argument would be if there is no express  
26 provision to mix the two, then you can take it that you  
27 can't do it?

28 **MR DAVID:** Yes.

29 **MS BATES QC:** That's your argument. I'm not saying I accept it,  
30 but that seems to be your argument.

31 **MR DAVID:** Yes, that's my argument.



1 **MS BATES QC:** Do you apprehend it that way?

2 **MR RENNIE QC:** Yes, that's fine.

3 **DR BERRY:** I'd just like to take up -- can I just follow up one  
4 line of argument that's been developed I think. We've got  
5 two applications seeking to rely upon the same benefits, and  
6 as I took your statement you're indicating that you ought to  
7 seek to achieve and recognise those benefits in the least  
8 restrictive way. I'm just trying to think through how that  
9 may play out where you've got two applications, one  
10 structural, the other in a sense behavioural of the Trade  
11 Practice Act, the merger.

12 As I understand your line of questioning it may go  
13 something like this, that if the benefits were obtainable  
14 under the alliance arrangement the trade practice alone,  
15 that that may be a reason to attach zero benefits to the  
16 merger because that's not necessary to achieve the benefits.

17 **MR DAVID:** That's exactly right.

18 **DR BERRY:** Does that then lead to another question that the  
19 Commission would have to be satisfied that, for example, Air  
20 New Zealand would have to have other forms of funding other  
21 than the equity injection from Qantas?

22 **MR DAVID:** Air New Zealand would have to have other funding in  
23 the equity injection? And you're saying that the equity  
24 injection itself would be a benefit?

25 **DR BERRY:** The Applicants are simply saying the two proposals  
26 are interconnected and I just question whether the  
27 Commission ought just to take it on the Applicant's say so.  
28 It seems to me an objective assessment has to be made on  
29 that issue, but I'm just searching for what you think may be  
30 the relevant question to ask in assessing whether or not  
31 zero benefits ought to attach to the merger application.

*Infratil (cont)*

1 **MR DAVID:** I agree that the applications are not intertwined  
2 simply because the Applicants choose to treat them as  
3 intertwined. In other words, we won't enter into the  
4 alliance if we're not allowed to take an equity share.  
5 That's not a sufficient nexus, in my view, to have regard to  
6 the benefits that attach to the alliance and somehow  
7 transfer them across the equity proposal.

8 **CHAIR:** Are there any further questions? [**No questions**].

9 **MR DAVID:** The last is the "legalistic" and at the risk of  
10 inflaming the Commission, there are -- we say that you have  
11 come to the right conclusions in relation to the Draft  
12 Determination. As I said, at the outset, we agree with  
13 almost all of the conclusions that are set out in the Draft  
14 Determination, but we have pointed out on occasion some  
15 procedural errors that we think the Commission has strayed  
16 into, and we have taken the liberty of pointing them out in  
17 this paper, primarily to suggest that these are matters that  
18 could be perhaps avoided and that thought be given to them.

19 If I just go through them very quickly, the timetable  
20 extensions that have been granted to the Applicants, some of  
21 which we say don't comply with the strict statutory  
22 requirements; by our calculation the alliance application  
23 should have been dealt with by the end of May. There are  
24 good policy reasons why these matters need to be dealt with  
25 expeditiously. It has been a very long courting between the  
26 two parties; it will be almost 11 months by the time the  
27 final decision's made and of course that does have an impact  
28 upon other parties in the marketplace.

29 **MS BATES QC:** Could I just ask you, just by way of  
30 clarification. Paragraph 4.3, what do you say is the date  
31 fixed under s.62(3)? I just wanted to make sure that I had

1 it right. What date is the date that you say was the date  
2 fixed under s.62(3)?

3 **MR DAVID:** There wasn't a date fixed and we are arguing --  
4 sorry, we've submitted on a number of occasions that a date  
5 ought to have been fixed, and that was done in Pohokura; and  
6 that the fixing of that date triggers a process.

7 **MS BATES QC:** Okay. Thanks. I just wanted to make it  
8 absolutely clear. And in terms of any prejudice that you  
9 say, or any bad downside from the -- not having it heard  
10 sooner...?

11 **MR DAVID:** Well, there's the commercial prejudice of course.  
12 You've got an arrangement in place that is waiting to be  
13 authorised, you've got the parties acting together in the  
14 context of that arrangement for a very long time, you've got  
15 the long uncertainty for the marketplace of the arrangement,  
16 will it be in place or will it won't, you've got the  
17 deterrent effect on other potential entrants anticipating  
18 whether they are going to be facing two airlines operating  
19 independently or a very strong alliance, and in terms of  
20 parties interested in the proceedings, of course, the  
21 factual matrix does change over time.

22 **MS BATES QC:** I accept that. Do you accept that we need to  
23 weigh into the equation the ability of the parties to get  
24 all the -- all of the parties to get all of the information  
25 that is relevant before the Commission?

26 **MR DAVID:** Certainly. I'm not intending to criticise the  
27 Commission in its handling of the applications, but I think  
28 it perhaps indicates the previous matter that I raised, the  
29 intertwining of the applications; if you are going to deal  
30 with them together, you need to deal with them in a way that  
31 accommodates the statutory requirements in respect of both

1 of the applications.

2 **MS BATES QC:** Where do you get to the no later than the 27th of  
3 May then? How do you get there again?

4 **MR DAVID:** The Commission needs to send a notice out to parties  
5 that fixes a date and then there is a timeline that runs  
6 from that date.

7 **MS BATES QC:** Yeah, but no date was fixed.

8 **MR DAVID:** No date was fixed.

9 **MS BATES QC:** So how do you get to 27 May? Are you putting in  
10 there what the date ought to have been.

11 **MR DAVID:** We assume the date of the Draft Determination. We  
12 say that triggers the process.

13 **MR CURTIN:** Just in your 3.4, you appear to be claiming that the  
14 Commission has made a procedural error by allowing the  
15 Applicants to claim something.

16 **MR DAVID:** What I'm saying is that in terms of the cross-  
17 submissions and elsewhere the Applicants have pointed to the  
18 Government's view as being relevant when in fact there's an  
19 express mechanism available for the transmitting of the  
20 Government view to the Commission, that's the Section 26  
21 Statement. We say that that is not something --

22 **MR CURTIN:** I understand that, but how is something that the  
23 Applicants claim a procedural error on our part?

24 **MR DAVID:** To the extent that it's suggesting it's an error,  
25 what I'm saying is that that should be resisted strongly,  
26 that suggestion.

27 **MR CURTIN:** I understand that point, but I also understand you  
28 to list four things where you claim we have done things  
29 without due process, and I'd like to suggest to you that one  
30 of them doesn't seem terribly compelling.

31 **MR DAVID:** I would agree, I would agree. It's the haste with

1 which I compiled this in the early hours of the morning.

2 **MS BATES QC:** Just coming back before we leave the date issue, I  
3 understand the legal argument thing, on prejudice, how  
4 particularly have the parties you represent been prejudiced  
5 by this?

6 **MR DAVID:** The parties I represent, as I said, at the outset,  
7 are not treating this as an adversarial process, what we're  
8 trying to do is put forward information that assists the  
9 Commission. A result of extending the process by several  
10 months, by adding in a process of cross-submissions, has  
11 meant that we've had to stretch the limited resources that  
12 we've got even further.

13 I did a deal with Professor Hausman over there that  
14 would make VBA operators proud of me to get him here, and  
15 we've approached this process on that basis. It has  
16 extended it out and the consequences in terms of costs for  
17 all parties has been significant.

18 **MS BATES QC:** Okay, thank you.

19 **MR RENNIE QC:** Just a couple of questions. On the one hand you  
20 seem to complain that extended time has been allowed by the  
21 Commission to deal with the matter and on the other hand you  
22 seem to complain that you haven't had enough time to deal  
23 with the matter yourself. Is there an inherent  
24 contradiction in that?

25 **MR DAVID:** I wish there were but there's not. It stands in  
26 stark contrast to the fact that the Commission's had so long  
27 to deal with the applications -- again I'm not being  
28 critical -- but the release of confidential information to  
29 interested parties has been quite slow. Indeed, I received  
30 a very -- [**refers to document**] -- a very chunky document as  
31 late as last Friday, confidential material that the

1 Applicants had submitted at the beginning of the process.

2 Now, to some extent that may be inevitable, but given  
3 the large volumes of confidential material that this process  
4 involved, the slow release of that information to other  
5 interested parties has given rise to a difficulty.

6 **MR RENNIE QC:** Do you accept that the Commission when it  
7 released the Draft Determination stated that it would be  
8 calling a Conference of its own motion?

9 **MR DAVID:** Yes.

10 **MR RENNIE QC:** And for that purpose the Commission had to fix  
11 dates under s.62(6), namely a date for the Conference and a  
12 date from which to calculate the Conference date under  
13 subsection (3)?

14 **MR DAVID:** Yes.

15 **MR RENNIE QC:** It's not then necessary when proceeding under  
16 subsection (6) to announce the subsection (3) date, is it?

17 **MR DAVID:** [**Pause**]. I think it's the reverse engineering of it.  
18 The fact that you omitted to set the date that is the  
19 concern we have.

20 **MR RENNIE QC:** Well, it's more a matter of your belief that a  
21 date wasn't set, isn't it?

22 **MR DAVID:** Indeed, a date wasn't set.

23 **MR RENNIE QC:** We might just have to differ on that.

24 Thirdly and lastly, your reference to what you described  
25 as the Government's supposed intentions, which I think was  
26 your midnight drafting point; do you accept that in fact  
27 it's necessary to distinguish between a number of separate  
28 elements connected to the Government, the Government as  
29 shareholder, for example, the Government as holder of the  
30 Kiwi Share, the Government as a setter of economic policy  
31 and so forth?

1 **MR DAVID:** Yes, I do. If the Government as shareholder has got  
2 a view, the Government as shareholder has had the  
3 opportunity to be present at the Conference.

4 **MR RENNIE QC:** The point I'm making is to confirm, if I have it  
5 right, that in your 3.4 point, that would be raised only in  
6 relation to statements by the Government in the sense of  
7 economic policy which you say would have to be raised under  
8 Section 26. Is that correct?

9 **MR DAVID:** Yes, the Government as Government ought to make its  
10 Policy Statements to the extent that it is inclined to make  
11 them in terms of Section 26.

12 **MR RENNIE QC:** Thank you.

13 **MS BATES QC:** Just one question about the chunky document you  
14 received last week. When did you ask for that?

15 **MR DAVID:** We asked -- we put in a general request for all  
16 information relatively early in the process.

17 **MS BATES QC:** When did you ask for that particular piece of  
18 information? Do you know.

19 **MR DAVID:** When I became aware of it.

20 **MS BATES QC:** Which was?

21 **MR DAVID:** Which was last week.

22 **DR BERRY:** I just have a couple of further questions but they're  
23 perhaps more of a general nature, they might come at the end  
24 of Mr David's presentation.

25 **CHAIR:** Do you have anything further to present?

26 **MR DAVID:** No, that's -- other than to summarise what we say.

27 **DR BERRY:** I just had two points of clarification. In the  
28 submission dated 20 June at paragraph 9.2 you state there  
29 that the pooling of benefits and detriments inappropriately  
30 obscures the distinct substantive issues relevant to each of  
31 the equity and alliance applications.

1 **MR DAVID:** Yes.

2 **DR BERRY:** Are you suggesting there that the substantial  
3 lessening of competition threshold plays out differently  
4 under ss.47 and 27, or are you alluding to something else  
5 there?

6 **MR DAVID:** No, I'm not suggesting it plays out differently. The  
7 outcome could be different to the extent that conditions are  
8 imposed by the Commission that mitigate the competition  
9 consequences. They correlate to the alliance. They can't  
10 relate to the equity proposal.

11 **DR BERRY:** I understand. Just going on to that same submission,  
12 in paragraph 11.2 you refer to a matter that was taken up by  
13 way of legal arguments when the Applicants appeared on the  
14 first day. I think you were present when that happened.

15 I'd just like you to comment to the extent to which you  
16 think it is a particular problem that conditions attaching  
17 to a trade practice application may be used to rectify the  
18 undertaking problem to which you've referred before?

19 **MR DAVID:** I think it's a real potential problem in terms of, if  
20 you ask me how to drive a horse and cart or a 747 through  
21 the merger provisions of the Act, I would enter into a  
22 partial merger; if I were a shonky lawyer, enter into an  
23 arrangement between the parties who are not yet completely  
24 merged. Say there are conditions attaching to the way in  
25 which I'm going to behave, and say also that the merger's  
26 not going to go ahead unless the alliance or the arrangement  
27 goes ahead as well, and seek authorisation for them both.

28 **DR BERRY:** But do you think there is any way that the Commission  
29 could fashion its decision in a way to prevent the kind of  
30 mischief happening to which you refer? What kind of  
31 limiting principles might be attached in permitting



1 conditions to be imposed in this case?

2 **MR DAVID:** The way --

3 **DR BERRY:** At least it's not just conditions, it's the nature of  
4 using the trade practice authorisation.

5 **MR DAVID:** I'm mindful, if we go back to the original, I think  
6 the first of the restrictive trade practice authorisations  
7 that I listed there, the one to do with the Whakatu freezing  
8 works where -- it's almost the other way around -- there  
9 was, a freezing company fell over and the assets of that  
10 freezing company were sold to one or other of the remaining  
11 players in the industry.

12 The Commission quite -- and then there was a desire on  
13 the part, because all benefit from the reduction in  
14 capacity, there was a desire on the part of the remaining  
15 companies to share the costs of the acquisitions. And the  
16 Commission quite correctly said in its decision, the merger  
17 applications or the acquisition applications only allow for  
18 the buying of the assets, they specifically don't allow for  
19 any sharing of benefit, any sharing of cost, any ongoing  
20 behaviour. There's a quite careful prescription as to what  
21 was allowed in terms of what.

22 So the analysis was carried out separately and a  
23 decision was quite carefully tagged as to what the  
24 authorisation of restrictive trade practice allowed and what  
25 the acquisition clearances allowed for.

26 I think that kind of approach, that kind of untwining  
27 and a quite careful tagging of what is permitted from what,  
28 and what conditions can mitigate what, and in particular  
29 what are the consequences if those conditions are not  
30 complied with, is probably the best approach.

31 **DR BERRY:** Thank you.

1 **MR STEPHEN:** Mr David, I have just a couple of questions on the  
2 matter of confidential information, and in 5.1 of your paper  
3 you say, "an extraordinary volume of information has been  
4 withheld from interested parties under the guise of  
5 confidentiality". And you go on to say, "this lack of  
6 transparency has been highly prejudicial to the ability of  
7 interested parties as not being able to justify legal and  
8 economic -- sorry, justify significant legal and economic  
9 assistance to give properly informed and structured comments  
10 to the Commission".

11 **CHAIR:** Could you speak closer to the mike; people are having  
12 trouble hearing.

13 **MR STEPHEN:** Sorry. Did you hear my start?

14 **MR DAVID:** I heard the start.

15 **MR STEPHEN:** Thank you. I just wanted to check that you weren't  
16 in this statement suggesting that the Commission had  
17 improperly --

18 **MR DAVID:** No.

19 **MR STEPHEN:** Good. I might finish the question so it's on the  
20 record. I could say anything at all, couldn't I?

21 **MR DAVID:** You probably will, Mr Stephen.

22 **MR STEPHEN:** That the Commission has not improperly applied its  
23 mind, or indeed done anything untoward in relation to the  
24 withholding of appropriate information on the basis of  
25 confidentiality?

26 **MR DAVID:** No, what I'm saying, what I was intending to imply  
27 there was that, having to deal with extensive requests for  
28 confidentiality, having to depart indeed from the usual  
29 prescriptions and usual approach to confidentiality has  
30 imposed a burden on us to the extent that we do have limited  
31 resources. That's what that was intended to imply.

1 Certainly no impropriety or anything else on the part of the  
2 Commission --

3 **MR STEPHEN:** I'll pick up on the theme that Commissioner Curtin  
4 was suggesting. It's not your suggestion in that that this  
5 was a procedural error on our part?

6 **MR DAVID:** No.

7 **MS BATES QC:** Can you tell me if you think that you have not  
8 been able to present your case as fully as you would like to  
9 have?

10 **MR DAVID:** We would have been advantaged by earlier access to  
11 more of the material. We would have been advantaged by not  
12 having to have detailed discussions as to the form of the  
13 confidentiality undertakings we took at the last minute,  
14 yeah.

15 **MS BATES QC:** I'm talking in terms of what you've actually been  
16 able to present. Are you happy that you have been able to  
17 tell us everything you want us to know?

18 **MR DAVID:** We've done our best to assist the Commission to the  
19 extent that we're able to, given our limited resources.

20 **MS BATES QC:** Yes. So, if you didn't have such limited  
21 resources, you may have said more?

22 **MR DAVID:** Quite possibly.

23 **MR CURTIN:** I further put it to you that more is more.

24 **MS BATES QC:** No, less is more.

25 **MR DAVID:** More is laud.

26 **MS BATES QC:** So, just to summarise where I think we get to;  
27 anything that you may have had a concern with pre the Draft  
28 Determination is not something that you want to pursue  
29 because you agree with the conclusion in the Draft  
30 Determination?

31 **MR DAVID:** We agree with the conclusion, yes.

*Infratil (cont)*

1 **MS BATES QC:** And so anything that you have raised that took  
2 place after the Draft Determination is something that you  
3 want to take further, or just bring to our attention?

4 **MR DAVID:** I'm bringing it to your attention at the moment.

5 **MS BATES QC:** At the moment. So, is there anything that you  
6 think is worthy of taking further? Is there anything that  
7 gives rise, from what you've put forward, is there anything  
8 that you think would give rise to a review?

9 **MR DAVID:** I wouldn't want to hypothesise.

10 **MS BATES QC:** Preserving your options. Okay, I think that's it.

11 **MR DAVID:** Thank you Ms Bates.

12 **CHAIR:** Can I just, Mr David, before you sum up, I just want to  
13 assure you there was no risk that you would inflame the  
14 Commission by submitting to us on these matters.

15 **MS BATES QC:** No.

16 **CHAIR:** And we always have these matters raised to us, and we'd  
17 prefer that they are raised so we can consider them. So, I  
18 just want to assure you on that point.

19 **MR DAVID:** I'm grateful for the Commission's tolerance, Madam  
20 Chair.

21 **CHAIR:** No tolerance required. Please proceed with the rest of  
22 your submission.

23 **MR DAVID:** Yes, well I'll mercifully be brief I hope. It's just  
24 to try and bring together the threads of what we've said  
25 over what was a longer time than I'd anticipated would be,  
26 and to pick up on that thread a bit more I suppose; since  
27 the applications were made and the date of the Draft  
28 Determination time has passed, there has been the prospect  
29 of fringe entry by the Fifth Freedom carriers, there's been  
30 the advent of Air New Zealand's Express service and the  
31 promise of the Tasman Express. At the moment Qantas and Air

*Infratil (cont)*

1 New Zealand do seem to be acting competitively towards one  
2 another, and as has been observed by Commission members, the  
3 threat of entry by Virgin Blue does seem closer than it was.

4 The reasons for the alliance to counter the potential  
5 killer effect of that entry is something obviously that the  
6 Commission will be wanting to play close regard to.

7 So the points that I would make is that, the Applicants  
8 propose that the merger, while giving them over 90% of many  
9 of the markets in which they operate, will not adversely  
10 impact upon the New Zealand domestic markets or the Tasman  
11 markets, as is the threat to competition from Virgin, but as  
12 we've pointed out, Virgin has been in discussions in  
13 relation to entering these markets for over 2 years. The  
14 Virgin Blue's representative said that he was promising  
15 nothing, that they are looking at all of their routes before  
16 deploying any capacity and that they'll add that capacity  
17 over time.

18 But even if Virgin Blue were to come, there has to be  
19 consideration given as to the scale of that impact as the  
20 Virgin Blue representative said, cheap Sydney-Auckland fares  
21 will have little flow-on effect to other routes. He  
22 directly contradicted the assertions that the Applicants  
23 have made when they said that a VBA entry would have wide  
24 ripple effects. The Virgin Blue representative said that  
25 airlines manage the cheap flight seats on a route-by-route  
26 basis.

27 Mr Walker for us explained that the notion of full  
28 service airline down to a VBA is a continuum. Virgin Blue's  
29 categorisation as a VBA doesn't necessarily give it an  
30 intrinsic advantage over Air New Zealand, which is  
31 categorised as a VSA.

*Infratil (cont)*

1           So I suppose generally in relation to the threat of  
2 entry by Virgin Blue, we say the Commission must have regard  
3 to its own "let's test" that is the likelihood, the  
4 extensiveness, the timeliness and the sustainability of  
5 entry by Virgin Blue. Is it going to be here long-term? Is  
6 it going to enter in a way that provides effective  
7 competition in all of the areas in which the existing  
8 airlines, the Applicants currently operate? But I don't  
9 just mean the geographic routes. As we heard from  
10 Mr Walker, the VBAs tend to grow the market rather than  
11 satisfy existing demand.

12           I agree with Professor Hausman, we don't want to get  
13 into the detailed analysis of whether they are separate  
14 markets, but in assessing the competitive impact of Virgin  
15 Blue, the possible entry of Virgin Blue do give some  
16 consideration to whether or not that's going to provide an  
17 effective constraint right across the spectrum of the  
18 services the existing airlines operate.

19           But even if Virgin Blue does satisfy the likelihood,  
20 extensiveness, timeliness and sustainability of entry, even  
21 if there is some impact from them, we've seen from the  
22 evidence that Professor Hausman has brought before us, even  
23 assuming that there are very considerable adverse  
24 competition effects; even taking the best case scenario,  
25 that is taking Virgin Blue's entry as likely, extensive,  
26 timely and sustainable, even then the competition effects of  
27 what the Applicants are proposing does give rise to very  
28 substantial detriments.

29           And as we've demonstrated in terms of the economic  
30 modelling that's been done, there is still very considerable  
31 doubt as to whether the benefits claimed by the Applicants

1 in fact will come home to roost.

2 Madam Chair, members, it's been a lot longer than we  
3 thought we would be here. We thank you again for your  
4 indulgence and we wish you well with the task that we say is  
5 very very daunting but ought not to be difficult.

6 **CHAIR:** We'll talk about that at some point, I'm sure.

7 **MS BATES QC:** I'm sure they all say that.

8 **CHAIR:** It's now left for me to thank Infratil for providing the  
9 Commission with access to a great deal of industry and  
10 economic expertise and also extensive legal opinion.

11 There's no doubt that the Commission does benefit very  
12 considerably when parties who are affected by a proposed  
13 arrangement help to test the proposals and submit to us, so  
14 once again we're grateful to you and I thank each one of  
15 you.

16 I propose now to break for lunch for one hour. When we  
17 return the next session will be with Gullivers Pacific, and  
18 at the beginning of that session I will update interested  
19 parties on how we will proceed through to the end of the  
20 hearings. So at this time I will adjourn for lunch. Thank  
21 you.

22

23 **Adjournment taken from 12.05 pm to 1.12 pm**

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26

27 **CHAIR:** I'd like to reconvene the Conference now, and before we  
28 start the next session I said I would update all interested  
29 parties on the process from here. We have updated the  
30 timetable to allow for the overruns in time that we've had  
31 up to this point. I do appreciate the parties that have

1 agreed to move their presentations to Monday instead of  
2 today. This should allow the Commission to fully consider  
3 submissions from all parties.

4 We will continue to ask parties to try to keep their  
5 submissions brief to allow sufficient time for the  
6 questioning, but note that we don't want to do that to the  
7 extent that it sacrifices the opportunity for parties to  
8 focus on the key points that they want to make to us.

9 The plan is from now until 3 o'clock that we will hear  
10 from Gullivers. At 3 o'clock Origin Pacific; 3.30 there  
11 will be an afternoon tea break; 3.45 we'll continue with  
12 Origin Pacific; 4.15 Christchurch Airport; 4.45 CTU and  
13 EPMU, and with a proposed finish time today of 5.15.

14 On Monday the plan will be to start at 9.30 with Bon  
15 Voyage; 10 o'clock TAANZ; 10.30 Save New Zealand -- Air New  
16 Zealand; 11 o'clock morning tea; 11.15 the Consumers  
17 Institute; 11.45 Invercargill Airport; 12.15 lunch; 1.15  
18 Polynesian Airlines; 1.45 Jumpjet; 2.15 we will then have  
19 the Applicants' reply with a proposed closing of the  
20 Conference at 3.45.

21 So, that is the plan as of now. Are there any questions  
22 on that before we proceed? [**No questions**]. The revised  
23 timetable is being produced for people to take away; it  
24 should be available shortly.

25 I'd now like to welcome Gullivers Pacific and ask them  
26 to please introduce the people who will be presenting, and  
27 ask you to proceed when you're ready. Thank you.

28  
29  
30 \*\*\*



## PRESENTATION BY GULLIVERS PACIFIC

1  
2  
3 **MR BAGNALL:** Thank you Madam Chair and Commissioners, I'm Andrew  
4 Bagnall, Managing Director of Gullivers Pacific. I have  
5 extensive travel interests in both Australia, New Zealand  
6 and in the markets of wholesale, leisure corporate and  
7 travel technology. With me today is Kathy O'Connor, Chief  
8 Executive of our technology interests; Professor Hazledine,  
9 Professor of Economics at the University of Auckland who  
10 will be speaking on the modelling and economic analysis, and  
11 Ralph Lattimore together with Simon Hope from the  
12 New Zealand Institute of Economic Research who are here to  
13 answer any questions the Commission may have.

14 It has been an interesting week for me hearing so many  
15 experts with differing views of the changing world of  
16 aviation. What I will share with you is my practical  
17 experience accumulated over more than 30 years in the  
18 industry.

19 We have heard from both Mr Norris and Mr Dixon that the  
20 airline industry is in a crisis and that an anti-competitive  
21 and an alliance should be permitted. Well, I can assure  
22 them that this industry has never stopped changing or  
23 evolving since the day I started. Change is nothing new,  
24 it is part of the environment.

25 We have heard people talk about connectivity, point-to-  
26 point routes, LCAs, VBAs, FSAs, and the USA and European  
27 experiences. While there is very little certainty in this  
28 world, what I can state with certainty is that the  
29 Australian and New Zealand market is very different to the  
30 domestic USA and Continental Europe.

31 The obvious difference is population, in density,

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1 numbers, economic wealth as well as geographic position and  
2 the number of airline suppliers.

3 Over the years I have seen many airlines come and go as  
4 they struggled to compete against both Air New Zealand and  
5 Qantas in their respective domestic, USA and Tasman routes.  
6 These include the major airlines of Pan American, American  
7 Airlines, Continental, United Airlines, together with the  
8 Europeans such as UTA, Canadian Airlines and one of the  
9 bigger of all, British Airways. Together with the LCAs that  
10 have been here of recent times, Canada 3000, Kiwi, Compass  
11 Mark I and II, Impulse and others. If Air New Zealand and  
12 Qantas have managed to outlast these carriers individually,  
13 it is thought provoking to consider the impact of Qantas and  
14 Air New Zealand working together with the combined resources  
15 to send off the minor remaining incumbents.

16 But just as importantly, the fear must be with us that  
17 they will deter any future potential international or  
18 domestic competition from entering. Given our respective  
19 geographic positions at the bottom of the world we just may  
20 not have a long list of suitors.

21 The real challenge for the Applicants I suggest is to  
22 get their own efficiencies under control, lower prices and  
23 optimise long-term revenue yield from the market while  
24 competing strongly and rationally. I have been reminded  
25 constantly throughout these proceedings that new  
26 efficiencies come through innovation which has always been  
27 the child of competition, not the reverse.

28 There has been much discussion this week on the impact  
29 of the alliance on the various markets identified by the  
30 Commission and it is clear to me from my experience that  
31 there would be a substantial lessening of competition in a

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1 number of these markets. Virgin Blue has identified that  
2 this segmentation may be too broad and they would only  
3 consider a route-by-route basis which is how many LCAs set  
4 up business. However, in looking at the markets that the  
5 Commission has identified, we would make the following  
6 observations:

7 Provincial markets are likely to see a substantial  
8 lessening of competition. Origin Pacific have made it clear  
9 they could not survive on many of their routes without their  
10 ongoing feed and support from Qantas and their alliance  
11 partners.

12 Virgin Blue has confirmed it is unlikely to enter this  
13 market. With regard to the main trunk, there has been a lot  
14 of discussion about Virgin Blue's entry. If the gestation  
15 period to date is any indication, this egg may never be  
16 hatched, but possibly their entry may depend on the results  
17 of the forthcoming IPO. Time will tell.

18 I suggest an unleashed Qantas may be a better and more  
19 effective antidote to any perceived lack of competition bass  
20 as I recall Qantas has its newly born JetConnect of 7  
21 aircraft about to become 8, with all of its required LCA  
22 infrastructure, including airport slots, terminals and AOCs  
23 in place.

24 For the Pacific, the alliance will deliver a monopoly on  
25 Pacific routes to the major destinations of Fiji, Cook  
26 Islands, Norfolk Island and Hawaii which are already  
27 operating at a significant price premium over more  
28 competitive routes.

29 This particular market produces more revenue at a higher  
30 yield than the Trans-Tasman for Air New Zealand which is  
31 where discussion this week has focused.

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1 United States, the alliance will deliver a 100% monopoly  
2 in services with an associated likelihood of monopoly  
3 pricing which will be detrimental to our in-bound tourism,  
4 exporters and travellers.

5 For Asia, the alliance will have a monopoly to Japan and  
6 confirm a duopoly regime to Hong Kong and Singapore.

7 For international, we have heard that Air New Zealand  
8 has capacity constraints on its London routes and,  
9 therefore, we can only assume that this has enabled a higher  
10 yield to be obtained and greater profitability on this route  
11 which is so important to our tourism and which is a great  
12 feeder to the USA and Pacific.

13 Turning back to the Trans-Tasman, where our focus has  
14 been. Much has been talked about this little stretch of  
15 water and its impact on the proposed alliance. If it is  
16 true that a 5% market share by LCAs results in a substantial  
17 reduction in price, then the Trans-Tasman is already there  
18 as Freedom has for the last 18 months taken in excess of  
19 market share -- sorry, 8% market share.

20 Furthermore, it has been alleged that the Fifth Freedom  
21 carriers significantly influence pricing on the Trans-  
22 Tasman.

23 My 30 years of experience says this is not quite  
24 correct. Over the years I have seen many airlines come and  
25 go on the Tasman. From the biggest in the world, we've  
26 already said Pan American, Continental, United Airlines to  
27 the latter Asia experiments and VBA start ups, including  
28 Korean, China Airlines, EVA, and Kiwi and others. At all  
29 times the standard modus operandi has been to price a few  
30 dollars under the incumbents Qantas and Air New Zealand.

31 As far back as the 80s, if the price was \$950,

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1 Continental Airlines would be \$899 to \$930, \$20 to \$50 bucks  
2 under what the incumbents charged. If the price dropped to  
3 \$400 Continental would drop from \$349 to \$380, similar price  
4 margin. This has not changed in the 20 to 30 years I have  
5 been in the business.

6 It was not just load factors or yield, but more  
7 significantly corporate head office decisions in many of  
8 these cases that ultimately took these airlines out of the  
9 market. This is a problem for our area of the world.

10 Referring to the table, you can see that in 2002 Fifth  
11 Freedom carriers provided 4.4% of flights on this market,  
12 8.5% of seats, yet carried less than 4.8% of passengers.  
13 Then, as of now, it is the two major incumbents, Qantas and  
14 Air New Zealand that set the price and dominate the market  
15 with a market share of 95% of flights, 91% of seats and 95%  
16 of Tasman origin destination traffic. Prices rise and fall  
17 according to the actions of Qantas and Air New Zealand, not  
18 because Fifth Freedom carriers have forced the issue.

19 While the share of capacity is important in considering  
20 competition, the scheduling problems facing Fifth Freedom  
21 carriers are not superficial, and in the main are difficult  
22 to rectify. Quite simply, while Fifth Freedom carriers have  
23 the price and product quality, they do not have the timing  
24 of departure required for much of the Trans-Tasman passenger  
25 market. Unless the aircraft is based in New Zealand, it  
26 must overnight, to access both the premium business market  
27 and the leisure passengers who want to maximise this holiday  
28 time.

29 This issue may be of concern to any possible Virgin  
30 implementation plans as there are difficulties in attempting  
31 to use the same aircraft for international and domestic

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1 operations, given fundamentals such as separations of  
2 terminals, and the differing Civil Aviation requirements for  
3 domestic and international flights.

4 Table 2 illustrates the load factors achieved by various  
5 airlines on the Tasman for the year ended June 02. It is  
6 clear that Qantas, Air New Zealand and Freedom are head and  
7 shoulders above all other carriers. In fact, with load  
8 factors for both Qantas and Air New Zealand at or exceeding  
9 75%, these would be routes and loads the envy of the FSAs  
10 and LCAs worldwide. Whereas, the Fifth Freedom people on  
11 this market operate at approximately 45% load factor.

12 In April 03, the figures aren't on the graph because I  
13 have the one month figures for April, we can find that  
14 Qantas and Air New Zealand have increased their load factors  
15 from 75 to 78%, Qantas has gone from 79 and held it at 79,  
16 and Freedom has gone from 73 to 76%, while at the same time  
17 the Fifth Freedom carrier of China Airlines is gone, Garuda  
18 has dropped from 46 to 32%, Thai has gone from 42 to 40% and  
19 the new incumbent, or I won't say incumbent, the new venture  
20 by Malaysian on a Trans-Tasman produced a load factor in the  
21 month of April of 18.7%.

22 It is also a reflection on the competitiveness of the  
23 existing fares as much as the brand strength and dominance  
24 of Qantas and Air New Zealand in the Trans-Tasman market  
25 that the impact of the Fifth Freedom carriers has been so  
26 minimal. Fare comparisons indicate that the current Trans-  
27 Tasman offers are little different on an RSK basis to those  
28 offered by LCA's around the world.

29 Despite assertion to the contrary, it is clear to date  
30 that there is and has been no effective competition on the  
31 Trans-Tasman route to the dominance effected by Qantas and

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1 Air New Zealand both individually and collectively, and that  
2 the current efficient pricing is the result of competition  
3 between Air New Zealand and Qantas.

4 If an effective duopoly produces this result, the  
5 addition of Virgin Blue should add further to the consumer  
6 benefit, whereas Virgin Blue versus an alliance would be a  
7 mockery, as New Zealand and Qantas deploy a fleet on the  
8 Trans-Tasman with more aircraft than Virgin has or will have  
9 in total including its whole Australian operation.

10 **CHAIR:** Can I just clarify one thing. SJ?

11 **MR BAGNALL:** That's Freedom.

12 **CHAIR:** That's what we thought. Maybe we should know those  
13 things by now, but it's hard to remember them, thank you for  
14 that.

15 **MR BAGNALL:** As to comments regarding on-line versus inter-line  
16 implications which we have heard a bit about, my observation  
17 as to the outcomes between on-line and inter-line  
18 arrangements in this area of the world is contrary to  
19 Professor Willig in that the arrangements depend on the  
20 prices demanded by the airline participants.

21 For example, Auckland to London is often cheaper inter-  
22 line than on-line as one party is prepared to accept a lower  
23 price for their appropriate sector.

24 As to Qantas Holidays: There is considerable doubt that  
25 Qantas Holidays would be able to generate \$50,000 additional  
26 in-bound tourists to New Zealand on the basis of its  
27 proposed initiatives. Qantas Holidays is focused primarily  
28 on domestic and out-bound Australian travel. This  
29 represents approximately 85% of their total business. They  
30 would be attempting to generate a significant increase in  
31 tourism in a market where they are not a specialist and rely

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1 substantially on third party assistance.

2 Qantas Holidays proposes to achieve this increase in  
3 tourism through outlets that are not exclusive to them and  
4 where they currently achieve less than five sales per annum.

5 Qantas Holidays also requires, as a prerequisite to  
6 this, preferential fares exclusive to Qantas Holidays. I am  
7 not an expert on in-bound tourism, but I do know from my  
8 Australian investments that Qantas Holidays has dominated  
9 the Australian market because of its unique fares made  
10 available to it by Qantas to the detriment of every other  
11 independent wholesaler.

12 The IT platform Calypso described by Qantas Holidays as  
13 key to their success and unique system which Air New Zealand  
14 would not have access to is in fact a commercially available  
15 software product. It is also the tourism system used by  
16 Gullivers and which has been offered to Air New Zealand, and  
17 this offer still remains open.

18 Finally, I can confirm that we support the Commission's  
19 Draft Determination and wish to thank them for the  
20 opportunity to attend this Conference.

21 This concludes my presentation and I will now handover  
22 to Professor Hazledine.

23 **CHAIR:** Thank you for that presentation, Mr Bagnall, and I'd  
24 just like to see if we'd like to take some questions before  
25 we proceed, if we can.

26 I might go first and then I'll pass over to my  
27 colleagues. You commented on the provincial routes and what  
28 might happen to Origin Pacific, and I wonder if it might not  
29 be reasonable to assume that Origin Pacific probably would  
30 develop some sort of relationship with Virgin Blue if it  
31 entered, and if that's correct how significant is the



1 concern in the provincial markets?

2 **MR BAGNALL:** I cannot speak for Origin, but if I recall,  
3 Mr Huttner made it very clear that his model, under Virgin,  
4 was not into connecting with anyone.

5 **CHAIR:** But they will still need to get feed from somewhere  
6 presumably?

7 **MR BAGNALL:** Again, Mr Huttner made it very clear; that wasn't  
8 the rationale. The route wouldn't stand up by itself. They  
9 weren't interested in going there.

10 **CHAIR:** I just wanted to come on to the Fifth Freedom carriers,  
11 and we've heard a lot of submissions about the carriers sort  
12 of coming and going, but I guess as long as they keep  
13 coming, whoever they are, they must provide some constraint.  
14 Does it really matter if it's unstable in the sense that  
15 it's different players all the time, as long as they are  
16 there?

17 **MR BAGNALL:** I accept that they will always provide some  
18 constraint on some flights and some timings, but part of  
19 what the objective of this was to demonstrate that the  
20 constraint was not nearly as substantial as what had been  
21 asserted in a number of the submissions.

22 **CHAIR:** The other question I had related to your comments about  
23 the position of Qantas Holidays in Australia. I took it  
24 from that concern possibly that they would achieve the same  
25 position in the New Zealand market, and I guess the question  
26 really is, as long as customers are getting the benefit of  
27 those cheaper fares should it matter to the Commission if  
28 they are able to achieve that through their -- through  
29 whatever means they achieve it as long as it's not in some  
30 form anti-competitive?

31 **MR BAGNALL:** No, the issue I have there, if they effectively

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1 have an exclusive right, my belief would be that the  
2 consumer would not get the benefit because a substantial  
3 proportion of the out-bound routes over which they will  
4 operate out of New Zealand will be a monopoly. That  
5 position is not nearly substantial in Australia. There are  
6 few monopoly routes from Australia.

7 **MR CURTIN:** Thank you, I'd like to talk about the IT platform  
8 that Qantas Holidays have or have not got, because it's --  
9 I'm not -- I accept what you say, but it's at startling  
10 variance with what we were told earlier in the week. I  
11 distinctly remember Qantas Holidays telling us -- and I  
12 thought they had done it -- that they were on version 46 of  
13 their software and were building a web enabled thing and I  
14 got quite a strong impression, perhaps wrongly, that this  
15 was a kind of proprietary good oil product that was a  
16 worthwhile thing to have.

17 **MR BAGNALL:** On the contract that we have with the tourism  
18 technologies, which is the company which owns the software,  
19 every party to that software, and it's not an unusual  
20 contract, as they update and input additional applications  
21 and additional bits and pieces and fix it, that is made  
22 available to all parties who buy the -- who are contracted  
23 and either lease or have bought the software. So that we're  
24 entitled to any upgrades that Qantas do to it and vice  
25 versa.

26 **MR CURTIN:** You say it's offered to Air New Zealand and the  
27 offer still remains open. If it's an important element in  
28 assembling and keeping track of holiday packages, and I'm  
29 quite prepared to believe it is, I just wonder why Air New  
30 Zealand haven't adopted it or some other system.

31 **MR BAGNALL:** So do we.

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1 **MR CURTIN:** Well, would you care to sort of develop that is bit?  
2 I mean the Applicants can speak for themselves, but...

3 **MR BAGNALL:** I can only tell the Commission that we were asked  
4 to make a major submission, off the top of my head August,  
5 September last year, to potentially handle all Air New  
6 Zealand Holidays, and we have not heard another word.

7 **MR CURTIN:** The reason I'm pressing it is for two reasons; one,  
8 it doesn't stand -- not reflecting on anybody's truth  
9 situation -- but it stands at quite variance with that  
10 previous understanding, and secondly, the \$50,000 tourists  
11 are one of the bigger moving numbers in the assessment we've  
12 got to make.

13 So in your opinion, how important is the back office IT  
14 platform? If you want to get into 50,000 new tourists  
15 coming through packages you've assembled, and there would be  
16 a number of elements, brand and price and God knows what,  
17 market research, and a back end.

18 Would you care to tell us a little bit about how this  
19 market works and the relative importance of the bits you  
20 need to make a go of it?

21 **MR BAGNALL:** You need some form of tracking mechanism and  
22 accounting mechanism to handle the business, both to act as  
23 a job card effectively for the customers. You need an  
24 interface into a reservation system for whatever supplier  
25 you want, that's by both hotels, airline seats, other supply  
26 connectivity, you need to be able to produce itineraries.  
27 It is helpful to have that on-line to your customer base;  
28 that's a speed of issue but not essential.

29 I can't be sure as to how Qantas plan to market this  
30 product in other areas. That's an issue for what their  
31 relationship is; people on the ground, how much money

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1 they're prepared to spend to get at it, or what wholesalers  
2 or retailers they are using in other markets.

3 I do know that if they start undercutting direct in  
4 other markets their existing wholesalers will be somewhat  
5 upset.

6 **MR CURTIN:** I appreciate that too, that you've probably got to  
7 manage it with other distribution channels, I understand  
8 this.

9 This platform Calypso, could I turn up in the morning  
10 and buy Calypso from someone?

11 **MR BAGNALL:** Yes.

12 **MR CURTIN:** Other than you?

13 **MR BAGNALL:** Yes. It's not just Qantas and us; I'm not sure how  
14 many they've sold, but to the best of my knowledge British  
15 Airways have it now, Singapore Airlines, Ansett Australia  
16 used to have it. There are a number of parties that have  
17 that, both big and small.

18 **MR CURTIN:** I mean, what you would pay by way of licence fee  
19 would have to be your own affair, but would it be a  
20 substantial barrier to entry to someone interested in this  
21 market?

22 **MR BAGNALL:** For a business with about \$1 billion worth of  
23 shareholders funds, no.

24 **MR CURTIN:** Okay, thank you.

25 **MS BATES QC:** Just something I didn't catch properly on the  
26 Pacific routes that you were talking about. You say there'd  
27 be a monopoly in Fiji, the Cooks. Isn't there presently a  
28 monopoly in the Cooks?

29 **MR BAGNALL:** Off the top of my head, Polynesian occasionally  
30 flies in and out, I can't recall exactly, but --

31 **MS BATES QC:** It's mostly in Air New Zealand, isn't it?

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- 1 **MR BAGNALL:** Yes, it is. It's predominantly Air New Zealand.
- 2 **MS BATES QC:** So, at the moment Qantas flies into Fiji?
- 3 **MR BAGNALL:** Through Air Pacific.
- 4 **MS BATES QC:** And who flies into Norfolk?
- 5 **MR BAGNALL:** Well, Qantas does from Australia and Air New  
6 Zealand does from New Zealand.
- 7 **MS BATES QC:** But Air New Zealand is the only one that goes from  
8 New Zealand?
- 9 **MR BAGNALL:** Yep.
- 10 **MS BATES QC:** And Hawaii, who goes from New Zealand to --
- 11 **MR BAGNALL:** Air New Zealand. And I can go via Australia if I  
12 want to go via Qantas.
- 13 **MS BATES QC:** But Qantas doesn't fly from New Zealand to Hawaii?
- 14 **MR BAGNALL:** Not directly, no.
- 15 **MS BATES QC:** So, that doesn't seem to me there will be much  
16 change.
- 17 **MR BAGNALL:** No, not much change; it just establishes that it  
18 certainly won't change.
- 19 **MS BATES QC:** The bit I didn't catch, you said something about,  
20 that it was -- did you say it was more significant business  
21 in the Tasman? Did I hear you correctly?
- 22 **MR BAGNALL:** On the breakdown in the Air New Zealand annual  
23 report, June 02 on the amount of volumes -- of sales they  
24 get from different markets, if I recall correctly, the  
25 business that they achieve from the Pacific is greater than  
26 what they achieve on the Trans-Tasman.
- 27 **MS BATES QC:** Just turning to the 50,000 additional tourists  
28 question. Where did you get your figure that it was 85%  
29 of --
- 30 **MR BAGNALL:** There's a figure in, I think the part of the  
31 original submissions, about 166,000 in-bound tourists into

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1 Australia that Qantas Holidays handles and elsewhere they  
2 state that Qantas Holidays handles just over 1 million  
3 passengers.

4 **MS BATES QC:** What they have said to us was, well 50,000  
5 additional tourists isn't really very much when you consider  
6 the total number is 2 million, something like that -- I  
7 think it was 2 million tourists into New Zealand -- would  
8 one of you gentlemen know the answer to that?

9 No? We'll just assume that's right, and put that way it  
10 doesn't seem a lot. So, why do you think it would be so  
11 difficult for it to --

12 **MR BAGNALL:** If it was that easy Air New Zealand would have  
13 taken an extra 50 every year it possibly could for the last  
14 10 or 20 years. It's a lot more difficult -- every last  
15 passenger that you get from long haul markets take more and  
16 more effort to get the last passenger.

17 **MS BATES QC:** So, are you basing that on your own experience?

18 **MR BAGNALL:** Very very much on own experience. We get pushed  
19 every year by our various airline suppliers to increase the  
20 amount of business we tip into whatever the appropriate  
21 bucket is, and I can assure you that it is extremely  
22 difficult to push additional -- to get additional  
23 passengers, and particularly it's very very hard if the  
24 competition from the suppliers is not there, and it's not  
25 just a matter of pricing.

26 If you look at the figures for year 01 and 02 for  
27 domestic travel within Australia, that in actual fact the  
28 number of passengers travelling domestically within  
29 Australia actually dropped, if my memory's right for 02,  
30 that was during, of course, the debacle with Ansett. But  
31 the minute you lose numbers of participants, you actually --

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1 anecdotal evidence would say that you drop a number, you  
2 will drop a certain amount of business. So that three  
3 players at the same price each pushing their marketing  
4 strength, their frequent flyer clubs, all the other issues,  
5 will actually generate more business than any two players  
6 normally in that market.

7 **MR CURTIN:** Backtracking a little to the Fifth Freedom  
8 operators, sorry to take you back again; I hear what you say  
9 about the price a dollar cheaper than the FSA on the route,  
10 and I know there's a table somewhere in the NECG material  
11 that showed the current fares Trans-Tasman when Air New  
12 Zealand was being, I think, shown as 499. There were a  
13 bunch of them around 499, there was even one over 499 from  
14 memory.

15 But there were a couple of others that were doing sort  
16 of the 299s and the 399s, and we've at least read in the  
17 papers the Emirates initiative and what have you. I just  
18 wanted to confirm or otherwise from you whether you think  
19 that traditional just a dollar underpricing is going to  
20 continue as a rule of thumb, or whether it's got a bit more  
21 aggressive?

22 **MR BAGNALL:** I mean, I can't forecast the future, I can only say  
23 what I have observed from a very close look at it and  
24 intimate involvement in it over the last, going on 30 years  
25 now; and, it varies.

26 I mean, you have an airline say like Royal Tongan who  
27 does one flight a week, I don't know what it's timing is  
28 from Auckland; it's probably an awkward time and there's  
29 probably an uncertainty, depending on what the king wants to  
30 do, whether it's going to come back on the day it said.

31 So, you have different issues that attach to each

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1 carrier, and you have a different type of ethnic --  
2 particularly with a lot of Asian carriers coming into the  
3 marketplace that get a different form of loyalty, and  
4 depending on how far and hard that they are pushed by the  
5 distribution; because most of these carriers operate through  
6 a ticket consolidator or what we call a variant part of the  
7 tour wholesaling operation, and those parties have to make a  
8 judgment call also as to how much effort and weight they put  
9 behind pushing these carriers.

10 Because, we have been left -- and one of the  
11 uncertainties with carriers leaving the market is, when they  
12 do leave the market, often it's at pretty pretty short  
13 notice, and the parties who have been instrumental in  
14 selling them often get left picking up a lot of little  
15 babies of losses, unaccounted for revenue and those sorts of  
16 issues, plus a lot of very unhappy customers.

17 **MR CURTIN:** Thank you.

18 **MR PJM TAYLOR:** Just to finish off on Fifth Freedoms perhaps; do  
19 you have a view on the extent to which any constraint the  
20 Fifth Freedoms may have on the Auckland route would also  
21 have on Wellington and Christchurch?

22 **MR BAGNALL:** I tend to take Mr Huttner's viewpoint, which I know  
23 is not quite followed by the incumbent parties. I think  
24 those are virtually mutually exclusive, but you do get a  
25 howl of protest. Whether that flows over to say, if you  
26 don't lower the prices from Christchurch to Sydney we will  
27 use an alternative airline on our next trip to London... I  
28 think those are the issues, it's the potential threats that  
29 that has, but that's a pricing issue, not a Fifth Freedom  
30 issue.

31 **MR PJM TAYLOR:** It's a flow-on from the Fifth Freedom though,



1       isn't it?

2 **MR BAGNALL:** It could be argued it is a flow-on from the Fifth  
3 Freedom.

4 **MR PJM TAYLOR:** Just on the Calypso platform; am I right, you're  
5 basically arguing that it's an off the shelf product that  
6 with some training can be introduced pretty easily?

7 **MR BAGNALL:** Yep. There is certainly a substantial lead time,  
8 but it's a resource lead time in loading the database and  
9 obtaining the contracts.

10 **MR PJM TAYLOR:** And training?

11 **MR BAGNALL:** I suspect that behind this is far more the fact of  
12 the database that sits within Qantas Holidays rather than  
13 the technology.

14 **MR PJM TAYLOR:** Okay. But if there wasn't a database issue,  
15 what sort of lead time would there be involved in training  
16 and loading the database up for somebody who had the  
17 information to put into it?

18 **MR BAGNALL:** Three to six months.

19 **MS BATES QC:** I didn't quite finish on the 50,000 tourists, but  
20 I just couldn't quite understand the sentence, maybe I'm  
21 getting tired, but it's:

22       "Qantas Holidays propose to achieve this increase in  
23 tourism through outlets that are not exclusive to them and  
24 where they currently achieve less than five sells per  
25 outlet."

26       Can you just explain it to me?

27 **MR BAGNALL:** Well, they put a number up, I think it was 37,000  
28 outlets, and they said, well, they did 166,000 passengers,  
29 divide it out and it comes to whatever, around about 5  
30 passengers per outlet.

31 **MS BATES QC:** I see, that's where you get that from.

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1 **MR BAGNALL:** I'm sure there's some that do substantially more  
2 and an awful lot that don't do any.

3 **MS BATES QC:** And are all of them not exclusive?

4 **MR BAGNALL:** I think it's very unlikely that travel agents  
5 internationally are exclusive to Qantas. Most of them  
6 wouldn't even know who they were.

7 **MS BATES QC:** Okay.

8 **CHAIR:** Any further questions?

9 **PROF GILLEN:** Given your table on the Trans-Tasman load factors,  
10 would it be your view that with the entry of Virgin Blue the  
11 most likely exit would be the Fifth Freedom capacity?

12 **MR BAGNALL:** I would think that that would put substantially  
13 more pressure on the Fifth Freedom capacity, yes.

14 **PROF GILLEN:** And secondly, do you have any sense of, if  
15 you did observe the large increases in fares on, for  
16 example, the Auckland-Los Angeles route that  
17 Professor Hausman was discussing, whether there had been any  
18 feasible entrant on that route?

19 **MR BAGNALL:** I think that route would be very very unlikely to  
20 see another entrant. Primarily because you need a  
21 substantial number of corporate customers to enable that  
22 route to really financially work.

23 **PROF GILLEN:** Okay, thank you.

24 **CHAIR:** I'd like to proceed with the next part of your  
25 presentation -- sorry, Anthony.

26 **MR CASEY:** Thank you. You talked a bit about the software, but  
27 it is more than the software they're requiring with the  
28 alliance, it's their database and the expertise and the  
29 investment and promotion in networks and contacts and so  
30 forth? Is that right?

31 **MR BAGNALL:** I think that's very fair, yes.

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1 **MR CASEY:** So, would those assets under the alliance be capable  
2 of generating the tourism increases that they're after?

3 **MR BAGNALL:** Knowing the costs of tour operating and what you  
4 need as a retailer to divert traffic, it's very unlikely  
5 that 1.7 million will go very far and it certainly won't  
6 produce 50,000.

7 **CHAIR:** I'm going to take one more question and then we'll move  
8 on to the next session.

9 **MR CURTIN:** I have just one. In the Draft Determination we had  
10 a go at trying to define what we thought were the different  
11 bits of the travel distribution market and what --  
12 consolidators and aggregators and who knows what.

13 Would you care to give us your opinion on whether you  
14 think we've got the structure of your business right, or how  
15 would you view the distribution markets?

16 **MR BAGNALL:** I think you have -- within reason you've got the  
17 structure of the wholesale travel distribution market  
18 reasonably correct. Obviously, it's got little bits and  
19 pieces on it in principle, but I think you did miss the two  
20 major sectors of what I call the retail market, what we have  
21 mentioned a number of times throughout these hearings, of  
22 the corporate retail market and the leisure retail market.

23 As Mr Hausman said this morning, they're either  
24 different products within one market or they're different  
25 markets with a generic product of an airline seat being used  
26 on them.

27 **MR CURTIN:** Thank you very much.

28 **CHAIR:** Mr Bagnall, we might want to come back and ask you more  
29 questions towards the end.

30 **PROF HAZLEDINE:** My name is Tim Hazledine, I'm Professor of  
31 Economics at the University of Auckland where I've been

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1 since 1991. Before that I was an Associate and then full  
2 Professor at the University of British Columbia in Vancouver  
3 Canada. I'm privileged and pleased to be at these very  
4 interesting and important hearings, and to take part in  
5 them.

6 I have a slide show and with your indulgence I'll speak  
7 to it. My slide show does not look as original to me as it  
8 did about 48 hours ago when I finished it because we've  
9 heard Professor Hausman's testimony. Since then I can tell  
10 you that many of the points that Professor Hausman made, I  
11 will -- made very well, I will be echoing, I take comfort  
12 from that of course. Professor Hausman is a very leading  
13 expert indeed in these matters, and I'm pleased that most of  
14 my views appear to be in accordance with his, while  
15 reassuring you that there's been no conspiracy or collusion  
16 in this matter, I've always admired until today Professor  
17 Hausman from afar.

18 So, I have four topics to speak to, market update, the  
19 likelihood of substantial lessening of competition,  
20 modelling issues, technical modelling issues, and fairly  
21 briefly the claimed benefits of the proposed cartel, as I  
22 call it.

23 First though, I will just note my position that  
24 I believe that the Commission's Draft Determination was  
25 appropriate based on the evidence available to the  
26 Commission at the time earlier this year, and the essence of  
27 that is the proposition that the, or the finding that the  
28 proposed cartel would substantially lessen competition  
29 without compensating benefits to New Zealand.

30 However, events since the Applicants filed have,  
31 I believe, increased the likelihood of an SLC. For two

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1 reasons; first, that the market has become more competitive  
2 in the economist's sense of that word, and secondly, because  
3 Air New Zealand has become more competitive in the ordinary  
4 or every day business sense of that word, and I'll speak to  
5 that in the next couple of slides.

6 On the market: The base case, the actual current  
7 situation which in the original NECG report I suppose was as  
8 at 2002, is becoming in the real world in the real-time  
9 steadily more competitive in the economist's sense. Factors  
10 here include Air New Zealand launching its domestic Express  
11 Class system successfully, Virgin Blue gearing up -- I'll  
12 put it, perhaps the word I'll use at the moment for entry,  
13 Fifth Freedom entry, new entry on the Tasman imminent, and  
14 Air New Zealand about to launch or about to make operational  
15 its Express fare system on its Tasman routes.

16 Air New Zealand's introduction of Express Class into  
17 these two important routes has helped to make it a more  
18 competitive firm in the business sense I believe. I greatly  
19 admire their innovation of this Express Class fare service,  
20 and I note that it's already successful in New Zealand, and  
21 I am pleased about that, as we all are.

22 The Express fare system can be indeed very responsive to  
23 market conditions. It's now being used, or has been used  
24 I believe to decrease the average price paid by the  
25 travelling consumer, but of course it could easily be used  
26 to increase the actual price paid with no change in the  
27 system. You understand how that works with as many as 12  
28 fare points in the New Zealand domestic Express Class fare  
29 system, it's very much an issue of availability of seats at  
30 different fare points, which can and should be adjusted  
31 hourly, perhaps by the minute by the airline to improve its

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1 load factors. So that is a possible anti-competitive weapon  
2 though.

3 However, the implications of Air New Zealand's improving  
4 competitive position for this case are that New Zealand --  
5 we, New Zealand -- lose more under the factual, with the  
6 cartel scenario, from the coupon clipping transfer of  
7 profits to Qantas; by which I mean not their entitlement of  
8 22.5% of the dividend or profit flow, but the arrangement  
9 whereby, if I understand it correctly, each airline will  
10 receive 20%, I think that's the number, of the operating  
11 profit for a mini route under this agreement flown by the  
12 other airline.

13 That transfer could be quite considerable because Air  
14 New Zealand does more of the flying than Qantas, and I noted  
15 with great interest Mr Bernardi's response to Commissioner  
16 Bates' question to time -- you know, 48 hours or whenever --  
17 that in response to your question, Commissioner, about the  
18 incentives for Qantas Holidays owned by Qantas Airways  
19 really to push people on to Air New Zealand planes, and  
20 Mr Bernardi got very close to implying that Qantas would  
21 make about as much money, not flying and letting Air New  
22 Zealand do the work. Which implies, if that stands up, that  
23 statement, that this transfer system is indeed quite  
24 attractive to the airline that gains more from it, which is  
25 Qantas.

26 There is a greater likelihood of Air New Zealand,  
27 because of its stronger position, its current position,  
28 competing strongly in the counterfactual without the cartel.  
29 There is indeed, I believe, a greater likelihood of Qantas  
30 exiting the New Zealand market where it's managed to --  
31 well, it's only been for a couple of years in full form, and

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1 survived without being in the New Zealand market for 50  
2 years or whatever, it might indeed -- it could exit and  
3 perhaps be replaced by a VBA.

4 Finally, Air New Zealand's improving business  
5 competitive position does make it more attractive, I would  
6 imagine, for -- a more attractive partner for an  
7 complimentary or end-to-end, as Professor Gillen puts it,  
8 third party airline.

9 So, what I'm saying is that the base case is becoming  
10 more "competitive" in the economic sense, keener competition  
11 as the forecast changes become real or will in a few months  
12 will become real. That means I think that the base case --  
13 remember, there are three cases in these models; there's the  
14 base case which is the "observed" situation, former 2002,  
15 there's the counterfactual which is next year or whatever  
16 without the cartel, and then there's the so-called factual  
17 which is with the cartel. I submit that the base case and  
18 the counterfactual are merging now, absent irrational or  
19 predatory behaviour in the counterfactual.

20 I think in particular that means that, from a modelling  
21 perspective and a market analysis perspective, we have to  
22 treat Freedom Air, Virgin and Fifth Freedom as already here  
23 at least in their impact on full service airline pricing. I  
24 think Professor Hausman agreed with that or made a similar  
25 point.

26 That is the applicant's original scenario of 2002, back  
27 in 2002 of a counterfactual with no, in New Zealand, or  
28 limited across the Tasman, VBA entry, counterfactual entry,  
29 is now obsolete. I think this is common ground actually,  
30 and indeed in the response to your Draft Determination NECG  
31 claimed that you placed insufficient weight on Virgin Blue's

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1 submission and public statements that it will enter the VBA  
2 with or without the proposed -- VBA market or something,  
3 with or without the proposed alliance, and I think we're  
4 hearing a lot about that.

5 That doesn't mean they are going to enter, I think that  
6 means that the likelihood of them entering has, it seems to  
7 me, not been changed greatly by whether we're talking about  
8 a counterfactual or factual scenario. So, I will submit  
9 that the relevant scenario really has simplified from four  
10 to two. There are either Virgin in/Virgin in  
11 counterfactual/factual, or Virgin out/Virgin out  
12 counterfactual/counterfactual. That will have implications  
13 for the modelling.

14 So, the implications of this for the SLC: There is two  
15 big points to be made here. The first one is that the new  
16 counterfactual already has built into it most or all, or all  
17 or most of the competitive impact of actual or potential VBA  
18 entry and additional Fifth Freedom competition. We've gotta  
19 say that's the world now, and I don't think that's  
20 controversial.

21 Then the key point two out of it that I submit comes out  
22 of that is that, with -- say in the market or with its  
23 threat, a constraining participant in the market now in base  
24 case/counterfactual, loss of a strong independent competitor  
25 will result in a substantial increase in the market price.

26 Professor Hausman made that point better than I no doubt  
27 this morning and made it very forcefully. Professor Willig  
28 didn't make that point to my hearing but he has made it in  
29 written material, including his well-known 1991 Brookings  
30 papers article to which he referred us in his commentary in  
31 the NECG submission on your Draft Determination.



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1           So that means that the VBA doesn't get you out of  
2 trouble here. The trouble -- the whole pricing structure  
3 may be lower, which is good, but the change in the price  
4 from the cartel remains a threat.

5           How much will the price increase, as clearly that's  
6 material, as in, will it be substantial; will it lead to a  
7 substantial lessening of competition? The answering depends  
8 on your model or on your commercial instincts. I say let's  
9 start with the mainstream Cournot-Nash model.

10          Now, Professor Hausman didn't keep me awake last night,  
11 but he did forecast that he would be attacking the Cournot  
12 model, and I wondered what on earth he was going to do. The  
13 matter was resolved I think by the following questions in  
14 particular from Professor Gillen. I'm going to call it  
15 "mainstream". He did say, Professor Hausman, that if you  
16 didn't have VBA entry it's okay to use Cournot because  
17 you're dealing with full service airlines who are fairly  
18 similar.

19          Then later in response to further questioning from  
20 Professor Gillen he said -- I think, perhaps Dr Pickford,  
21 excuse me if so -- that if he had differentiated products,  
22 as the Gillen and Hazledine model both have, then that's  
23 okay too, Cournot's fine. So, that's good.

24 **CHAIR:** Can I just ask you a question Professor, sorry for  
25 interrupting. I just wonder on this VBA entry issue, when I  
26 read about the statements that were made yesterday by the  
27 CEO of Qantas, Mr Dixon, about the possibility of setting up  
28 its own low cost carrier, I wonder what impact that might  
29 have on Virgin Blue's own strategies.

30          Mr Dixon seemed to be strongly indicating that -- he  
31 came right out and indicated that Virgin had approached the

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1 30% market share point and for them that was a line in the  
2 sand and they were going to defend any further erosion, and  
3 opened up the possibility of setting up their own low cost  
4 carrier.

5 Is it clear, if they do that, that Virgin Blue's  
6 strategy is, we've been thinking of it up until today, would  
7 be unchanged and does it have any -- do you think it has any  
8 consequences for the sort of analysis that you've taken us  
9 through thus far?

10 **PROF HAZLEDINE:** Did Mr Dixon make the statement in introducing  
11 his financial results yesterday? I haven't read what he  
12 said.

13 **CHAIR:** Yes.

14 **PROF HAZLEDINE:** But I would think that anything that makes any  
15 incumbent airliner a sharper competitor is going to degrees  
16 the attractiveness of the market to an entrant; bearing in  
17 mind the entrant's apparent policy of only doing things when  
18 they make money, in other words, it doesn't cross-subsidise.  
19 But, I don't know. I can't say any more than that.

20 **CHAIR:** Okay, thank you.

21 **PROF HAZLEDINE:** If you move from three independent competitors  
22 to two in an extended Cournot linear model the demand curve  
23 as, for example, used in my model, you get a prediction in  
24 the market price losing an independent competitor, one going  
25 from 3 to 2 should go up by 10 to 15%; and that's  
26 conservative in this case because that's assuming, as NECG  
27 do, and have been criticised correctly for this, that the  
28 value based product is a perfect substitute -- is just as  
29 good as the full service product at the same price -- if  
30 they were at the same price.

31 So 10 to 15%, and if you go from there to monopoly, from

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1 duopoly to monopoly, a further increase of around 20%. You  
2 don't need a fancy model to come up with numbers like that.  
3 I think they're fairly -- Professor Hausman actually came up  
4 with bigger numbers; he may have a fancier model.

5 I'll whip through this. There are three what I call  
6 optional maths slides or optional modelling slides in  
7 smaller fonts, so you can't read them so well, and I don't  
8 think -- of course, I'm prepared to speak to them or to  
9 answer questions, but I don't think we need that.

10 So, the implications of these price increases for the  
11 SLC -- oh okay, and sorry -- that's my heading. Further, if  
12 the current situation is not Cournot but is more competitive  
13 than Cournot, as I believe it is, if the toughness of  
14 competition, the pricing tension, as Gullivers Pacific call  
15 it, in the market right now, or by the end of the year, is  
16 not normal Cournot competition, it's a bit more aggressive  
17 than that, then the potential relief to the parties from  
18 forming their cartel is greater because they will smack --  
19 knock that sort of tough competition on the head and so the  
20 price increases that you forecast would be larger.

21 Second -- the line here is that that 10 to 15% number  
22 says it's conservative -- if VBA air travel is not a perfect  
23 substitute for the FSA product, and in fact that the VBA  
24 product is what we call an inferior product, without  
25 pejorative meaning, in the sense that, if you went to the  
26 airport and there was someone standing there offering you  
27 two tickets for the same price, and one was on a VBA and one  
28 was on an FSA, same departure, same destination, most people  
29 would accept the FSA ticket I think. That's what I mean.

30 So, if the VBA was an imperfect substitute then its  
31 competitive pressure, as Professor Hausman noted, will be

1 less. So that, the cartel would be able to increase prices  
2 by more.

3 **MS BATES QC:** Can I just ask you something? If VBA comes in and  
4 assume both Qantas and Air New Zealand try to match the VBA  
5 price --

6 **PROF HAZLEDINE:** I wouldn't assume that, no.

7 **MS BATES QC:** Well, just say that there was evidence that they  
8 were going to do that.

9 **PROF HAZLEDINE:** Okay, sure, okay.

10 **MS BATES QC:** Then how would that impact on what you say? Would  
11 the same effect arise?

12 **PROF HAZLEDINE:** The same effect?

13 **MS BATES QC:** Yeah, I mean, would you get a -- let me go back, I  
14 am getting a bit tired. But what we're faced with here is  
15 the difference between VBA plus cartel as you call it and  
16 VBA plus Air New Zealand plus Qantas?

17 **PROF HAZLEDINE:** Correct.

18 **MS BATES QC:** And you're saying that there's a -- how much  
19 percentage difference between VBA plus cartel and the other  
20 option?

21 **PROF HAZLEDINE:** Conservatively 10 to 15% difference in the  
22 price charged to the market.

23 **MS BATES QC:** 10 to 15%, and just put it up as a hypothesis that  
24 Qantas and Air New Zealand brought their fares down to match  
25 the VBA, would you still think you'd get the same effect?  
26 In other words, would the VBA be pricing at 20% higher  
27 because it knew it could?

28 **PROF HAZLEDINE:** Would the VBA follow them up?

29 **MS BATES QC:** No, because I think it's the VBA that sets the  
30 price in that scenario.

31 **PROF HAZLEDINE:** You believe that the VBA is in fact a more

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1 powerful competitive presence in the market than say Qantas  
2 is for Air New Zealand?

3 **MS BATES QC:** I'm not sure, but let's just say we might have  
4 heard this, that the prices will be matched, then does your  
5 effect follow? The 20% increase in fares of one scenario  
6 above the other?

7 **PROF HAZLEDINE:** Yes, it does. Let's suppose they're offering  
8 the same product, so they have to match each other's prices.  
9 Let's suppose that there's no difference between the product  
10 offered; then in that case, yes, it does. Yes, it does.

11 **MS BATES QC:** And how, I just want to know so I understand.

12 **PROF HAZLEDINE:** If I may say so, that's a really good question  
13 because, how does this happen in these Cournot models? It  
14 happens as follows, if I may: When there are three people  
15 in the market, even if they are offering identical products,  
16 each one of them is thinking, how attractive would it be for  
17 me to say slip some more output on to the business market?  
18 And they think, what would that do to the market price? For  
19 three of them their average market share is third. So, to  
20 move a certain amount of product into the market -- well,  
21 there's two-thirds of the market they haven't got, so they  
22 would find it easier to imagine getting hold of a little bit  
23 of that extra two-thirds, and they would be more likely to  
24 want to do that.

25 On the other hand, if they're sharing the market 50/50,  
26 they'd say, well, there's only half the market left that I  
27 haven't got, so it will be harder for me to increase my  
28 number of passengers.

29 In the other direction, if they start considering  
30 whether it might be more profitable to raise their price, or  
31 reduce their output, the smaller they are, the less they get

1 out of that because there's so much other output still out  
2 there on the market holding the price down.

3 So, the Cournot-Nash model used by economists predicts  
4 that, even if they are selling exactly the same product so  
5 that the market price for all three end competitors will be  
6 identical, the price level in the market will differ  
7 inversely, or will relate inversely to the number of  
8 independent firms.

9 **CHAIR:** Excuse me Professor, we just need you to speak a little  
10 more slowly.

11 **PROF HAZLEDINE:** I beg your pardon. And, it may seem magic, but  
12 it seems to bear up empirically in many many studies in many  
13 many markets.

14 **MS BATES QC:** So, when would this happen, in this increase? On  
15 a scenario with the VBA coming in?

16 **PROF HAZLEDINE:** It would happen when the cartel forms.

17 **MS BATES QC:** Okay. I'll think about it.

18 **PROF HAZLEDINE:** I'm sorry if I haven't adequately resolved your  
19 doubts there.

20 On the VBA, the implications, some commentators and  
21 consultants have in effect thrown away their Cournot model  
22 and forecasted even small VBA entry, like 5%, will have a  
23 marked constraining effect on the pricing of the incumbents.

24 I would just add my opinion to the opinions that have  
25 been voiced in the last day and a half that, that doesn't  
26 seem likely. That the VBA will have a competitive effect  
27 when it enters on pricing, but it doesn't have this -- it's  
28 not the tail that wags the dog, I don't believe.

29 **MR CURTIN:** I've actually heard Professor Hausman in different  
30 proceedings, and he didn't refer to it here, basically run a  
31 line of argument akin to the 5% argument that you instance

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1 here; and there is a formula and I've forgotten how it runs,  
2 but it calculates what is the minimum market share under  
3 certain assumptions that will actually discipline even quite  
4 larger incumbents, you'll have to remind me what that little  
5 area of economics is, but I know Professor Hausman has  
6 almost -- he suggested to us in other proceedings we could  
7 almost use it as a brightline test for whether there is  
8 effective competition in a market or not.

9 So, I just suggest it back -- I hear what you say but as  
10 I say I've heard the other argument in other proceedings and  
11 I just wondered if you'd just care to expand a little bit on  
12 why you feel -- if a VBA actually turned up, and even if it  
13 only had 5% of the market, how much are we entitled to  
14 believe that will restrain the market?

15 **PROF HAZLEDINE:** Well, Commissioner Curtin we have in fact heard  
16 even that the VBA market in the United States of America has  
17 operated in such a way, haven't we? That Southwest Airlines  
18 doesn't have to do very much before the incumbents lower  
19 their price quite markedly. I'm not aware of Professor  
20 Hausman's testimonies in other cases but we've heard about  
21 that in these hearings.

22 I would suggest that come commentators have been perhaps  
23 too eager to assume that these effects, if they are real, in  
24 the North American and European markets would apply in the  
25 Tasman and New Zealand market.

26 I think we've heard testimony that the product  
27 disadvantage of the VBA is larger here in the sense, because  
28 the full service airlines -- well, in the United States of  
29 America, I don't want to be rude, but I think the phrase  
30 "full service airline" is almost an oxymoron. They're not  
31 particularly good on the service side, the main airports are

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1 crowded and often dirty unpleasant places, there's plenty --  
2 there's a dense network of other smaller airports available,  
3 there's no national carrier, there's a reasonable list of  
4 factors which I think apply in North America but do not  
5 apply in New Zealand, which means that the VBA doesn't  
6 look -- you know, it's got a tougher competitor in the  
7 marketing sense than they have perhaps in the United States  
8 and maybe in Europe.

9 Secondly, on the cost side I think we've heard that  
10 perhaps, thanks largely to the efforts made by Air New  
11 Zealand recently, that the cost disadvantage of in  
12 particular Air New Zealand and possibly Qantas with  
13 JetConnect, is smaller here.

14 So for those two reasons I would suggest that the  
15 Commission -- I would respectfully submit that the  
16 Commission be quite careful about hoping, or relying on --  
17 indeed that's what it amounts to -- relying on very small  
18 scale entry by a VBA to keep the market honest.

19 **MR CURTIN:** Thank you.

20 **PROF HAZLEDINE:** I note that the model I used in the submission  
21 we prepared for Gullivers Pacific of July 18, with these  
22 additional factors of product differentiation and possibly  
23 more competitive base cases or counterfactuals, predicts  
24 price increases in the range 20 to 40%, which I believe is  
25 substantial.

26 I turn fairly briefly to the role of Fifth Freedom  
27 airlines, and I actually -- I don't want to repeat what  
28 Andrew Bagnall has said, and he has much more experience in  
29 this market -- they've offered a product for a long time,  
30 it's taken about 10% or less of the Tasman origin  
31 destination market. It's often been offered a full service



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1 product at a discounted price, as Mr Bagnall told us or  
2 reminded us, but they have failed to take over the market.

3 While I believe they have, and they must have some  
4 competitive constraint on the pricing of the incumbents,  
5 again I don't believe that this can be relied on, including  
6 with the increased capacity promised by Emirates to  
7 adequately constrain any desire by a cartel of Air New  
8 Zealand and Qantas to increase their price.

9 I turn to modelling issues. Formal mathematical models  
10 or market behaviour can be quite useful in producing  
11 estimates of the likely impacts on competition of structural  
12 arrangements such as this proposed cartel. I submit that  
13 the parties and the various experts have much common ground  
14 with respect to modelling, more than has been admitted to.

15 The basic framework has been Cournot-Nash oligopoly and  
16 the key features of this for non-economists' benefit are  
17 that firms act in their own best interests. That just means  
18 they don't co-operate with their rivals, despite which they  
19 are able to get the price up if the number of rivals  
20 reduces. That there are few firms, two, three four five  
21 probably, that they are selling a reasonably closely  
22 substitutable product, and that results in -- those are the  
23 assumptions -- and the implications are, as  
24 Professor Hausman showed us, that market shares are  
25 determined by relative costs. A lower costs supplier will  
26 supply more of the market.

27 So, where do the experts disagree? I've used this  
28 conjectural variations parameter which I believe -- which  
29 can represent a wider range of behaviour than just Cournot.  
30 It does allow you to incorporate non-normal or abnormal  
31 situations of particular and usually intense competition,

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1 and it has been noted by -- the use of this statistic or  
2 this parameter has been around for a long time and has been  
3 noted by many people, used by many people, including noted  
4 by Professor Willig.

5 **MR CURTIN:** I have to ask one thing there. I know in the Willig  
6 and Geurin-Calvert comments on your model, I believe they  
7 said that conjectural variations were actually logically  
8 inconsistent at some level with Cournot, whereas you have a  
9 reference here to Willig 91 almost saying the opposite, or  
10 at least -- how do we sort of reconcile either of those two  
11 comments or how should we think about CV versions of the  
12 model?

13 **PROF HAZLEDINE:** I think theory can become a straitjacket and it  
14 can prevent you from actually seeing the world as it is.

15 I think the theorists -- I'll put it this way  
16 Commissioner: My interest in this market goes back to the  
17 mid-90s when, as a student, I studied the behaviour of the  
18 same two airlines in dealing with the competition in Kiwi  
19 International, which was a small, as you know, VBA start-up  
20 out of -- ex-Hamilton. We found, I believe, that in 1995,  
21 before Kiwi turned up, the behaviour was pretty close to  
22 Cournot, the way they were pricing.

23 If that was the case, it would be impossible to describe  
24 it as Cournot in 1996 when they slashed fares by hundreds of  
25 dollars on the Tasman to, I believe, to get rid of Kiwi.

26 So, if you believe Cournot's okay in 1995, how are you  
27 going to describe 1996? That's my point. The theory I  
28 think has to follow the facts. People have to explain what  
29 longer term game might be being played in this market, which  
30 means that, even though you're not Cournot-Nash 1996, it  
31 doesn't mean you're being stupid, it means you're doing

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1 something, you're investing if you will in a future market  
2 outcome that doesn't have Kiwi International in it, for  
3 example. So, I believe that's the way these problems can be  
4 reconciled.

5 **MR CURTIN:** Thank you.

6 **PROF HAZLEDINE:** Product differential should be an issue and has  
7 been made such in Professor Hausman's testimony. NECG's  
8 model has homogeneous product assuming that the three  
9 airlines or any airlines are offering the same product.

10 That leads to some embarrassments that have been pointed  
11 out, that they have to suppress basically the Cournot model  
12 in their factual -- in fact, in their counterfactual to  
13 avoid saying that Virgin Blue would grab most of the market.

14 The better way to avoid that happening is to  
15 differentiate the products and say that the VBA is not a  
16 perfect substitute for the FSA product. I did that.  
17 Professor Gillen did that and he went further and I think  
18 this is in principle a good thing to do, he differentiates  
19 Air New Zealand from Qantas as well I believe, and with the  
20 Express fare service offered by Air New Zealand, that may be  
21 increasingly a smart thing to do, but I haven't done that.

22 How do we model what has become a key matter in this --  
23 perhaps a decisive matter in these hearings, things that  
24 don't exist yet, particularly this Virgin Blue operator?  
25 Professor Willig has given us guidance here; model a  
26 potential competitor as considering whether to offer zero  
27 output, in other words, not to turn up at all, or  
28 alternatively to offer some positive level of output that  
29 would be more profitable than not turning up at all.

30 I really relied on NECG to tell me what that level might  
31 be, and that may be not the best thing you could do; it was

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1 the best that I could do at the time.

2 One alternative, however, which I did introduce in the  
3 work for Gullivers Pacific was, let's say the VBA is in the  
4 market and it sort of becomes normal, it becomes a  
5 competitor with the other firms, in other words, it becomes  
6 a player in the Cournot game. I think it's probably pretty  
7 close to doing that in the Australia now, it's probably just  
8 become the other airline and is competing with Qantas in  
9 those terms, and I do show a scenario doing that as well.

10 Conclusion on modelling issues, a caveat really, these  
11 models can be useful tools, you shouldn't claim too much for  
12 them and you shouldn't expect them to be precise, and  
13 reasonable people can certainly disagree on the best  
14 strategy.

15 The expression, "sensitivity tests" or analysis has been  
16 used, and that's the way you handle this; you say, if  
17 reasonable people disagree, how much does it matter? If you  
18 find it matters a lot to the results, then you better put  
19 some time and effort into trying to narrow down that area of  
20 disagreement.

21 So, the bottom line, in my opinion here on the  
22 detriments is that New Zealand consumers lose between \$50  
23 and \$300 million a year -- would do from the cartel. Not  
24 all of this gets transferred as profits to the airlines,  
25 that is, there are deadweight losses familiar to presumably  
26 everyone in the room, or everyone at this end of the room,  
27 because of the restriction in output meaning that valuable  
28 flights, or flights that would have been worth more to the  
29 consumer than they would have cost to supply are not  
30 supplied.

31 On Professor Willig's approximation, it depends a bit on

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1 the number of firms, but around about a third of the  
2 consumer losses on a back of the envelope basis would be  
3 your likely estimate, when you do it properly in the model,  
4 that's probably what you're gonna come out with for the  
5 estimate for the deadweight losses. So, up to about  
6 100 million a year, and from much less than that.

7 Airline profits, I find that Air New Zealand's  
8 New Zealand shareholders, this is the ones who retain the  
9 77.5% holding -- I'm assuming they're all New Zealanders --  
10 gain the most scenarios but not all, up to about 60 million  
11 a year. I should note, and I thank Willig and Geurin-  
12 Calvert for forcing me to note this, that plus the one off  
13 \$550 million that they got for their shareholding. Qantas  
14 loses that sum of money but gains an annual profit flow  
15 increment of \$200 million a year, I calculate, just on these  
16 two routes; that is without including this profitable coupon  
17 clipping going on on the London route, and the Pacific  
18 routes. So, that's conservative.

19 Total airline profits can fall in the extreme scenario,  
20 which was touted as the most likely scenario in the original  
21 submissions by the Applicants and NECG, where you don't have  
22 a VBA entrant without the cartel, because I guess it's too  
23 tough for them, but they do come into the market under the  
24 price umbrella provided by the cartel.

25 So, if you make that competitive constraint very strong  
26 so that price doesn't change very much, which is good for  
27 the consumers, you lose in the profits and it becomes  
28 difficult to find the commercial motive for the cartel --  
29 for the alliance, let me call it that in this case; unless  
30 of course they will in fact yield substantial efficiencies,  
31 which they do claim.

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1           Okay, other benefits to the final part of my  
2 presentation. Three large sources of benefits are being  
3 claimed, tourism benefits, cost savings and engineering and  
4 maintenance work.

5           I'll quickly summarise findings on them. The common  
6 theme which I think is quite important. All three of these  
7 major claimed benefits are in essence generated by threats.  
8 Either the threat to not do something that makes commercial  
9 sense or the threat to do something that doesn't make  
10 commercial sense.

11           Specifically, to not do engineering or maintenance work  
12 at Christchurch that is currently profitable if the cartel  
13 were not permitted; to not do whatever it takes to bring  
14 potentially profitable tourists to New Zealand if the cartel  
15 should not be permitted -- and we've had the phrase "refusal  
16 to deal" in this connection; or in the third case to, do a  
17 rational war of attrition increases in capacity if the  
18 cartel is not allowed.

19           I don't know what the legal status of threats are, but  
20 certainly the economists ask, are these threats credible in  
21 the sense would it make -- can you find a commercial motive  
22 for carrying them out?

23           On tourism, three big issues; one, should indirect  
24 benefits and costs, and this is a general issue, be given  
25 weight? Should we go beyond what we're expert at, which is  
26 determining S L Cs and POP downstream or upstream in direct  
27 matters. If the Commission believes that such should be  
28 done what then is the likely impact on New Zealand tourism  
29 of the cartel and if it should find an impact, what are the  
30 benefits of costs of such impact and how should they be  
31 quantified?

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1           The problem with indirect benefits, as these are, any  
2 expert opinion is that economists are not expert in telling  
3 us, or predicting indirect benefits. The further you go  
4 away from the scene of the crime, or whatever, the worst  
5 your predictive power is, forecasting power. I think that's  
6 particularly true with these so-called multiplier models.

7           Also, beware of public good -- public benefits not  
8 captured privately. Some good authorities here. Adam  
9 Smith: Affecting scepticism about the good that might be  
10 expected to be done by those affecting to trade only for the  
11 public good. And Milton Friedman famously urging that "the  
12 only social responsibility of business is to maximise its  
13 shareholders' returns."

14           I think we've become more appreciative in the last  
15 decade of the ethical considerations that should constrain  
16 the maximising of shareholders' returns, but the point I  
17 think remains valid.

18           So, and even if you say, well, I believe irrationally  
19 Air New Zealand is going to be a good Kiwi corporate  
20 citizen, why on earth should we expect Qantas to be a good  
21 Kiwi corporate citizen? There's a big motive problem there.

22           Will the tourists come? As we know, the issue here is  
23 whether the Applicants can convince the Commission on the  
24 source of the market failure that currently prevents more  
25 than 60,000 foreigners from realising their latent desire to  
26 visit New Zealand. So far they haven't -- well, I don't  
27 mean this week, but up until this week they hadn't convinced  
28 anybody who mattered.

29           Will we want them? What are the benefits from tourists  
30 should they come? The Applicants I note with approval have  
31 abandoned their flawed cost equals benefits methodology that

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1 they used in their first submission, but they're now using a  
2 more objective general equilibrium model. I think there is  
3 still large problems with extracting reasonable and reliable  
4 numbers from that.

5 Commissioner Curtin put his finger on one of those when  
6 he asked about the terms of trade effects that are built in  
7 -- inescapable really in these general equilibrium models.  
8 What that means is that these models give monopoly power to  
9 even small countries. There are no small countries in these  
10 models. If you put the price of your exports up, you make  
11 more money. So, if you've read in the paper that the  
12 New Zealand dollar is a big problem for exporters; such is  
13 incorrect according to these models. The higher New Zealand  
14 dollar is good. They also mean that tariffs are good. Free  
15 trade is bad because you can get leverage by putting tariffs  
16 on a country and forcing the supply price of your imports  
17 down. Those are graph problems, I believe, with this class  
18 of models.

19 How can they be dealt with? Commissioner Curtin asked  
20 that question. The technical way is, you make the products  
21 more substitutable, you take the market power away, but then  
22 the model tries to take you to implausible scenarios of  
23 complete specialisation. In essence, New Zealand would  
24 become one big large smelly dairy farm, or possibly one big  
25 large over-crowded theme park. It would become a complete  
26 specialist in a very small number of activities. These  
27 problems have been with these models for a generation now  
28 and the models have not dealt with them, and that is a  
29 worry.

30 The second thing is, they tack these employment  
31 modifiers on to these models. They say, even if you don't



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1 like our project, it will create jobs downstream in the  
2 economy, and they assign benefits to that; they've done  
3 that, at least up to the medium term.

4 That's more arguable, whether you should do that or not  
5 but it -- I don't believe you should do that, I'll just  
6 leave it like that; if anybody wants to ask me why, I'll  
7 tell them. So, there are problems there. Dr Lattimore may  
8 wish to speak on -- he's an expert on these models, trade  
9 policy uses in particular, on other problems with the  
10 particular model used by NECG most recently.

11 Cost savings: Apparently these are still mostly the  
12 discredited, what I call in one of my submissions "get that  
13 elephant off my foot" savings. Basically you ask an  
14 elephant to stand on your foot. After a while you ask the  
15 elephant to stop standing on your foot; the relief is  
16 enormous, you count the relief as a benefit. The question  
17 is, why did you ask the elephant to stand on your foot in  
18 the first place? Why did you do something stupid in the  
19 first place like having a war of attrition or something like  
20 that? I think that's still the situation.

21 I'd also note that, as far as I'm aware, there's an  
22 inconsistency in the applicant's approach to these matters.  
23 They are willing to claim that additional tourist spending  
24 in New Zealand will reduce unemployment from its flow-on  
25 effects. They don't, as far as I know, admit that reduced  
26 cost spending in New Zealand, because of these cost savings,  
27 would increase unemployment for exactly the same reason and  
28 it could well be that those two effects cancel out. Now,  
29 the sums involved on cost savings in their claims, and on  
30 tourist benefits are very similar, and they should have been  
31 consistent on that.

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1           Of course the issue for an economist here is why can't  
2 you -- can you get these -- the test is, should these cost  
3 savings, should they be technically feasible, be realisable  
4 by non-anti-competitive means, such as code sharing?

5           In conclusion, my opinion at the end of this week is  
6 that the evidence and arguments to hand do not seem to  
7 justify, or even overturn, or even perhaps significantly  
8 modify your Draft Determination Commissioners. Thank you.

9 **CHAIR:** And thank you for that presentation, Professor, and I  
10 know that we do have quite a few questions that we would  
11 like to put to you, and I might suggest in this instance  
12 that we will start with our Chief Economist and our external  
13 e-commerce replies. So, please.

14 **DR PICKFORD:** I have a couple of questions for you Professor.  
15 One is the question of other routes where market power might  
16 be enhanced by the alliance.

17           You've concentrated your efforts on the Tasman and  
18 domestic New Zealand, but I presume you may have views that  
19 other markets -- I don't want to put words in your mouth --  
20 but other markets may be affected as well. Do you believe  
21 that and, if that is the case, to what extent would that  
22 augment the size of the detriments you've calculated just  
23 based on the Tasman and domestic New Zealand market?

24 **PROF HAZLEDINE:** Yes, Dr Pickford. Dr Bagnall has told us that  
25 he believes that the Pacific route is as large as the Trans-  
26 Tasman, or larger in fact.

27 **MR BAGNALL:** In dollar terms for Air New Zealand. Tasman is  
28 obviously twice the size, but when you add Qantas and Air  
29 New Zealand together.

30 **PROF HAZLEDINE:** So I would suggest, particularly on the LAX  
31 through to London run, if there was a substantial lessening

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1 of competition on that run as a result of the cartel, then  
2 indeed the detriments, not of course that -- I mean, as you  
3 do this there's many many more foreigners involved rather  
4 than New Zealanders, so you're discounting unfortunately  
5 perhaps from the point of view of the United Nations, but  
6 you'd be discounting that, but you would find indeed  
7 higher -- you would be propping up the detriments, the  
8 consumer detriments if you included them, as we all should I  
9 think, if you took account of those changes in those  
10 markets.

11 **DR PICKFORD:** The other question is that, your analysis relates  
12 only to detriments associated with allocative inefficiency.  
13 Has your work raised any issues about potential losses of  
14 productive or dynamic inefficiency as a result of this  
15 alliance?

16 **PROF HAZLEDINE:** The answer is, no. I admire your bravery in  
17 dealing with these items, with these factors or these  
18 potential sources of inefficiencies in your determination,  
19 and I certainly share the -- what I believe really is one of  
20 the two original rationales for antitrust policy; one being  
21 to protect consumers and small firms, but the other being a  
22 fundamental almost visceral belief that in the long-run  
23 competition is good. And what you mean by "in the long-run"  
24 of course, is for dynamic and productive efficiencies.

25 That you get -- we've heard many examples of this,  
26 including the example of what happened in this market when  
27 Ansett turned up in 1987, and air bridges suddenly appeared  
28 overnight and things. I personally believe, but I cannot  
29 help you with quantification of that, that you are correct  
30 to forecast dynamic and productive inefficiencies from the  
31 cartel.

1 **DR PICKFORD:** Thank you.

2 **PROF GILLEN:** I have some questions, particularly on your  
3 models and you didn't go into a lot of detail but I think  
4 it's useful to explore some of what has gone on.

5 If you looked at the models both in your original  
6 submission as well as the submission with Gullivers more  
7 recently, in all of your counterfactual scenarios prices go  
8 up even with VBA entry, and yet what we see in the NECG  
9 model is a totally different result, and why is it that this  
10 occurs in your model?

11 **PROF HAZLEDINE:** So, we're referring to the various  
12 counterfactual simulations in the Gullivers Pacific  
13 submission?

14 **PROF GILLEN:** That's correct.

15 **PROF HAZLEDINE:** As you know, the price actual 2003 is  
16 calibrated say to 1, and apart from the war of attrition,  
17 duopoly, where price falls, but the question is with the  
18 entry; in both scenarios CF3, CF4, in both markets the price  
19 is forecast to go up. That is because, in the case of the  
20 CF scenario 3 we're going up from a more than competitive --  
21 a more than Cournot -- a more than competitive Cournot base  
22 case now to just Cournot with the VBA entry.

23 If indeed the more than competitive -- if the two  
24 incumbents continued to be as tough on each other with  
25 Virgin as they are at the moment, then the price would fall  
26 in the counterfactual, because Virgin obviously adds some  
27 price discipline to the market.

28 **PROF GILLEN:** So, if you were to include a JetConnect and  
29 New Zealand Express in your model now, in fact the prices  
30 would fall?

31 **PROF HAZLEDINE:** Yeah, I say actually 2003 but what month in

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1 2003? The prices have fallen. I think I may be -- I think  
2 the market may be -- the base case may be even more  
3 competitive now than I've modelled it at.

4 **PROF GILLEN:** Okay. Third question is, why is it from your  
5 model that Qantas gains so much when you look at the changes  
6 in profitable Qantas gains, by far the lion's share?

7 **PROF HAZLEDINE:** Because they're Australians, that's what  
8 Australians do. I don't know -- beg your pardon, but I  
9 won't resile from that. They gain because they are major  
10 beneficiaries of this coupon clipping, as I call it, this  
11 rentier effect of getting 20% of operating profits from the  
12 other air carrier. I should say that that's not a bad thing  
13 in itself because it does potentially allow the cartel to  
14 rationalise, you know, who is the best airline on this  
15 route; you do it, and we don't mind you doing that because  
16 we'll still get 20% of the profits, but I think that's the  
17 major reason. I think that becomes quite a considerable  
18 factor in diverting profits.

19 The other considerable factor is of course that they've  
20 bought their share of the profits with their \$550 million  
21 equity purchase, and that leads to the question which has  
22 not been mentioned at all, perhaps because it's not germane,  
23 but is that a good price or not? Well, I guess that's not  
24 germane -- well, it should be germane because it's a public  
25 benefit issue; are they getting the airline cheap? I think  
26 they are getting it cheap on the basis of this because the  
27 pay-back period on that \$550 million is about 2 or 3 years.

28 **PROF GILLEN:** You've noted that all the models use Cournot  
29 and that there are -- you drew some of your information out  
30 of the NECG model, so there are some real similarities with  
31 the NECG model and your model and yet you get very different

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1 results. Can you perhaps explain why and also can you  
2 comment on what you think the strengths and weaknesses of  
3 the NECG model are.

4 **PROF HAZLEDINE:** Professor Gillen can you help me a little about  
5 the different results. Where specifically do you find the  
6 major differences.

7 **PROF GILLEN:** Between the NECG model and yourself?

8 **PROF HAZLEDINE:** In terms of the market analysis.

9 **PROF GILLEN:** In terms of what happens to the fares, what  
10 happens in terms of the benefits and detriments.

11 **PROF HAZLEDINE:** I don't know how they do their cost/benefit,  
12 but I get -- yeah. [**Pause**]. I don't -- see what I did in  
13 the first submission I made was attempt to replicate their  
14 results, and I think I got fairly close to doing that. I  
15 think a major -- okay. I think the major difference from  
16 that period is that they -- their preferred scenario has no  
17 VBA in the counterfactual and a very effective VBA or an  
18 effective VBA in the factual. I now think we should be  
19 running scenarios that are, as I said, before, with the VBA  
20 in all the time or with the VBA out all the time, but not  
21 have this loading for VBA to soften the anti-competitive  
22 impact of a cartel.

23 **PROF GILLEN:** So, might you speculate that, if in fact you  
24 did put those conditions and information in the NECG model  
25 that in fact it would change the results that they get?

26 **PROF HAZLEDINE:** You know -- well, I can't really -- I haven't  
27 tried to operate the NECG model. I would hope that it would  
28 not surprise me if I did do that.

29 **PROF GILLEN:** Okay. When you look at the savings that are  
30 generated by the NECG model, in your view getting the  
31 elephant off the foot, you're in a sense rationalising the

1 excess capacity that you're getting.

2 Do you find it surprising or odd that, as NECG said,  
3 that the differences in the capacity in the factual and  
4 counterfactual are really very small, and so you're talking  
5 about changing very little capacity and you're talking about  
6 relatively small changes in fares and you're getting all of  
7 these benefits.

8 Is that a surprising result to you?

9 **PROF HAZLEDINE:** So NECG are getting all these benefits?

10 **PROF GILLEN:** That's correct.

11 **PROF HAZLEDINE:** They don't actually fight their war of  
12 attrition. That's my understanding. They don't -- they  
13 have it both ways, or they had it both ways in their  
14 original submission. They use, as has been noted, the  
15 Cournot pricing formula, but they don't use the Cournot  
16 model in these things, so they say, well, what happened to  
17 price and nothing much happens to price because adding the  
18 extra capacity doesn't change marginal costs I believe, or  
19 not materially.

20 So, they don't get much pricing action from it. If they  
21 actually fought the war of attrition, then the price would -  
22 - the counterfactual price would be much lower than they  
23 predicted that it would be -- than they currently predict.  
24 Does that address your concern?

25 **PROF GILLEN:** That's fine, that answers my question.

26 I guess the final point is, you subscribe to the notion  
27 that you look at the facts and try and look at a model that  
28 is at least going to allow you to represent the reality of  
29 what's going on in the marketplace, and again I come back to  
30 the results of your model that shows that fares are going up  
31 and yet when we saw, for example, the evidence of Dr Winston

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1 as well as the evidence of Dr Hausman, that when you have  
2 more players in the market and particularly when Virgin Blue  
3 enters you do get this depression of fares, so how does  
4 that, kind of the reality check of what's going on in the  
5 market again accord with what's happening in your model?

6 **PROF HAZLEDINE:** Well, if one goes, say, from my counterfactual  
7 2 to counterfactual -- sorry, to factual F2, in which case  
8 you have a Cournot duopoly without the entrant, and then the  
9 entrant does come in, then I predict that the price falls.

10 **PROF GILLEN:** Is it fairly close to what -- the kinds of  
11 results that we see on the Australian market? I mean,  
12 empirically?

13 **PROF HAZLEDINE:** Yes -- well, I haven't quality checked or  
14 whatever you like to say, the results of Dr Tretheway, so I  
15 haven't seen his regression model. He said 10% effect of  
16 Virgin Blue. Professor Hausman has had a look at these  
17 results, and he thinks it's a bit smaller than that, but  
18 that's the sort of number that comes out of my model too.

19 **PROF GILLEN:** Okay, thanks very much.

20 **MR PETERS:** Professor Hazledine, you mentioned just now that the  
21 NECG model doesn't seem to run a Cournot model, it just  
22 seems to assume Cournot pricing in that the counterfactual  
23 and the factual capacities are inputs to the model. Can you  
24 elaborate on your views on this aspect of the NECG  
25 modelling?

26 **PROF HAZLEDINE:** Yes. They had to do it because, if they hadn't  
27 done it, then if they'd played Cournot, given that they're  
28 assuming that the VBA is offering identical product to the  
29 FSAs, then the VBA -- and given that the VBA has lower  
30 costs -- the VBA would have gobbled up most of the market in  
31 the factual. There would have been a cartel and the VBA,



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1 and the VBA would have had about probably two-thirds of the  
2 market on their sort of cost differentials that they tell us  
3 are realistic.

4 So, they to do it or they would have got something which  
5 no-one would have believed immediately. So, they did  
6 something which no-one eventually believed once they figured  
7 out what they'd done; but I can understand, I suppose, why  
8 they did it.

9 **MR PETERS:** In the NECG model, I'm not sure if you've looked at  
10 it in this detail, but there seems to be this unexplained  
11 disconnect between price and capacity variables, and well,  
12 it happens on several routes, but in particular on the  
13 Sydney-Queenstown there was a substantial increase in  
14 capacity in the factual, and yet there's a significant price  
15 increase in the factual over the counterfactual.

16 Can you comment on what effect this might have had on  
17 the model's ability to predict the effects of the proposal?

18 **PROF HAZLEDINE:** This matter has been referred to earlier today,  
19 hasn't it? In some routes the price goes up -- sorry, the  
20 capacity goes up.

21 **MR PETERS:** Yes, and the price goes up as well.

22 **PROF HAZLEDINE:** Well, I believe it's because of this  
23 disconnect. That, of course, you want me to comment on it.  
24 The reason is presumably because the capacity is not linked  
25 to the price; they use the pricing -- the price cost markup  
26 formula from the Cournot model, but they don't bring the  
27 capacity back in to actually determining that outcome.

28 But I think your question was, well, if you did it  
29 properly, is that what you are asking? What would happen?  
30 The price should fall, yeah. If they put more capacity in  
31 the market, and you fill the seats, then you're going to

1 have to lower the price to do that, yeah.

2 **MR PETERS:** Just one more question. NECG's assumptions of pure  
3 Cournot pricing in both the factual and counterfactual were  
4 challenged on the bases that, one, the market is unlikely to  
5 be in a stable equilibrium during the periods modelled due  
6 to the war of attrition and entry by a VBA.

7 And two, that dynamic oligopoly models do not generally  
8 predict Cournot pricing in all periods. NECG's response was  
9 that pure Cournot pricing in both factual and counterfactual  
10 was conservative or unlikely to add bias.

11 Can you offer any comment on this?

12 **PROF HAZLEDINE:** I believe, on the facts of the market as I see  
13 them, that it does add -- it's not conservative; that's the  
14 opposite concern. What's the opposite? That, in fact, the  
15 market at the moment is more competitive than Cournot and  
16 would stop being so if the cartel was formed, therefore the  
17 price jump that I would forecast would be great.

18 So, I don't accept that in that respect NECG are acting  
19 or being conservative.

20 **CHAIR:** Thank you for that. I believe we have Dr Lattimore  
21 next, if I'm correct. Sorry, if I'm wrong, just correct me.

22 **MR LATTIMORE:** Mr Hope and I were not going to make a  
23 presentation in the interests of time but just make  
24 ourselves available in case there were questions on the  
25 submissions that we've been associated with earlier with  
26 Gullivers and with Professor Hazledine.

27 **CHAIR:** I'll just check on that.

28 **PROF GILLEN:** Professor Lattimore, one of the things that  
29 I've wondered about, and I know very little about general  
30 equilibrium models and treat theory is, how are changes in  
31 the exchange rate handled? Because we know that, with

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1 tourism, one of the most significant factors driving  
2 tourists into different destinations is changes in currency  
3 value?

4 **MR LATTIMORE:** The difficulty -- I can really just reiterate  
5 what Professor Hazledine has just told you, that computable  
6 general equilibrium models do have this problem of either  
7 tending to overestimate or underestimate the market power of  
8 a country depending on how you set them, and from that point  
9 of view you can get quite arbitrary responses from analysis  
10 of a particular issue.

11 What it means in particular is that one needs to use  
12 other pieces of analysis of market behaviour in the  
13 particular markets, partial equilibrium models, for example  
14 in conjunction with those, or at least to have a thorough  
15 understanding of how those markets operate in using a  
16 computable general equilibrium model of an economy.

17 Could I extend that just a little further because  
18 Commissioner Curtin and one of the staff of the Commission  
19 raised a couple of issues the other day that I think are  
20 important here.

21 We have seen in these proceedings over the last couple  
22 of months the amount of -- the resources that have gone into  
23 testing the Cournot models, the oligopoly models in this  
24 case. The resources that would be required to test a  
25 computable general equilibrium model of the New Zealand  
26 economy would be orders of magnitude greater than what we've  
27 seen for the Cournot models because they are so much more  
28 complex, they're dealing with a whole economy, not just a  
29 couple of markets or a single market in the case of Cournot  
30 model.

31 I think it's also important to realise, as economists

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1 do, that a computable general equilibrium model can be  
2 roughly described as being an input/output table on the one  
3 hand with many hundreds if not thousands of parameters  
4 imposed upon that to drive the model.

5 In the case of -- now, there are two problems with  
6 models like that for the New Zealand economy. One problem  
7 is that whilst I haven't looked in detail at Professor  
8 Dixon's model of the New Zealand economy from Melbourne, all  
9 the other computable general equilibrium models in Australia  
10 of the New Zealand economy are based upon the 1987  
11 input/output table.

12 As we all well realise, the transformation of the  
13 New Zealand economy in the last 16 years has been quite  
14 significant, and that's a potential problem for the analysis  
15 of models which are so out of date in terms of date, not  
16 that they can ever be completely up-to-date given the  
17 infrequency with which input/output tables are produced.

18 But the second problem that's particularly acute for  
19 computable general equilibrium models of the New Zealand  
20 economy is that, of the hundreds and thousands of parameters  
21 in the model, 99% of them are guesstimates. They have never  
22 been estimated in a New Zealand market environment.

23 So, if you think these Cournot models are -- in the  
24 flip-flops that they can show, depending exactly how they're  
25 specified, it's even worse with a computable general  
26 equilibrium model of the New Zealand economy.

27 So, it's very very important that the person that is  
28 doing the runs is very very familiar with the markets that  
29 they're dealing with, in this case the tourists markets, and  
30 the way in which they're interlinked into the other markets  
31 in the New Zealand economy, and the same criticism applies

1 to looking at employment effects.

2 I agree, I'm not sure Professor Hazledine does, but I  
3 agree with NECG that there are some circumstances where it  
4 might be important to take employment generating effects  
5 into account in these sorts of evaluations, and this might  
6 be one of them.

7 One reason for that in the New Zealand case is the  
8 tourism sector is extremely intensive in its use of  
9 unskilled labour, and New Zealand does have some serious  
10 unemployment problems with people in these categories, in  
11 particular regions of the country, and the two particular  
12 regions that I have in mind are Northland and the East  
13 Coast.

14 Now, we're not talking about creating direct links from  
15 Ruatoria to Sydney here, but to the extent that there are  
16 any of those sorts of links involved in an expansion or  
17 change in the tourist activity, then one might want to take  
18 those into account.

19 But, modelling employment gains is something that I  
20 think mainstream economists believe is best left to labour  
21 market models, not to the sledgehammer approach of a  
22 computable general equilibrium model which is of dubious  
23 structure and interpretation in a particular environment,  
24 and we have good labour market policy that can be used for  
25 that purpose. It's a matter of best practice.

26 **PROF GILLEN:** I've looked at the American and the Canadian  
27 input tables over time, and one of the things that you do  
28 see is that, in those industries which are relatively  
29 aviation intensive, the technical coefficients change and  
30 presumably that reflects changes in relative prices as --  
31 from substitute aviation services for other services.

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1           So, to the extent that you're using a 1987 set of  
2           coefficients, and you've observed changes in relative  
3           prices, and presumably firms in the market have responded to  
4           those, how might this bias the kinds of results that we're  
5           seeing from these CGE models?

6 **MR LATTIMORE:** That's extremely difficult to tell. First of all  
7           let me say I have not checked the input/output table that  
8           underpins the social accounting matrix of Professor Dixon's  
9           CGE model, and that needs to be done before exploring the  
10          bias. But a priori, I don't have any -- I don't know what  
11          the change in structure might have done to those  
12          multipliers.

13 **PROF GILLEN:** Thank you.

14 **CHAIR:** Now, if I can ask if that completes your presentation?  
15          Did you have any further comments you'd like to make?

16 **MR BAGNALL:** No.

17 **CHAIR:** I would then like to thank you very much for your  
18          considerable effort and expense that you have gone to to  
19          present evidence to the Commission; it's been particularly  
20          helpful to have the additional work done from a modelling  
21          perspective. We often don't get that so we've valued that,  
22          and in addition to have people come before us with industry  
23          expertise in the area of tourism which is critical to this  
24          application, as is also noteworthy, so we thank you very  
25          much.

26          And I propose now to break for afternoon tea and when we  
27          return at, I think we were supposed to return at about 3.15,  
28          I'll change this slightly, we'll start with Origin Pacific  
29          then rather than start and break after that. So, thank you  
30          very much.

1                   Adjournment taken from 3.05 pm to 3.27 pm

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5

**PRESENTATION BY ORIGIN PACIFIC**

6

7 **CHAIR:** Okay, I'd just ask everyone to be seated please.

8

I'd like to reconvene this session and I'd like to  
9 welcome Origin Pacific and would invite you to present to  
10 the Commission and if you could, for the record, state your  
11 name and I'm sure we'll have questions for you at the end,  
12 thank you.

13

**MR MARKS:** Good afternoon Madam Chair, Commissioners my name is  
14 Tony Marks, I'm Chief Executive of Origin Pacific, the small  
15 Nelson based regional airline founded by Robert Inglis in  
16 1997.

17

I trust you will forgive me first by not being able to  
18 afford any lawyers to introduce me, and secondly, not having  
19 a PowerPoint presentation either. We've also cut down some  
20 of the points that we would intend to make on the basis that  
21 some of the points I think have been very well covered by  
22 previous presenters.

23

In the New Zealand Herald on 22 July the Applicants  
24 accused their opponents of ignorance and lacking expertise  
25 and knowledge, so I feel it's important that we'd like to  
26 spend a few minutes establishing our credibility.

27

Firstly, Mr Inglis has been acknowledged by the  
28 Commission in establishing and developing a successful  
29 airline, Air Nelson, not "Nelson Air" as it's in some of  
30 your papers from the Applicants. Mr Inglis, therefore,  
31 probably knows more about the requirements of developing a

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1 successful provincial airline than anyone else in the  
2 country; far more so than any so-called independent experts  
3 who, I would note, collectively and individually have made  
4 no attempt whatever to contact us to discuss their  
5 assumptions or their conclusions when developing their  
6 position on regional routes. Not even a phone call. So, I  
7 would respectfully suggest that their independence and  
8 informed view is not that.

9 I would therefore submit that our views on regional  
10 airlines should be registered as having greater weight than  
11 any others put before the Commission. The experts can talk  
12 about regional New Zealand from their bases in the  
13 United States and in Europe. Mr Inglis has not talked about  
14 developing regional airlines, he's actually done it, and  
15 done it successfully.

16 As for myself, I was successively General Manager Sales  
17 and Marketing and General Manager Commercial for Air New  
18 Zealand International between 1989 and 1998 and was  
19 responsible during those 9 years with the then Managing  
20 Director, Jim McCrea, for the development of the  
21 international airline's strategy, marketing and alliance  
22 development.

23 During my time at Air New Zealand we recovered from a  
24 period of poor profitability in the early 90s, went through  
25 shareholding-backed alliance with Qantas, incorporating a  
26 full revenue profit share across the Tasman and the  
27 potential for further co-operation, survived the collapse of  
28 that arrangement in the mid-90s and the independent  
29 expansion of Air New Zealand to several parts of Asia, Japan  
30 and the United States, and ultimately strong international  
31 profitability. We also developed alliances with United



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1 Airlines, Lufthansa, Air Canada, Ansett and Singapore  
2 Airlines which culminated with successful entry into the  
3 Star Alliance.

4 I hope you will understand that I'm not saying this from  
5 any sort of self-promotion or aggrandizement, but more that  
6 Robert and I can claim to have some genuine knowledge and  
7 expertise in the business, and we can hopefully avoid the  
8 sobriquet of ignorance on the key issues.

9 We intend to keep this submission short as we believe  
10 the Commission is probably suffering from witness fatigue.  
11 In our first submission we highlighted the benefits of  
12 competition in provincial New Zealand through the creation  
13 of Origin Pacific, and the subsequent combination with  
14 Qantas, and the critical importance to Origin's position of  
15 having such a partnership to help regional development and  
16 compete with Air New Zealand in the provinces.

17 The alliance tended to belittle this need, indicating  
18 that it was a false assumption for Origin to have expanded  
19 in conjunction with Qantas if it sought longevity, and they  
20 offer two potential futures for Origin; a substantial  
21 reduction in size or an alternative partnership.

22 The alliance in all their submissions purport that the  
23 partial or complete cessation of the Qantas Origin  
24 relationship will have no effect on either the market or on  
25 Origin's ability to expand. We believe this to be a  
26 complete misrepresentation of both the market dynamics and  
27 Origin's abilities and we concur with the Commission's Draft  
28 Determination, Origin Pacific's ability to compete "will be  
29 reduced".

30 Access to feeder traffic from international flights is,  
31 as the Commission has noted, very important to survival and

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1 existence in provincial markets. With Qantas and Air New  
2 Zealand dominating in-bound and out-bound traffic, we agree  
3 with the Commission that it is very unlikely that any other  
4 market participant would be able to access the feeder  
5 traffic; indeed, it will probably be sequestered at the  
6 point of departure.

7 The Tasman traffic, regardless of carrier, is  
8 predominantly local; that is, it is Australian or  
9 New Zealand origin and there is not very much international  
10 traffic being carried. Don't be seduced by the methodology  
11 of dual destination across the Tasman; both airlines, and  
12 particularly the New Zealand Tourism Board have done a  
13 spectacular job in achieving mono-destination traffic.

14 Again, as illustrated in the Draft Determination, the  
15 alliance would have a minimum market share of 95%. That  
16 would rise to around 98% should it replace Origin Pacific's  
17 seats on the Christchurch-Wellington route, as seems  
18 implied. Origin, far from expanding as alleged by the  
19 alliance, would in our opinion be contracting.

20 We have noted that on behalf of the Applicants Dr Willig  
21 has attempted to look at some of the provincial routes and  
22 has reached some conclusions and we'd like to examine those.  
23 Firstly we'd like to draw the Commission's attention to the  
24 domestic routes being "superficially susceptible to the loss  
25 of competitive pressures following the alliance", assuming  
26 no new contenders. We believe this to be a massive  
27 understatement in the context of Air New Zealand and Qantas  
28 exercising their 95% market share, robbing Origin Pacific of  
29 its codeshare partner, the importance of which the  
30 Commission is fully aware.

31 If the acquisition of a 95% domestic market share has "a

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1 superficial effect on competition" I would love to know what  
2 would have to happen in Dr Willig's opinion for something to  
3 seriously upset the competitive apple cart. Of course with  
4 a new competitor things would change a bit depending on  
5 their penetration.

6 In Dr Willig's note 83 Origin is quoted as "a potential  
7 competitor on domestic New Zealand routes", and as we are  
8 already flying domestically, we must assume that he means on  
9 the main trunk. In the same note, we go from a potential  
10 competitor, through his analysis, to be able to able to  
11 "serve as an effective competitor to the alliance and  
12 domestic New Zealand". So, we've gone from potential  
13 competitor to an actual competitor across all domestic  
14 markets. However, immediately afterwards in note 84 he  
15 completely contradicts this assertion by saying "Origin  
16 Pacific may not serve as an effective competitor on the main  
17 trunk routes", thus completing our journey from a potential  
18 main trunk competitor to an effective competitor, to an  
19 ineffective competitor, presumably back where we started,  
20 all in two paragraphs.

21 So, having killed off our main trunk abilities, he then  
22 goes on to discuss Christchurch-Wellington. In a  
23 fascinating analysis in item 84 which rightly says that  
24 Origin Pacific offers 6,000 seats a week, with 4,000  
25 contracted to Qantas; 68% to be exact. After the alliance  
26 Dr Willig asserts that Qantas' codeshare will cease and he  
27 cites Origin saying this in February, which by the way we  
28 did not, and possibly contradicts Qantas' submission that  
29 opportunities will still exist.

30 Anyway, let's assume that Willig knows more than we do  
31 and that he has information that it is the Christchurch-

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1 Wellington service on which the alliance may replace Origin.  
2 According to Dr Willig's analysis, Origin will lose 68% of  
3 its business to its now sole competitor, with a 98% market  
4 share, but Origin will continue to offer 6,000 seats a week  
5 regardless. We would invite the Commission to join us in  
6 expressing some commercial incredulity at that.

7 Continuing to extrapolate from the same Wellington-  
8 Christchurch example, Dr Willig also says "we have been  
9 exposed to no evidence that would suggest Origin Pacific  
10 would be a substantially less competitor with the alliance".  
11 This after the acknowledged loss of 68% of its business to  
12 its sole opponent.

13 In item 88 he goes on to assert that Origin has  
14 acknowledged that capital is not a barrier on provincial  
15 routes, quoting us as the source. What we actually said was  
16 that barriers to entry in the provincial market relate to  
17 scale, for a small operator with limited services in a local  
18 area there are minimal barriers. However, we said that to  
19 expand into a full provincial service there are major  
20 capital and associated requirements which contribute the  
21 barrier, especially obtaining and servicing capital. We  
22 feel it's one thing to make assertions but it is poor  
23 scholarship to deliberately misquote us and get it 100%  
24 wrong.

25 In items 90 and 91 Origin is alleged to be able to offer  
26 a competitive constraint on Wellington-Christchurch because  
27 we fly larger aircraft, ATRs with 64 seats. Dr Willig has  
28 conveniently forgotten this point two pages earlier that  
29 these aircraft are totally dedicated to Qantas and he  
30 assumes that Origin can simply just fill them up with other  
31 passengers.

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1           Also in his point 91 he says "we are well positioned to  
2 compete because of the volume of local traffic, using an  
3 example of Wellington-Dunedin, because 68% of the traffic is  
4 local and any concerns about the roll of feed as a barrier  
5 are "misguided" we would suggest that perhaps it's Dr Willig  
6 who's misguided, we actually don't fly the Wellington-  
7 Dunedin route.

8           However in item 92 he makes the point that feed is an  
9 issue after all on Christchurch-Queenstown but however it is  
10 "far from evident that the alliance would harm competition".  
11 Seeing as the Christchurch-Queenstown route will become a  
12 100% Air New Zealand/Qantas route and that by his admission  
13 65% of the traffic is international, where exactly is any  
14 competition going to come from and far from the alliance not  
15 harming competition, we would suggest it was self-evident  
16 that this key tourist route will become a monopoly.

17           There's a presumption then that regardless of our lack  
18 of effectiveness on the main trunk, the partial demolition  
19 of our capacity sale to Qantas on Christchurch-Wellington,  
20 and half our other routes, a monopoly position on tourism  
21 routes, and major barriers to entry or prosperity, we and  
22 provincial New Zealand will be saved by acts of God or  
23 Virgin Blue, whichever comes first.

24           We now also know that Air New Zealand has an excellent  
25 track record of defending its domestic position. After all,  
26 Mr Murdoch's Ansett millions failed to dislodge the  
27 company's preeminence, and with the Express product,  
28 pricing, airpoints, schedules, frequency and other  
29 advantages, if you will forgive me paraphrasing Shakespeare,  
30 "me thinks yon Ralph doth protest too much" when talking  
31 about their domestic vulnerability.

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1           We would therefore wish to simply restate our concern  
2 regarding the proposed alliance and recap our position. In  
3 our original submission we stated inter alia, the benefits  
4 from the alignment with Qantas and expansion into more  
5 routes and bigger aircraft were highly beneficial both for  
6 provincial New Zealand, Origin Pacific and Qantas. We have  
7 steadily expanded by virtue of meeting the requirements of a  
8 long-term partner and we've been able to increasingly meet  
9 the need for competition in provincial New Zealand.

10           The competitors to Air New Zealand on the main trunk  
11 route requiring regional feed was critical to our position  
12 as a provincial carrier and that of any other provincial  
13 carrier of any substance.

14           Origin lacked the necessary capital to expand on the  
15 main trunk routes, and in any event now, successful  
16 competition with an anticipated virtual monopoly, together  
17 with all the attendant virtues of scale and presence could  
18 not be financially sustained.

19           We note that the Applicants "largely agreed with much of  
20 what Origin Pacific has said". Although questioning the  
21 importance of Qantas' feed to Origin's viability, the  
22 Applicants conceded that without any feed "it will merely  
23 result in Origin Pacific returning to a scale of operation  
24 and growth that it envisaged when it initially entered the  
25 segment in 1997". Quite how this transition either benefits  
26 or fosters competition, we don't think has been adequately  
27 explained.

28           The Applicants also seem to believe that their actions  
29 will have little or no effect on the operations of Origin  
30 Pacific. As previously indicated, the Applicants have  
31 always held out that either Virgin Blue or a Fifth Freedom

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1 carrier will be our salvation. Indeed, our current  
2 arrangements with Qantas "will assist Origin Pacific in  
3 dealing with the transition period prior to Virgin Blue's  
4 expansion" and their subsequent submissions continue to  
5 strongly promote either or both of the above possibilities  
6 as a viable alternative.

7 We would make the following comments. Fifth Freedom  
8 carriers have been flying the Tasman for many years as the  
9 Commission has learned, and none so far have ever felt the  
10 need for a relationship with Origin, despite our codeshare  
11 relationship with Qantas not being exclusive.

12 The lack of a main trunk presence would be the logical  
13 reason for the lack of interest, and the Applicants know  
14 this perfectly. The main trunk is the feeder mechanism for  
15 provincial New Zealand, and as Qantas has acknowledged,  
16 making losses on this route despite its market power and  
17 penetration, the Applicants would be well aware it would be  
18 financial suicide for Origin Pacific to enter the route.

19 Origin has few flights to Auckland, which is the main  
20 destination of Trans-Tasman flyer's Fifth Freedom traffic.  
21 So, to counter the alliance offering several flights from  
22 Sydney to Auckland and then onwards to Wellington and  
23 Christchurch from Auckland 10 to 20 times a day and all  
24 their provincial networks, the Fifth Freedom carriers, were  
25 they to hook up with Origin Pacific, would have to put their  
26 passengers on a twice a day flight to Wellington or  
27 Christchurch via Nelson. We don't think it's a serious  
28 proposition. One expert witness did say that Sydney-Nelson  
29 could work, so we live in hope, but as a 737 can't actually  
30 land there, it could be a little difficult.

31 Qantas supplies Origin with traffic from its extensive

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1 global network and we feel it begs credibility that there  
2 would be "no lessening of competition and no material impact  
3 in the market as Origin without Qantas will continue to  
4 compete." The Commission is well aware, as are the  
5 Applicants, of the importance of Qantas to Origin's current  
6 and future viability.

7 Virgin Blue, were it to become associated with Origin  
8 Pacific in some form, and we hope that it does, has a  
9 smaller network or feed capability, and by definition the  
10 quantum and nature of the traffic would be significantly  
11 different and unlikely to be any form of serious replacement  
12 for the business lost to the alliance in the short-term.  
13 However, this relationship does offer a lifeline in the  
14 event of the merger proceeding.

15 Finally, it has been stated that Air New Zealand exiting  
16 Star will benefit Origin. Having had some involvement with  
17 the entry to Star, I can understand why wisely the authors  
18 make no argument whatsoever as to why that should occur.  
19 The alliance, one can legitimately assume, will seek to  
20 optimise the opportunities afforded by the gains in traffic  
21 taken from Origin. Origin, therefore, just to stand still  
22 has to find urgent opportunities to replace this business,  
23 opportunities which will be very difficult to secure.

24 As indicated in our submission, and as perhaps  
25 encouraged by the Applicants, Origin would have to down  
26 gauge its operations. In our confidential submission Origin  
27 has indicated the nature and depth of the process it is  
28 likely to have to follow, which is contrary to the concept  
29 that there would be no lessening of competition.

30 In summary, therefore, the differences between the  
31 current market competition, Air New Zealand versus Qantas



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1 and Origin, and the proposed market competition -- Air New  
2 Zealand and Qantas versus Origin -- would be that Origin  
3 would lose most of its Qantas business, have no main trunk  
4 feed unless Virgin Blue fly the route and we can do a deal  
5 with Virgin Blue, be forced to look at downsizing in  
6 provincial markets, face major schedule and frequency  
7 inequities; we feel we'll have to reduce our commitment to  
8 serve provincial New Zealand, and we may indeed act as an  
9 example of the difficulty of getting established and then  
10 having the playing field dramatically tilted against you.

11 Origin, therefore, endorses the Draft Determination and  
12 sees little evidence of any great concern over the impact on  
13 regional and provincial services. We believe that these  
14 markets have been perceived as only of having incidental  
15 importance, notwithstanding the acknowledgment that between  
16 25 and 40% of traffic in New Zealand emanates from, or is  
17 destined to a provincial port.

18 In our latest submission we tried to be explicit on the  
19 economics of operating a regional airline. Air New Zealand  
20 itself is claiming that it cannot compete in major markets,  
21 perhaps even domestically, without a partner, which seems to  
22 be shorthanded as partnerships equals prosperity and  
23 loneliness equals poverty; either in money or in scale. Yet  
24 it seems to be accepted that there will be little or no  
25 competition regionally, and that perhaps this is a small  
26 price to pay for an alliance.

27 We believe we can survive and possibly ultimately  
28 prosper, but we would have to acknowledge we're going to  
29 find it very difficult indeed if our feed dries up or the  
30 Applicants fully exercise their 98% market share. However,  
31 we do note that perhaps something of our Qantas relationship

*Origin Pacific*

1 may survive and we simply don't know.

2 In conclusion, Origin Pacific has confined its comments  
3 today to provincial New Zealand. Our basic proposition is  
4 that it's hard to make sustained profitability or relatively  
5 thin provincial routes even with a low cost structure, that  
6 sustainability depends on compatible partnerships with  
7 complementary feed requirements, hence the relationship with  
8 Qantas which fulfilled those requirements.

9 The total or a substantial loss of these arrangements  
10 and any inability to substantially replace them gives a  
11 relatively bleak prospect to any provincial carrier.

12 The combination of virtual control of in-bound and out-  
13 bound international traffic, coupled with a huge domestic  
14 market share, a 70% market share on the Tasman and 100% from  
15 the United States and from Japan means any carrier, no  
16 matter how well funded, is going to struggle for penetration  
17 or profitability in the near term.

18 In the interests, therefore, of preserving some form of  
19 regional competition, or perhaps preserving the opportunity  
20 for regional competition, we would urge the Commission to  
21 turn down the application. Thank you for your time.

22 **CHAIR:** Thank you very much for that, Mr Marks, and we would  
23 like to ask you a few questions, if we may.

24 The first question I'd really like to ask you is, we  
25 have asked other parties about whether an alliance with  
26 another carrier such as Virgin Blue, would that address the  
27 issues that you have in terms of any market power that the  
28 alliance would possibly lead to in the provincial markets?

29 **MR MARKS:** I would very much like to think so, although  
30 listening to Mr Huttner yesterday, I think he gave us all  
31 the distinct impression of where their priorities will lie.

*Origin Pacific*

1 He also did not confirm, and we do not have any knowledge of  
2 when they may come, and with what degree of capability. So  
3 on the assumption, I think one would have to make an  
4 assumption in the first year at least that they will be  
5 relatively small and will focus their efforts on main trunk  
6 activity.

7 Mr Webster in his presentation seemed to imply that the  
8 route to prosperity was to attack the key routes rather than  
9 the marginal routes.

10 So on that basis certainly we will be able, assuming  
11 that we could reach a commercial relationship, we would be  
12 able to replace some of our traffic; it would be helpful,  
13 but it would, as I said, in my submission, it would not be  
14 of the same quantum, or perhaps quality of the traffic that  
15 Qantas can bring in, simply because Qantas has worldwide  
16 capability rather than just Australia capability.

17 **CHAIR:** So, can I take it from what you've said that you haven't  
18 actually -- and if it's something you can't comment on  
19 please tell me, but you haven't actually had discussions  
20 with Virgin Blue?

21 **MR MARKS:** We have had discussions with Virgin Blue, but we are  
22 nowhere near fully understanding what their intentions might  
23 be, or having any form of commercial arrangements with them.

24 **CHAIR:** I just want to get your view about another matter, and  
25 that is, can you envision a situation where it would be  
26 worthwhile for Virgin Blue to move from the main trunk into  
27 the provincial routes?

28 **MR MARKS:** On the assumption that they maintain their successful  
29 formula which is to operate 737 aircraft, the number of  
30 provincial routes depends on your definition of  
31 "provincial", it does move around a bit. I mean, I note

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1 Mr Huttner talked about Auckland-Dunedin as a route that he  
2 seems to be focused on. There are one or two regional  
3 airports in New Zealand which can accommodate 737 aircraft.

4 The issue is probably more that Air New Zealand, I  
5 think, have done an excellent job in matching their types of  
6 aircraft to the route requirements and, therefore, they've  
7 got 737s on the main trunk and other routes but then they  
8 have ATRs and then they have Beech 19Ds, so they've got a  
9 complete mix of aircraft. Because, as in routes like across  
10 the Tasman, it used to be that you put a 747 on at 8 o'clock  
11 in the morning and that was what you did. Subsequently  
12 frequency became far more important than grunt, and I would  
13 suggest that that's still very true in many of the markets.

14 We find that the difficulty of competing with Air New  
15 Zealand is not necessarily one of price, but it's certainly  
16 one of frequency, and so consequently even if some of these  
17 regional airports can accommodate a 737, you may be able to  
18 generate more traffic, but on the other hand putting a 737  
19 in once a day may be significantly less effective in that  
20 market than putting a Saab in five times a day.

21 **CHAIR:** Just one last question from me and then I'll ask my  
22 colleagues to direct questions, but how different is your  
23 situation now than say when you entered.

24 **MS BATES QC:** I mean, I would have thought now you have  
25 developed some brand awareness and loyalty and some of your  
26 business must be driven simply from people in your own  
27 markets who have loyalty to you.

28 I just want to get a sense of how you see that?

29 **MR MARKS:** Well, I've only been with the airline a few months  
30 and so therefore I -- much of what I might say is what I  
31 have picked up and also from observation rather than from

*Origin Pacific*

1 experience. I believe Origin has carved out a market niche  
2 for itself, and in some markets where there are -- there is  
3 the opportunity of putting frequency on, then there is the  
4 opportunity of competition.

5 But if we go back to the Christchurch-Wellington market  
6 as perhaps apposite. There is one where I believe Air New  
7 Zealand flies 12 times a day, and Origin flies 8, but one of  
8 the underlying factors of the ability to put a J41 on 8  
9 times a day is because Qantas are helping to support that  
10 route by also putting a number of passengers on it. Absent  
11 that, the economics of operating a J41 eight times a day  
12 become very difficult.

13 So, although you can develop your own brand, and I would  
14 like to feel that Origin will continue to do so, and its  
15 partners will perhaps not be quite so fundamental, you have  
16 to have some routes on which you are making a substantial  
17 profit in order to be able to fund both their continuation  
18 and any form of expansion, and it would be true to say that  
19 the launch of the Express product, for which I congratulate  
20 Air New Zealand, it's a very very clever move, has caused a  
21 lot of difficulties.

22 I believe it's caused difficulties for Qantas, it's  
23 certainly caused difficulties for us, and so consequently it  
24 just gets that much harder when and if you have a period of  
25 uncertainty in terms of knowing quite where to take the  
26 airline and in what form.

27 **CHAIR:** Thank you.

28 **MR PJM TAYLOR:** I've just got one, Mr Marks. The Christchurch-  
29 Wellington route, you fly prop planes? You fly jet prop  
30 planes?

31 **MR MARKS:** Yes. Well, they're all -- yeah.

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1 **MR PJM TAYLOR:** Will they complete largely against Air New  
2 Zealand 737s?

3 **MR MARKS:** Yes.

4 **MR PJM TAYLOR:** Do you find a problem with that in terms of  
5 being competitive?

6 **MR MARKS:** You find some problems. The smaller aircraft, there  
7 are some negative consumer perceptions which we endeavour to  
8 overcome by price, but in general terms one can compete  
9 with -- as long as the frequencies and schedules are  
10 appropriate. It's more what Origin lacks is the huge base  
11 of business flyers that Air New Zealand's been able to  
12 attract and maintain, and once those people get accommodated  
13 on their services, it's very difficult to prise them away.  
14 And for business traffic price is not so much of a weapon  
15 because a substantial number of the people buying the  
16 tickets don't actually worry too much about how much they  
17 cost.

18 I know perhaps we feel they should, but they don't, and  
19 I think we heard Mr Huttner yesterday talking about power  
20 frequent flyer thing, and having been instrumental in  
21 actually establishing airpoints, it is now being used  
22 successfully against me.

23 **MR PJM TAYLOR:** Thanks.

24 **MR CURTIN:** Just briefly, I appreciate it's before you joined  
25 Origin, but can you remind us, when Origin started, was it  
26 on a business model of point-to-point without feed, or was  
27 it always predicated on having feed? Can you give us a  
28 little bit of the history of the evolution of the company?

29 **MR MARKS:** Well my understanding was that ironically the  
30 original encourager for the creation of Origin was James  
31 Strong, then the managing director of Qantas, who sat down

*Origin Pacific*

1 with Robert Inglis the founder and suggested to him it would  
2 be a good idea if New Zealand had a low cost airline  
3 operating in the provinces. Whilst there wasn't, to the  
4 best of my knowledge, any form of formal relationship with  
5 Qantas, and therefore, the operation started in a very  
6 modest way out of Nelson.

7 Certainly, when Tasman Pacific went down, and I believe  
8 somewhat before that, the relationship with Qantas  
9 commenced, and then when Tasman Pacific went down, then  
10 Qantas were left with a big hole on any formal feed  
11 mechanism and evolved a strong relationship with Origin  
12 Pacific and indeed Origin Pacific went out and actually  
13 acquired aircraft, particularly the ATRs on the strength of  
14 giving them -- fully leasing them to Qantas. So, does that  
15 answer your question?

16 **MR CURTIN:** Yes, it does, thank you.

17 **MS BATES QC:** Just a couple of questions. Does Air New Zealand  
18 compete with you on all the routes you fly, does it?

19 **MR MARKS:** Yes, they do.

20 **MS BATES QC:** Would some routes like say Christchurch to  
21 Queenstown become attractive to you? I mean, you fly it  
22 already presumably, don't you?

23 **MR MARKS:** We only fly it for Qantas.

24 **MS BATES QC:** Yes, but if you say that Air New Zealand would  
25 become a monopoly, isn't it quite a popular route, that one?

26 **MR MARKS:** It's a very popular route. The issue is that, as Air  
27 New Zealand have submitted, or perhaps Dr Willig has  
28 submitted; I'm not quite sure which is which.

29 **MS BATES QC:** Do you agree with him this time or not?

30 **MR MARKS:** I'm agreeing with him on the basis that most of the  
31 traffic is international origin on the Christchurch-

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1 Queenstown route, so in other words, that traffic is seduced  
2 in London and it's seduced in Los Angeles and Tokyo. So  
3 consequently, long before they ever get to New Zealand  
4 they've bought their tickets.

5 The amount of local traffic, people living in  
6 Christchurch going to Queenstown and vice versa, or perhaps  
7 people living in Auckland going to Queenstown via  
8 Christchurch, obviously there's some, but this is slightly a  
9 peculiar route in that sense in that it is actually  
10 dominated by the Japanese, or the Koreans or others and,  
11 quite rightly, Air New Zealand and Qantas go after that  
12 traffic in their point of origin.

13 **MS BATES QC:** As a domestic user until very recently, I've  
14 always found it an extremely expensive route. Would you  
15 agree with -- I just wondered whether there was a gap there  
16 that you could actually go for?

17 **MR MARKS:** We're trying to find gaps, so if you're willing to --

18 **MS BATES QC:** No, but is that the sort of strategy you would...?

19 **MR MARKS:** Absolutely. I mean, Origin has tried very hard to  
20 find routes that other carriers are less represented on or  
21 routes in which we think we can turn a dollar, but Air New  
22 Zealand, as I said, earlier, has done a very very good job  
23 in blanketing both regional, provincial and main trunk  
24 services, and what has really changed that has been this, or  
25 has enhanced their position, has been this mix of aircraft,  
26 perhaps more capable now of frequency, and allied to a  
27 clever yield management system, therefore being able to move  
28 prices around, it's hard; it's very hard.

29 **MS BATES QC:** Okay, thank you very much.

30 **DR PICKFORD:** Mr Marks, you said in your submission that the  
31 introduction of New Zealand Express has -- Air New Zealand



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1 Express has caused difficulties to your operations. Could  
2 you explain in what way that's happened, please?

3 **MR MARKS:** Yes, well, Origin really did what Commissioner Bates  
4 has implied, by having a pricing strategy which to some  
5 extent undercut Air New Zealand on many of its routes. Air  
6 New Zealand's Express product, where they brought all their  
7 prices down by 20 to 25%, perhaps more so on some routes  
8 than others in terms of the availability of cheaper pricing,  
9 has meant that one of Origin's substantial benefits of being  
10 able to promote to you that you should be on Origin because  
11 of the price, has been removed. So in that sense the yield  
12 spread has significantly narrowed.

13 **DR PICKFORD:** So, I hadn't understood this, but you are saying  
14 that Air New Zealand Express has applied to its provincial  
15 services as well as its main trunk?

16 **MR MARKS:** Absolutely.

17 **DR PICKFORD:** What proportion of your passengers are derived  
18 from Qantas, codeshare and the like?

19 **MR MARKS:** I'd rather leave that -- it's covered in our  
20 confidential submission and I'd rather leave that if I may.

21 **DR PICKFORD:** I know that you've progressively entered new  
22 markets since you started up. What has been the impact on  
23 fares in those markets as you've entered and expanded  
24 services?

25 **MR MARKS:** That's hard to answer now. I think in the --  
26 originally communities such as New Plymouth and Invercargill  
27 were highly delighted that they had competition for the  
28 first time; in fact I believe that Tim Shadbolt is on record  
29 as thanking Origin Pacific for halving the cost of getting  
30 out of Invercargill. [**Pause**]. Perhaps it would be more  
31 appropriate that I should say "halving the cost of getting

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1 into Invercargill".

2 And Origin was very pleased to be able to do that, but  
3 as I say in recent times the Air New Zealand Express  
4 initiative has been very cleverly thought through, and with  
5 the lower pricing and all the other attendant benefits of  
6 everything from airpoints to lounges, particularly  
7 frequency, then some of the advantages which Origin Pacific  
8 had have disappeared, and so, consequently we have been  
9 forced to review our route network in recent times; we've  
10 had to send one or two aircraft back because we're now  
11 having to cut our cloth to a somewhat different shape to the  
12 one we had a year ago.

13 **MS BATES QC:** Just one question and that's, I mean, what is your  
14 competitive response to Air New Zealand doing this? I mean,  
15 are you in a position to lower your fares too?

16 **MR MARKS:** Yes, we will, we've done that -- well, we've had two  
17 competitive responses. We changed our pricing structure  
18 back in June to see if we could find a mechanism similar to  
19 Air New Zealand's to combat it. Subsequently we have  
20 amended that. For instance, we now offer low fares without  
21 the use it or lose it conditions, and we've also lowered  
22 fares to business people by as much as 30% over Air New  
23 Zealand's similar flexible fares.

24 The issue we have, as I said, it would be nice to feel  
25 that business traffic would respond instantly to that kind  
26 of discount, and some have, but there are all sorts of  
27 contracts and incentives and other issues where price only  
28 plays a part in the competitive mix.

29 **MS BATES QC:** But do you think it's been a successful strategy  
30 you've adopted?

31 **MR MARKS:** Too early to say. I mean, we didn't have a lot of

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1 choice in the end. Our business suffered as a result of the  
2 Express launch. We initially thought that perhaps some of  
3 the detriments to our business would multiply over time.  
4 They didn't appear to, and so consequently we went in and  
5 started making these changes which we've been making fairly  
6 frequently.

7 In recent weeks, it's true to say that our business  
8 seems to be picking up again a little, so -- but it's very  
9 early days, and if Air New Zealand drop another seat -- say  
10 a quarter of a million seats on us some time in the near  
11 future, then that sort of wipes out everything for the next  
12 6 or 8 weeks, so -- and I have no idea what Mr Miller may be  
13 plotting as he sits behind me.

14 **PROF GILLEN:** You discuss codeshares with Fifth Freedom  
15 carriers and the lack of them. Is that because of your  
16 relationship with Qantas or the lack of interest on the part  
17 of the Fifth Freedom carriers into Auckland?

18 **MR MARKS:** It's certainly not because of our relationship with  
19 Qantas. In fact, I think what we hope to be able to sell to  
20 a Fifth Freedom carrier was that, if we could meet all the  
21 service standards and requirements of Qantas, that that  
22 would show that we were quite capable of meeting theirs as  
23 well.

24 The difficulty is, as you've heard already, is that a  
25 lot of the Fifth Freedom carriers come into Auckland and we  
26 are not very well represented in Auckland, and as you've  
27 also heard, one of the issues for a long long time is Fifth  
28 Freedom carriers cannot be relied upon, they come and they  
29 go, they have varying pricing strategies dictated by their  
30 respective head offices at different times.

31 I mean, as you've already heard, I had a wonderful

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1 conversation some years ago with the Marketing Manager of  
2 Continental who said that they didn't bother with any yield  
3 management systems, they simply pitched their prices at \$50  
4 lower than anything that Air New Zealand had. And I said,  
5 "well what happens if we get down to \$50?" And he said,  
6 "well, we'll actually give them away for nothing". A  
7 facetious remark, but nevertheless it sort of illustrates  
8 that Fifth Freedom carriers have a need to primarily meet  
9 the requirements of their head office in terms of the long  
10 haul traffic and to find a mechanism for topping that up  
11 with some Trans-Tasman activity.

12 Sometimes that's effective, but for a provincial  
13 carrier, for a regional carrier, the regional people who  
14 wish to go to Australia across the Tasman can get out of  
15 Christchurch on Air New Zealand and Qantas, they can get out  
16 of Wellington. So, it's much less of an incentive for  
17 people probably anywhere south of Palmerston North to  
18 actually go to Auckland to pick up a Fifth Freedom carrier.  
19 So, that would deprive us from the opportunity of carrying  
20 people up there, or vice versa.

21 **PROF GILLEN:** To Singapore coming into Christchurch they  
22 would pass their passengers on to Air New Zealand because of  
23 a Star relationship?

24 **MR MARKS:** To be honest I'm not sure what they do. When I  
25 originally negotiated with Singapore Airlines, one hoped  
26 that that would be the case. But having been out of that  
27 particular part of the industry for some years, I'm not  
28 qualified to tell you what Singapore airlines does.

29 **PROF GILLEN:** How important is freight to your operation?

30 **MR MARKS:** Freight?

31 **PROF GILLEN:** Freight, yes.

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1 **MR MARKS:** We do operate freight. We have freighters, two  
2 aircraft which operate overnight and fulfill the needs of  
3 people like DHL. It's a useful addition to our business,  
4 but it's not that -- in terms of turnover, it's very helpful  
5 but it's not significant.

6 **PROF GILLEN:** Okay, thank you.

7 **MR PETERS:** Just one question, Mr Marks. You mentioned in  
8 passing, I believe, the benefit of Air New Zealand's  
9 membership in Star Alliance sounded as though you had some  
10 knowledge of this and some views on this. Can you elaborate  
11 on this aspect of your presentation?

12 **MR MARKS:** Well, I think -- yes. I mean, back in about 1995  
13 when Air New Zealand in those days was the 7th most  
14 profitable airline in the world, but despite that we could  
15 see the world was going to change, that it was going to  
16 break into a series of alliances, and that was the reason  
17 why we went out and negotiated with United and Air Canada,  
18 which caused us to dump our relationship with Canadian and  
19 with Lufthansa. They were the principal drivers of the  
20 Star Alliance.

21 Basically what the Star Alliance would offer was ease of  
22 access, say from Los Angeles through to Chicago or Denver or  
23 other places you couldn't get to; throughout Europe using  
24 Lufthansa's services, a far better relationship in Canada.  
25 The most money is made internationally on Business Class  
26 passengers, and Business Class business passengers could be  
27 far more facilitated by having another airline that treated  
28 them as if they were their own.

29 So, lounge access for instance -- I made a trip to  
30 Europe last year wearing another hat. It's very useful for  
31 me as a Gold Elite member of airpoints to -- though I doubt

*Origin Pacific*

1 whether that will continue -- to be able to sit in British  
2 Midland's lounge facilities in Heathrow, and to have British  
3 Midland extend to me the same benefits as they give their  
4 frequent flyers. So, it's a whole series of value adding  
5 benefits that would accrue from a membership of the club;  
6 it's a club and there are benefits of belonging to the club.

7 Air New Zealand, therefore, is able to extend its reach  
8 and be able to get advertising, promotions, even money from  
9 time to time, because when Air New Zealand joined, Star  
10 immediately gave Air New Zealand \$5 million US to start  
11 promoting the alliance. So they have very powerful  
12 abilities, especially for a carrier such as Air New Zealand  
13 which I think does a spectacularly good job as a regionally  
14 based carrier, especially one far away from its principal  
15 markets.

16 But the Star Alliance enabled you to be able to have a  
17 much bigger presence than you actually would have generated  
18 based on your turnover or penetration in the European  
19 markets or even in the United States.

20 **MR PETERS:** Thank you.

21 **CHAIR:** Thank you for that, Mr Marks. If you had any further  
22 comments you would like to make?

23 **MR MARKS:** No, just thank you very much for your time.

24 **CHAIR:** I'd like to thank you on behalf of the Commission and  
25 you will, I'm sure, be aware that one of the key things that  
26 the Commission looks at in doing competition analysis is the  
27 impact on other existing players in the market, and Origin  
28 Pacific has been very forthcoming in providing information  
29 to the Commission and we thank you for that. Thank you once  
30 again. We will not take a break now, but we will just  
31 quickly change over and I would invite Christchurch Airport

*Christchurch Airport*

1 to come forward, please. [**Pause**].

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**PRESENTATION BY CHRISTCHURCH AIRPORT**

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7 **CHAIR:** I'd just like to ask everyone to be seated, please.

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I'd just like to welcome Christchurch Airport, Mr Bellew and Mr Weston, both familiar faces to us, I know you have one more person with you and I'll ask you to introduce her, but once you've done that we'll invite you to present your submission, thank you.

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**MR WESTON QC:** Thank you Madam Chair, and Commissioners, to my right is Janine Loader who is trying to make the technology work without a great deal of success at the moment. Unlike the previous team, we're here with a lawyer and a laptop, but the lawyer at the moment's going and the laptop's not.

We're here for a short presentation, the main purpose to make Mr Bellew available for question, but we have a few points we'd like to make first and if I might do a short introduction.

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It's obvious from the submissions that the airport has filed that we're not approaching this from a modelling point of view. There are a couple of pragmatic issues that we wish to put before the Commission, and the three issues that Mr Bellew is going to touch on, in one way or another, are these: First, explain the perspective of Christchurch Airport, how it sees itself as a gateway to the South Island; it's not a hub airport in any real sense of that word, but it does see itself as a gateway, and this is a point that's made to the Commission before, and no doubt

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1 will be familiar, but there's a couple of matters that  
2 Mr Bellew will rehearse, we believe, for your benefit.

3 The second point is to talk a little bit about the  
4 counterfactual. Air New Zealand has put forward what has  
5 been labelled the "war of attrition" and to an extent  
6 Christchurch International Airport supports that, not under  
7 the label war of attrition which seems to be a little over-  
8 dramatic, but in the sense that Christchurch is concerned  
9 that over time Air New Zealand will fail and that that is  
10 the appropriate counterfactual.

11 We realise the fundamental question to answer for your  
12 benefit is, why now, why is that the case now? Why has that  
13 not happened previously and what is it about now that  
14 suggests that this thing's any different? So, we will focus  
15 on that. And the third point is to talk about what  
16 facilities Christchurch has available, and again that should  
17 be a reasonably straightforward matter.

18 So, I'm going to invite Mr Bellew to address these. It  
19 won't be necessary to follow that strict tripartite  
20 distinction that I've just set out, but he will cover those  
21 three topics.

22 **MR BELLEW:** Well, Madam Chair, Members of the Commission, I  
23 thought Tony Marks was a client of ours and therefore  
24 relatively friendly, but he's obviously sabotaged our AV  
25 presentation, so let's run. After all, successful managers  
26 in an ever changing world should be innovative, so here's my  
27 test.

28 Let me say by way of introduction, and I want to make a  
29 few philosophical comments and perhaps as part of that try  
30 and establish my credibility, that I emphasise with the  
31 Commerce Commission as to their task as I also continually



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1 face similar, shall we call it, intellectual chasers. By  
2 intellectual chasers I mean forming a view of what the  
3 future holds and what are the consequences of a particular  
4 course of action; i.e. Which scenario will be relevant and  
5 sufficiently real, I emphasise "sufficiently real", as to  
6 warrant commitment?

7 It is axiomatic, according to my rules, that I can only  
8 at best influence the future, and I say that as a manager.  
9 By that I mean that I have no respect for creative  
10 accountants and others and I do have some apprehension,  
11 should I say, about those who are backward looking  
12 philosophers. I think in the real world in which I exist  
13 it's increasingly irrelevant.

14 Let me also say in my experience, and I say this with  
15 some continual dismay, the real world is very complex, but I  
16 live in the real world.

17 I also admit to the enjoyment that it's delightfully  
18 imperfect. Especially compared to many of the abstractions  
19 which we all too frequently use.

20 Whilst I applaud and indeed often am enthralled, perhaps  
21 even captivated by today's experts, too often in my  
22 experience to my subsequent dismay and disappointment their  
23 current mantras are often found to be very perishable, and  
24 hence despite their obvious sincerity they're too frequently  
25 destined with the rigors of hindsight to be but mere  
26 advocates.

27 You might then reasonably conclude that in my continual  
28 search for sufficient understanding as to the future I am  
29 somewhat suspicious. I admit to that.

30 But yet, like you, as a manager I cannot luxuriate in  
31 delay. Indeed, my economic rent, i.e. Salary, comes from

*Christchurch Airport*

1 taking a position, i.e. Making a decision as to what may  
2 happen. But indeed, if I fail to do this, or if the  
3 positions which I take are insufficiently relevant to what  
4 actually transpires, I am quickly consigned to what I shall  
5 refer to as the "EX" category, and let me assure you,  
6 economic rents do not exist in that category.

7 Indeed, some of my cynics might already say that as I've  
8 been in this role for some 15 years, and I'm approaching my  
9 late 50s, that I'm already probing the outer limits of the  
10 normal curve. I now proffer some observations.

11 Firstly, I have to say that while we at CIAL do use  
12 modelling as an aid to decision-making, and indeed I have a  
13 modicum of numeracy myself, and indeed we also attempt to  
14 secure where possible the best of practitioners, it is  
15 always in my practical experience but an aid.

16 I acknowledge that as one who has spent his life in  
17 commerce, indeed our successes or failures are inevitably  
18 measured in quantifications with dollar signs. But I must  
19 say that we continually find in an ever increasingly complex  
20 and changing world, too heavy a reliance on quantifications  
21 which have an almost precocious precision may be misleading.  
22 Indeed, large numbers can mean that you are very right; they  
23 can also equally mean that your assumptions are very very  
24 wrong.

25 Let me now move on and give some market characteristics,  
26 and here I'm talking about a market for travel as perceived  
27 from the Christchurch perspective. For me, air travel is  
28 increasingly becoming likened to a commodity product. Air  
29 travel is increasingly becoming likened to a commodity  
30 product. Corollaries, if you buy my assumption, and I  
31 emphatically believe it, is that supply, except for short

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1 periods of time, is not usually an issue; in fact, over-  
2 supply is quite frequently the norm.

3 Furthermore, it is difficult to permanently -- and I  
4 emphasise the word "permanently" differentiate your product  
5 in such a market. In fact, commodity suppliers often find  
6 adaptation difficult.

7 Continuing on with my thesis, price in a commodity  
8 market is hugely influential as to buyer's choice, hence  
9 suppliers increasingly, despite their protestations to the  
10 contrary -- and I'm referring here to stockholder's  
11 meetings -- become price takers. Margins, as a consequence,  
12 due to a combination of over-supply, buyer's emphasis on  
13 price and the relentless pursuit of market share, inevitably  
14 become eroded.

15 Suppliers often seek refuge in attempts to achieve  
16 economies of scale, but these are at best temporal. Another  
17 observation which I would have to make is that market  
18 failures are, or failures by market participants are not  
19 uncommon and witness the recent carnage in the airline  
20 industry.

21 Let me now refine my market definition a little and say  
22 that for us it is the leisure travel market which is  
23 particularly important as far as Christchurch is concerned,  
24 and particularly important when looking forward.

25 In the leisure travel market, according to my  
26 definition, aspirant suppliers compete for the discretionary  
27 consumer dollar. In other words, the consumer has the  
28 absolute right, given finite buying power, to again  
29 absolutely determine their allocation of their resources.

30 Furthermore, with the increasingly more knowledgeable, I  
31 contend, empowered consumer of today with a wide use of IT

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1 systems, they do make a very informed decision and often at  
2 the last moment.

3 I am obviously referring to tourism which is a  
4 substantial driver of especially the in-bound market and at  
5 Christchurch approximately 75% of all our international  
6 visitors are non-New Zealand residents, but it also  
7 influences domestic travel; in other words, domestic sectors  
8 that are flown within New Zealand.

9 We believe that on average the number of air journeys by  
10 tourists will grow. But New Zealand is but a niche player  
11 and market share and hence ability as a tourist destination  
12 to market influence is small. In many of our markets we  
13 have less than 1% market share. Airfares represent a  
14 significant proportion of total costs for travel, especially  
15 as we are somewhat geographically remote from the major  
16 centres of population. Hence, I would argue that  
17 continually unattractive offerings are quickly seen for what  
18 they are.

19 In this regard I am somewhat perplexed by the emphasis  
20 during last evening's discussion on, say, the concentration  
21 of market power and how it may be exploited on the  
22 Australasian US market. To me it lacks substance given the  
23 argument that I have developed. I believe now that we're  
24 facing sufficiently influential consumers that we must offer  
25 an attractive price solution. If not, they have the power  
26 and the determination to look elsewhere and we, for leisure  
27 travellers at least, compete with a myriad of other  
28 destinations.

29 Furthermore, particularly for those who have aspirations  
30 either from or going to beyond North America, there are many  
31 other routes which allow them to bypass the unattractive

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1 offerings and thereby put pressure, market influence if you  
2 like, on the uncompetitive.

3 We have witnessed in recent years some quite severe  
4 external market shocks. These inevitably take out -- I'll  
5 use the assassin's term -- the weak players. Most  
6 commentators, and here I travel frequently and indeed I'm a  
7 past vice-president of the Airport's Council International,  
8 the Geneva Airport's Organisation, and we airport people are  
9 continually somewhat candid in real-time information, agree  
10 that we have not seen the end of such events, be they public  
11 health issues, i.e. SARS, terrorism events, despite the huge  
12 investment that all players are making, etc.

13 Indeed, let me talk about another corollary of that: A  
14 person who has been referred to by one of the Commissioners  
15 already, Peter Harbison, I'll attribute the Harbison theory  
16 to him. Let me say that I argue frequently with Peter when  
17 I'm in Sydney and invariably end up paying for lunch, it's  
18 probably because he's Australian and I'm a New Zealander.  
19 But he's developed a theory to which I subscribe, and that  
20 is that recent external shocks have excessively sensitised  
21 the traveller.

22 What are the market consequences of that? That  
23 inevitably, when there is another external shock, they  
24 respond very very suddenly indeed. So you hit a shoulder,  
25 drop off very quickly. There is still some debate as to  
26 what the other side of the curve looks like. In other  
27 words, are you down in a narrow bottom chasm, a U-shaped  
28 valley, or is it flat and then you climb up the other side  
29 again quite quickly? In that regard the jury is out a  
30 little. But let me observe some stats which I recently  
31 commiserated on with a colleague of mine who's airport

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1 director, SFO San Francisco.

2 John Martin, for whom I've got the most high respect,  
3 was swapping e-mails with me and he pointed out that he is  
4 still 26% down in real passenger numbers compared to 2 years  
5 ago.

6 Let me move on. To me, as the chief executive of a  
7 supplier to the airline industry, I have heard concerningly  
8 little about the Air New Zealand long haul market except  
9 that profitability was unsatisfactory, yet this represents  
10 about 75% of their activity. At the risk of being insulting  
11 to my major customer I emphatically contend that Air New  
12 Zealand's current long haul offering is barely market  
13 competitive; barely. And in this regard I am demonstrating  
14 some uncharacteristic due deference to my major customer.  
15 They urgently need to re-equip and to reposition their  
16 offerings in terms of passenger comfort, but also aircraft  
17 efficiency and configuration. All of that will take many  
18 many tens of millions of dollars.

19 Let me move on away from what some might contend are  
20 inappropriate proxies or observations on the market, yet  
21 they're my beliefs. Some observations about restructuring  
22 and right sizing. When you have market upheaval and change  
23 which is endemic and continual, for existing suppliers  
24 restructuring and right sizing is inevitable. As somebody  
25 who during their management career has been there with, I  
26 contend or admit, varying degrees of success, let me observe  
27 that the task facing Ralph Norris and his team, and even  
28 Geoff Dixon, is a daunting and inevitably costly one.  
29 Indeed, I would muse that it is probably this very reason  
30 why we have not seen earlier adaptation.

31 As one who has spent rather more years of his life than

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1 he would care to reveal as a change agent, for the benefit  
2 of the modellers let me make one other observation. My  
3 insurance experience, and I say with some bitterness, is  
4 that the cost of such exercises are usually grossly  
5 understated, and in part this is because senior managers  
6 often think -- and I'll revert to a medical term -- they are  
7 better clinicians than they really are.

8 But let's not wallow in this perhaps inevitable  
9 challenging area and move on. But before I do, if the  
10 Commission hasn't seen -- and I acknowledge that Australians  
11 don't always propose or project the world as "fair dinkum" -  
12 - if you haven't seen the Business Review Weekly of last  
13 week I would commend it to you for some reading -- [**holds up**  
14 **Business Review Weekly**]. I think there was a lot of  
15 relevance there in terms of Qantas's perception of the  
16 market.

17 Let me say that nobody, nobody who is a sane manager  
18 willingly undertakes a restructuring whereby one has to  
19 strip out in the order of A\$1 billion of costs. \$1 billion  
20 of costs. One only does that in terms of desperate times,  
21 desperate measures. That is the real world. Let me move  
22 away from this somewhat Malthusian subject.

23 I still have some optimism for life and indeed that's  
24 why I'm still a manager. We are currently investing -- we  
25 the company that I head -- in facilities for Virgin Blue.  
26 What can be more emphatic is a statement as to my belief?  
27 Let me say that, although they are somewhat agile  
28 entrepreneurs, that we put to them six scenarios, perhaps as  
29 further emphasis of our sincerity as to their future plans  
30 and longevity of presence, let me disclose that the price  
31 tabs on those investments range from \$400,000 through to

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1 approximately \$5 million. So, excuse my triteness, but in  
2 terms of this we are literally putting the company's money  
3 where our mouth is.

4 We're currently completing a 50 year master plan and  
5 this assumes on average continuing growth, and a lot of  
6 analysis has gone into that. But let me say, on average, I  
7 have frequently publicly taken issue with the fiscal analyst  
8 and I believe some economists, having listened to them ad  
9 nauseam for the last week, should also have this infliction:  
10 Their view of life is so pure that they should continually  
11 wear white in my view. You know, the onward and upward  
12 smoothly exponential growth curve in my bitter experience,  
13 and I've sought for it almost as a pilgrim, does not exist.

14 Continuing on, our commitment to life: We're currently  
15 in the final stages of a very detailed study involving a new  
16 domestic terminal. If I say that that will have an  
17 investment in the order of NZ\$100 million, if I were  
18 Australian I think that would indicate that we're fair  
19 dinkum.

20 Life is never easy at Christchurch and yet -- [pause] --  
21 despite the representation of an earlier speaker, let me  
22 share this with you. I have here the summer slot schedule;  
23 assuming that Virgin Blue come and we've said we're  
24 investing on that premise, we are facing in the peak period  
25 of that summer a 44% increase in available seats. Now,  
26 there may be a modicum of optimism there in that some who  
27 have applied for slots, and some of them are what you've  
28 been referring to as "Fifth Freedom carriers", may not  
29 arrive. But, even if one is somewhat down on that, it is  
30 still a significant increase in capacity.

31 And let me say that in my experience in the shorter term



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1 I find that invariably capacity is a reasonably proxy for  
2 market share. If not, the operators quickly adjust but I  
3 usually find that it's a reasonable proxy.

4 To reiterate my opening remarks and by way of closure  
5 and before I invite questions, my economic rent is only paid  
6 when I make the right decisions. Today I've shared with you  
7 my reasoning and the form of decisions that we're making.  
8 Thank you for your attention. I invite questions.

9 **CHAIR:** Thank you very much for that presentation, and if I can  
10 I'll start off before I invite questions from my colleagues.

11 I wanted to come back to the statement that you were  
12 currently investing in new infrastructure for Virgin Blue.  
13 I wanted to get a sense of what that meant in terms of  
14 facilities in comparison to what you have already at  
15 Christchurch. How significant is that development of the  
16 facilities and what's the timeframe for it?

17 **MR BELLEW:** With even our most capital intensive solution, we  
18 were committed to having an on-line facility by 1 November  
19 this year. So, it was going to be quite a chase, but it --  
20 with a little bit of cajoling etc by suppliers, it was  
21 practical.

22 Let me answer your question, though, in a market  
23 relevant sense if I may, if you'll indulge me.

24 **CHAIR:** Please.

25 **MR BELLEW:** One of the slides that I had in actual fact showed  
26 by way of Virgin Blue capacity what we are estimating  
27 they'll provide on free routes. Christchurch-Brisbane  
28 return, Christchurch-Melbourne by return and Christchurch-  
29 Sydney by return. Our assumption is that either when they  
30 start or very shortly after starting they will provide daily  
31 services with a 737-700 or 800. The resulting capacity

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1 increase is relative to total market as we see it available  
2 seats, Christchurch-Brisbane 38%, Christchurch-Melbourne  
3 34%, Christchurch-Sydney 14%. Average for those three  
4 gateways, 23% available seats.

5 Perhaps I can go on a little and say that, I think that  
6 we should not underestimate Virgin Blue's position in the  
7 marketplace. I think they are in one sense audacious in  
8 terms of their approach to life. On the other hand they've  
9 got a huge image. I mean, I was walking to the foyer of  
10 this building when David Huttner arrived yesterday and the  
11 media train, which is pretty indicative of market interest  
12 to me, was huge; and I think David would excuse me for  
13 saying, I don't think he's that good looking or charismatic,  
14 it's really the Virgin image.

15 But I mean, those are the sort of factors that assure  
16 success and longevity in markets.

17 **CHAIR:** How long do you think it will take Virgin Blue once it  
18 enters across the Tasman and on the domestic routes to get  
19 to the point where it will be a sufficient constraint on the  
20 alliance to satisfy, for instance, the requirements that we  
21 have to be mindful of under the Act? How long do you think  
22 it will take? We've heard mixed things, and we didn't  
23 exactly get an unqualified commitment from Virgin Blue about  
24 the extent of their expansion in New Zealand, so what is  
25 your own view?

26 **MR BELLEW:** Look, I sympathise. My experience with Virgin Blue  
27 is that, as I said, they're a somewhat nimble entrepreneur  
28 and part of their, shall we call it negotiating stance, is  
29 to leave it to your imagination as to what you might assume.  
30 And that's not a bad negotiating stance, but they are  
31 definitely, in my opinion, committed to entering the market.

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1           As one who runs a business that's very dependent on A  
2   availability of seats and, if you'll excuse the expression,  
3   bums on seats, I'm vitally interested in that question you  
4   raised. I believe that they will have almost immediate  
5   success, they've got a base already in Australia, they've  
6   got an image due to the Virgin brand, they will come in  
7   I believe at a price point which will be quite aggressive,  
8   and they will attract quite quickly a market share which  
9   will be very influential in terms of the other operators.

10 **CHAIR:** The other question that I have for you is, Virgin Blue  
11 has made a number of demands really in terms of things they  
12 think they require in order to enter effectively, and there  
13 are two components to those, and one of which is access to  
14 facilities.

15           Now, there are supposedly issues at Auckland, Wellington  
16 and Christchurch to varying degrees, and it seems to me  
17 you're in a pretty good place to comment on whether you  
18 think there's anything significant in that, and I'd be  
19 interested in your views across the airports. Because I  
20 think, if you benefit from their arrival, you'd be concerned  
21 as well if you thought they had facing constraints in other  
22 airports that were slowing down their entry.

23           So, what can you tell us about the reality or not of  
24 these impediments at airport facilities around this country  
25 for a new entrant like Virgin Blue?

26 **MR BELLEW:** Can I make a preliminary comment first on the asks.  
27 I mean, I think one of the interesting approaches, if I can  
28 generalise for a moment, of low cost carriers is that when  
29 they approach a destination they take the stance, "what are  
30 you gonna give me?" and in that regard they are quite  
31 unabashed as to what they aspire to by -- yeah, I'll use the

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1 term -- subsidy.

2 And indeed, there are in some jurisdictions some  
3 interesting legal battles going on now as to whether that's  
4 allowed, for example in the EU. But, you know, some of  
5 those low cost carriers have been very adroit practitioners  
6 of that. Ryanair in particular, I was surprised that  
7 yesterday's expert commentator didn't bring this out, had  
8 been very very adroit, in actual fact enticing should we  
9 say, secondary destination to underwrite their costs of  
10 market entry, and in some cases on a contractual 15 year  
11 period.

12 For us we have to walk the fine line of being loyal to  
13 existing customers but yet competing for the new. In that  
14 regard, we -- and I have gone down on record on this, as  
15 saying we will move heaven and earth to provide a  
16 commercially acceptable solution, and facilities are in fact  
17 not a constraint as far as Christchurch is concerned.

18 If I heard Mr Sheridan, my colleague from Wellington  
19 correctly, when he was presenting, I think he indicated that  
20 there is not a constraint in terms of facilities at  
21 Wellington, although I think we all experience as travellers  
22 here that from time to time during inclement weather, which  
23 I know all Wellingtonians represent as infrequent, that  
24 there are some delays, and that, you know, air space at such  
25 times when instrument landings are required could be a  
26 scarce commodity. But then, you know, it's first come first  
27 served and all are equal I suppose in that regard.

28 In terms of Auckland, I think Auckland temporarily are  
29 suffering the ravages of success, but I -- by that I mean --  
30 and I think there's an Aucklander in the panel -- by that I  
31 mean, and I'm not talking about, you know, the congestion

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1       when you drive, but -- and I've spent most of my life in  
2       Auckland by the way and I still have substantial property  
3       interests in Northland of all places, so I'm fairly familiar  
4       with it.     But let me just say that Auckland compete  
5       vigorously, they're stock market listed, they will find a  
6       solution I know, and I also, of course, have to acknowledge  
7       that the Applicants have given some undertakings as to what  
8       they'll provide, and I think it's been interesting to  
9       observe the continual flow of documents that have been sort  
10      of increasingly focussing on that during this last week.

11 **CHAIR:**     What about the price?     The price in terms of that  
12      accessing of facilities?     What is the balance of power  
13      between someone like Virgin Blue trying to enter and  
14      regional monopoly, if I can use that word?

15 **MR BELLEW:**   Well, let me protest that word for a start.

16 **CHAIR:**     I really didn't mean to provoke that discussion.

17 **MR BELLEW:**   Can I develop an argument there first?     I mean, I  
18      think firstly, if we were a regional monopoly where would --  
19      why would somebody as astute as David Huttner, who after all  
20      referred to us in those very terms, at least as a monopoly,  
21      why would he bother his time in asking us for some monetary  
22      concessions?     After all, you know, the true behaviour of a  
23      monopolist -- and here I'm being a pure economist for a  
24      moment -- would be "biff off" or words to that effect.

25             The other thing is, I think that I can prove  
26      conclusively to you, that we don't actually recover our  
27      weighted average cost of capital, and again, this is pretty  
28      symptomatic of some variance away from that accusation.

29             The other thing I'd remind you of is that I think that,  
30      in a very recent determination by this group, that I think  
31      you could have inferred to any reasonable and careful reader

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1 that Christchurch in actual fact was probably underpricing,  
2 which again is rather at variance with the assertion that  
3 you have just made.

4 But let me move on --

5 **CHAIR:** I just want to pursue this a little bit, because the  
6 Commission's never taken the view that, because someone is a  
7 monopolist, they necessarily are in monopoly rents,  
8 otherwise --

9 **MR BELLEW:** Thank you.

10 **CHAIR:** -- otherwise we wouldn't have to do the inquiries that we  
11 seem to be requested to do on a regular basis. I would  
12 simply assume that must be the case.

13 But what I'm really asking you in part, and I'll frame  
14 it in a different way that you might find more acceptable:  
15 There is a concern being expressed by Virgin Blue that they  
16 will not get a price in terms of access to facilities that  
17 is competitive with what, for instance, the Applicants might  
18 have, and I'd like your view on that. Do you believe that  
19 may be the case?

20 **MR BELLEW:** Let me answer that. In the case of Christchurch  
21 they will be exactly line ball, exactly line ball with  
22 existing incumbents, some of whom of course are much more  
23 valuable as customers but counter rentals etc, exactly line  
24 ball. No more, no less, all right.

25 I can't speak for Wellington, but I think as Wellington  
26 have already admitted, that they -- or put on the record  
27 that they have got capacity; I would be surprised if they  
28 would charge a premium to a new entrant. I would have  
29 thought that their shareholders would be desperately seeking  
30 growth in their activity, right.

31 In terms of Auckland -- you're leading me into dangerous

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1 ground now because I'm about to talk about a potential  
2 customer. I thought it was an interesting argument, should  
3 I say, that David Huttner was running on the fact that as  
4 the new entrant he would be disadvantaged if he had a new  
5 terminal. I thought he might have been running two horses  
6 in the same race, which of course is not a bad betting  
7 strategy I suppose, but in actual fact, umm, my impression  
8 will be that -- and if I believe the undertakings by the  
9 Applicants -- he will get access to counters at, I would  
10 have thought, exactly the same price as them. I guess what  
11 he was indicating was that, if he grows his market rapidly,  
12 then there may be a hurdle, if you like, but hey, he's a  
13 very adroit negotiator and I would put a pretty heavy bet on  
14 him compared to a mere airport company, even one as  
15 successful as Auckland.

16 **CHAIR:** I'll just see if my colleagues have any questions.

17 **MR CURTIN:** Just very briefly. You've obviously advanced your  
18 thinking on the scale and likelihood and timing and  
19 everything else?

20 **MR BELLEW:** Yes, we have. That's real-time, yep.

21 **MR CURTIN:** So, just to get it clear: If you were making a  
22 guess at the extent of Virgin Blue's entry, you instance  
23 some of the Christchurch routes. Would you care to guess at  
24 what you think it might look at now, because, from what  
25 you've said, you've moved on even from your second  
26 submission.

27 **MR BELLEW:** Yeah, sure. My suspicion, my forecast, if you like,  
28 is that, three services a day Christchurch, which is what  
29 I've referred to.

30 Let me then, being Cantabrian for but a moment, talk  
31 about main trunk domestic. In our discussions with them

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1 we've been talking swing gates; now, excuse the language,  
2 but a swing gate is really a gate which allows you to bring  
3 in a parking gate, which allows you to bring in say  
4 passengers, international passengers, disembark those  
5 passengers but then load without repositioning the aircraft  
6 domestic passengers and squirt in or do a main trunk  
7 domestic sector. We've had discussions along those lines.

8 It's got huge appeal to carrier because it improves  
9 aircraft turn around and it means you can get more  
10 flying hours and, therefore, more revenue per day and, you  
11 know, one of the characteristics of the low cost carrier is  
12 cost avoidance; cost avoidance. And let me say to you as  
13 manager, cost avoidance is an immanently easier approach  
14 than cost removal. And they do that by way of working their  
15 fleet, a standard fleet in most cases, incredibly hard, like  
16 a 20 minute turn around.

17 So moving on, I suspect that they will probably,  
18 depending on fleet availability, aircraft utilisation,  
19 curfews and all the other sort of limitations that come in,  
20 look at the main trunk; my suspicion is probably Auckland,  
21 Wellington Christchurch. Whether they'll do the shorter  
22 haul like Wellington-Christchurch, which frankly is not too  
23 badly accommodated by way of turbo props, you know, block to  
24 block time with a turbo prop on a sector of that length is  
25 not too bad and, therefore, I wonder, you know, whether a  
26 relationship with Origin isn't something that might have  
27 sort of economic appeal.

28 In terms of Wellington, I think you will see some Trans-  
29 Tasman operations there, possibly not with the same  
30 frequency as what I was alluding to, but at least daily on  
31 some of those gateways in Australia.



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1           In terms of Auckland, I think it's an interesting one.  
2           I mean, there's huge capacity coming into Auckland now in  
3           terms of the advent of Emirates, and I think that, you know,  
4           you can't ignore that reality in any market scenario.

5           Despite that though I think they will believe that their  
6           price point, their market image is such that they will  
7           probably operate three times a day to the main gateways,  
8           possibly look at some other route developments such as  
9           Adelaide -- remember Adelaide is 1 million people. I know  
10          that their slot application involves two frequencies a day,  
11          Sydney-Auckland; but it's a bit of a mysterious to me, and  
12          perhaps I'm reading it wrong, those two slots are quite  
13          close together and perhaps that's just a bit of gaming shall  
14          we call it.

15 **MS BATES QC:** I've got a couple of hopefully quick questions for  
16          you. One of them is this; you have said you put your money  
17          where your mouth is as far as Virgin is coming in to --

18 **MR BELLEW:** Yep.

19 **MS BATES QC:** -- New Zealand. Probably your article, I don't  
20          know if it does, but certainly the Financial Review makes  
21          reference to the possibility of Qantas putting a VBA on in  
22          Australia.

23 **MR BELLEW:** Yep.

24 **MS BATES QC:** The commentators say that that could be a very  
25          difficult thing for Virgin Blue -- I'm just saying what they  
26          say.

27 **MR BELLEW:** Yep.

28 **MS BATES QC:** But certainly Virgin Blue might have a few more  
29          things to think about. Do you think that might influence  
30          its decision as to whether to come into New Zealand, or when  
31          to come into New Zealand, if that happens? I know it's a

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1 bit speculative, but you've invested a lot of money, you  
2 say; if I tell you that, does it worry you at all?

3 **MR BELLEW:** Well, I think if you referred to either my wife or  
4 the family dog, I occasionally suffer from insomnia, so it  
5 worries me, yes. And I'm not being facetious, I say that  
6 with respect.

7 **MS BATES QC:** No, I just want to know --

8 **MR BELLEW:** But I'm concerned to the extent that I'm continually  
9 interested in the dynamics of the marketplace. I mean,  
10 that's the world.

11 As I understand relative competitiveness -- and I think  
12 this has been publicly stated by Qantas -- their price delta  
13 at the moment compared to VB is at least 20%, at least 20%.

14 Geoff Dixon's article, if I read it correctly, and, you  
15 know, I'm dependent here on the accuracy of journalism --  
16 and that's not a cheap jibe at journalists -- would indicate  
17 that, if he takes out his billion, he would still be within  
18 about -- he would still be 5 or 6% difference on price  
19 compared to Virgin Blue.

20 **MS BATES QC:** So, is the short answer that you don't really  
21 consider it a major impediment to coming to New Zealand?

22 **MR BELLEW:** I don't think so, no.

23 **MS BATES QC:** Okay. Now, you talked about the concentration on  
24 the Air New Zealand route to LA.

25 **MR BELLEW:** Sure.

26 **MS BATES QC:** Which Professor Hausman, it's fair to say, and  
27 others did concentrate on.

28 **MR BELLEW:** I agree.

29 **MS BATES QC:** Was your view that that coming monopoly would not  
30 necessarily lead to higher prices?

31 **MR BELLEW:** My argument was that I believe with empowered

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1 consumers it would be very difficult to extract continuing  
2 monopoly prices on that route.

3 **MS BATES QC:** Okay. You talked -- now, how much of the traffic  
4 coming into Christchurch Airport is long haul from Air New  
5 Zealand?

6 **MR BELLEW:** I would have to check my stats. Japan market, which  
7 we account for on average about 40% of in-bound from Japan,  
8 which is something like 160,000 passengers, they're the only  
9 carrier there, and I'll have to check the other stats.

10 **MS BATES QC:** All I wanted to know for is because I'm running  
11 out of time so I'm being hurried on a bit here. I wanted to  
12 know, you seemed to be concerned about Air New Zealand on  
13 the long haul.

14 **MR BELLEW:** Yes, I am.

15 **MS BATES QC:** And are you concerned from the perspective of  
16 Christchurch Airport?

17 **MR BELLEW:** Yes, I am.

18 **MS BATES QC:** And you say it's going to take many millions of  
19 dollars to get them into the position where they can offer  
20 something you consider is competitive?

21 **MR BELLEW:** Yes, and let me explain --

22 **MS BATES QC:** I just want to know where you see the millions  
23 coming from?

24 **MR BELLEW:** I don't at the moment, unless the alliance proceeds.

25 **MS BATES QC:** Okay, so you think it's a good -- the alliance  
26 would be good from that perspective?

27 **MR BELLEW:** Yes, I do.

28 **MS BATES QC:** Okay, thanks.

29 **CHAIR:** I'd just like to ask if you have any further comments or  
30 submissions that you would like to make to us?

31 **MR BELLEW:** No, thank you.

*Christchurch Airport*

1 **CHAIR:** I'd just like to thank you for your submission in this  
2 proceeding, and it has been interesting to receive the  
3 submission given it's quite a different view to one of the  
4 other airports, and it's interesting to contrast the two, so  
5 I thank you for that and I know we've kept you a bit longer  
6 than what we asked for, but we are grateful to you. Thanks  
7 again.

8 I would ask now for the CTU and EPMU to come forward,  
9 please.

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## 1 PRESENTATION BY CTU AND EPMU

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3 **CHAIR:** I'd just like to welcome you both to these proceedings,  
4 and invite you to introduce yourselves and then begin your  
5 presentation when you're ready.

6 **MR CONWAY:** Hello, I'm Peter Conway, the economist with the  
7 Council of Trade Unions.

8 **MR LITTLE:** And Andrew Little the National Secretary for the  
9 EPMU.

10 **MR CONWAY:** We realise time is an issue; we will be brief in our  
11 presentation. We represent three affiliates as the CTU  
12 within Air New Zealand, some 5,000 workers covered by three  
13 unions, of which the major union is the EPMU.

14 The CTU recognises the risks around price and we  
15 recognise that in an a broader sense could directly impact  
16 on workers in terms of their own travel and indirectly  
17 impact on workers in terms of costs associated with firms in  
18 terms of movement of people and goods.

19 However, we do think it would be a great pity if the  
20 alliance is rejected based on a market power price effect  
21 unless there's a strong likelihood that such a price effect  
22 is going to occur.

23 We're acutely aware that unions are sometimes seen in  
24 various theories as having an interest in monopolies because  
25 they share some of the rents that are associated with that.  
26 And we're not -- we are aware that you have received many  
27 submissions, many detailed submissions, considered many  
28 models on the price issue and we don't want to dwell on  
29 that, we simply recognise that's obviously a major issue.

30 We would like to focus mainly on the worker benefits and  
31 although we could argue, as others have, in relation to the

1 worker benefits in relation to tourism and other associated  
2 benefits that have been attributed in various of the models  
3 in terms of flow-on effects from the alliance; we prefer to  
4 concentrate mainly today in the interests of the workers  
5 within Air New Zealand and I'd ask Andrew Little to comment  
6 on that.

7 The issues that we've looked at there includes  
8 sustainable employment, the benefits of stability and also  
9 the benefits that would flow from the connectivity based on  
10 the concept of the alliance.

11 **MR LITTLE:** Thanks Peter.

12 As will be clear from our written submissions, we've  
13 proceeded on the basis that the analysis of what would  
14 happen if the applications are not approved happens, that  
15 the key result would be a stepping up of competition between  
16 Qantas and Air New Zealand to the detriment of Air New  
17 Zealand.

18 Our key concern are the emphasis on the workforce, the  
19 size, nature and quality of the workforce. Our interest is  
20 in stability both in the airline and in the aviation  
21 industry as a whole.

22 In our submission the alliance -- the applications that  
23 have been placed by the Applicants, if approved, will create  
24 that stability that is necessary in the current environment.  
25 Necessary in order to create stability in -- of employment  
26 and in employment terms, and when it comes specifically to  
27 engineering or the engineering services, that stability is  
28 necessary both for retention and recruitment of the type of  
29 skilled workforce that in our submission is needed, not only  
30 for the airline but as part of a total infrastructure of the  
31 skilled workforce needed for the type of economy that we

1 aspire to as a nation.

2 In our submission it is necessary, in considering the  
3 applications as well as the alternatives, if the application  
4 isn't approved, what the impact on employment and the nature  
5 of the jobs in the industry might be. And our concern is  
6 that if there isn't a stable industry, that in our view  
7 would be created by this type of alliance, then it's  
8 necessary to consider what might happen to, not just the  
9 business as a whole, but services -- specific services like  
10 engineering, and whether or not an airline of the size in  
11 terms of the global airline industry, an airline of the size  
12 of Air New Zealand, how able or capable it would be to  
13 retain the sort of high quality engineering service that it  
14 currently has when its competing with much larger much more  
15 powerful airlines overseas for what is a very competitive  
16 labour market for that type of skill or that end of the  
17 labour market.

18 In our submission a stable and sizeable airline is  
19 necessary in order to create a platform from which quality  
20 engineering services are able to be offered, and there is an  
21 important national interest in having that type of skilled  
22 labour, skilled workforce in New Zealand.

23 So those are the comments we wish to make.

24 **CHAIR:** Thank you for that presentation, I'm sure that we do  
25 have questions for you and I will start with them.

26 I just want to be clear; it seemed to me you were saying  
27 that if you thought there was significant price effects here  
28 as a result of this alliance, that your position on -- in  
29 supporting this alliance might not hold. Was that fair to  
30 say?

31 **MR CONWAY:** The Council of Trade Unions generally directly

1 represents affiliates, but obviously we are usually in a  
2 position of seen as a general advocate on behalf of workers  
3 and I think it would be foolish for us to ignore price  
4 effects that affect workers directly or indirectly. We  
5 don't claim to have special insights, we haven't been  
6 working with a whole team of economists in a back room on  
7 our own model and we have some --

8 **CHAIR:** I just want you to hypothesise now, not about what you  
9 think is going to happen. I'm putting to you a  
10 hypothetical, if you thought there were going to be very  
11 significant price increases, and people have talked of large  
12 amounts, 15, 20% as a result of the alliance. If that  
13 turned out to be correct, would that change the Union's  
14 position on its support of this application.

15 **MR CONWAY:** Well, in respect of -- and what I was just going to  
16 go on and say was that, obviously -- we do have some  
17 scepticism that there will be some price effects that are  
18 implicit in a position of market power that could occur, in  
19 terms of we believe there are other business reasons why  
20 prices in fact will not -- they're sort of rents that could  
21 be associated with that will not occur, but we don't claim  
22 to have some special insights that others don't around that.  
23 So, first point is, we don't necessarily think that will  
24 happen.

25 Secondly, if I set that to one side and say well, yes,  
26 if we did believe they would, well then I think there would  
27 be some difficulty for the CTU as a whole because we would  
28 have to acknowledge that, if there was that cost effect on  
29 workers, and particularly perhaps the effect on firms that  
30 rely heavily on movement of people or movement of goods in  
31 terms of air travel, then that would be a concern. We'd



1 have to offset that with the real concern we have about the  
2 stability and ongoing employment conditions of Air New  
3 Zealand workers, but yes, obviously that would be an issue  
4 for us.

5 **CHAIR:** I just have one other question then I'll give my  
6 colleagues a chance to pursue some questions, and that is  
7 also another hypothetical really: There's been a lot of  
8 talk about a war of attrition in that it could necessarily  
9 be Air New Zealand that would lose it.

10 If the scenario was one where it was clear that Air New  
11 Zealand was viable in the short-term and medium term, long-  
12 term, would the union still be supporting this alliance?  
13 And, if so, why?

14 **MR LITTLE:** If the question is, on the assumption that the  
15 airline -- it could be demonstrated that the airline could  
16 be viable short, medium and long-term, then it might modify  
17 the view somewhat, but looking at the -- sort of, the range  
18 of markets you might say that the airline is in, and I go  
19 back specifically to engineering services, in particular  
20 third party engineering services work, then it's not just a  
21 question of being viable in that regard, there has to be a  
22 sufficient critical mass and size to justify and -- justify  
23 the infrastructure of that type of operation that is  
24 currently profitable for the airline.

25 So, even if as a result of considerable competition  
26 between Qantas and Air New Zealand it can still be shown  
27 that the airline was -- could be viable in the long-term,  
28 it's not clear that that would necessarily justify the  
29 retention of the type of skilled labour that -- and the  
30 operation of engineering services that the airline currently  
31 has. It goes back to the point I made before.

1           Given even the recent events of Qantas, their  
2           announcement of restructure, and the events of this week  
3           with Qantas, which is clearly addressing cost issues  
4           including labour cost issues, it seems unlikely to me that  
5           either airline could be regarded as viable, certainly into  
6           the medium to long-term in their current form.

7   **CHAIR:** Thank you.

8   **MR CURTIN:** Just one point and we've had quite a lot of debate  
9           at these proceedings about the engineering work that Air New  
10          Zealand does currently for Qantas. And there have been  
11          various debates about what might or might not happen to that  
12          if Air New Zealand did or did not go ahead, and would people  
13          take it away and all the rest. What's your perspective on  
14          the debate about the future of that with or without the  
15          alliance?

16   **MR LITTLE:** There are a number of airlines around the world in  
17          the last 10 or 15 years have exited their own engineering  
18          businesses, engineering services with a view to contracting  
19          out and allowing a consolidation and rationalisation of  
20          aviation engineering services into some main centres, and  
21          the question is whether with those -- and predominantly in  
22          the Northern Hemisphere, with those sorts of operations,  
23          whether two relatively small airlines and one very small  
24          airline in global terms down in the bottom of the southern  
25          ocean could justify maintaining those engineering services.

26                My speculation would be that in the medium to long-term  
27                it would be very difficult to do that.

28                So I would say that without the alliance there must be a  
29                real prospect that engineering services, certainly in  
30                New Zealand, would come under severe threat and possibly in  
31                Australia because it would become -- with the concentration

1 and consolidation of engineering services in the Northern  
2 Hemisphere centres would become likely to be -- would likely  
3 to become more viable to have that engineering carried out  
4 in those places, as if it would also be as a further  
5 consequence of, through intense competition in those  
6 airlines, those airlines being driven into essentially  
7 predominantly value based type services.

8 **MR CURTIN:** Thank you.

9 **CHAIR:** I'd just like to thank you both for your submissions and  
10 for taking questions from the Commission, and I will at this  
11 time adjourn the meeting until 10 o'clock on Monday --  
12 sorry, 9.30 on Monday morning. Okay, thank you very much.

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Hearing adjourned at 5.20 pm

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Resuming Monday, 25 August 2003 at 9.30 am

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