

CHAPTER 13

ENGINEERING AND MAINTENANCE BENEFITS

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INTRODUCTION

Applicants' evidence

- 13.1 The Applicants have previously submitted that under the Alliance, Qantas would have an incentive to direct up to 80% of its subcontracted external engineering and maintenance work (**E & M Work**) to Air New Zealand. In contrast, in the Counterfactual, potentially, only 10% of Qantas' E & M Work might be contracted to Air New Zealand.
- 13.2 Accordingly, the Applicants submitted that the benefit to Air New Zealand of the increase in the level of Qantas E & M Work being awarded to Air New Zealand in the Factual (i.e. the difference between 80% and 10%) would be \$39 million per year.

Commission's preliminary view

- 13.3 In the Draft Determination, the Commission reached the preliminary view that the E & M Work benefit resulting from the Alliance should be assessed as nil on the basis that:
- in the 2002-2003 financial year, Qantas directed 78% of its E & M Work to Air New Zealand and the estimate of only 10% of Qantas' E & M Work going to Air New Zealand in the Counterfactual would involve a great reduction in the level of E & M Work currently directed to Air New Zealand;
 - Qantas' statement that it would seek the most cost-effective arrangements in the Counterfactual implied that Qantas does not do so already and would not do so under the Factual;
 - Qantas' equity holding in Air New Zealand does not provide the incentive to engage Air New Zealand for up to 80% of its E & M Work, especially given that Qantas already purchases 78% of its requirements without an equity incentive; and
 - the claimed benefit is a measure of gross expenditure rather than welfare.

Overview of the chapter

- 13.4 This Chapter addresses the issues raised by the Commission in its Draft Determination in response to the Applicants' claim that the Alliance would generate \$39 million per year in benefits through increased Qantas E & M Work being awarded to Air New Zealand.
- 13.5 The chapter is separated into three substantive sections, which, in turn:

- explain the factors that contribute to Qantas' decisions regarding E & M service providers, how those factors have been influenced by Ansett's failure and explain Qantas' differing incentives under the Alliance and the Counterfactual;
- provide evidence that the amount of Qantas E & M Work awarded to Air New Zealand Engineering Services (**ANZES**) is highly volatile and explain the implications of this volatility; and
- explain the impact that the Confidential Counterfactual would have on ANZES' operations.

QANTAS' INCENTIVES

Commission's preliminary analysis

13.6 The Commission's preliminary view outlined above is premised on the fact that Qantas directed 78% of its E & M Work to ANZES in the 2002-2003 financial year, and therefore Qantas either:

- (i) currently uses ANZES because it is the lowest cost-provider and therefore, will continue to use ANZES in the Counterfactual; or
- (ii) currently does not seek out the lowest cost E & M Provider, which means that it is acting irrationally.

13.7 Accordingly, the Commission's preliminary view is that Qantas will not have an increased incentive to direct E & M Work to Air New Zealand under the Alliance.

Qantas' E & M Work decisions are not driven solely by cost

13.8 While the Applicants acknowledge that Qantas directed a substantial amount of its E & M Work to ANZES in the 2002-2003 year, in the Applicants' view, this fact is not inconsistent with their submission that the level of Qantas' E & M Work contracted to ANZES would decline to 10% in the Counterfactual.

13.9 In the Applicants' view, the Commission's preliminary analysis focussed too greatly on the role that cost plays in Qantas' decisions regarding E & M Work. Although cost is an important factor in E & M outsourcing decisions, there are number of other equally important factors such as:

- the location of the service provider - Qantas needs a service provider based in the Asia-Pacific region;
- the performance characteristics of the service provider – Qantas needs a service provider who can provide a high quality, flexible service within an acceptable timeframe;
- the level and urgency of the servicing requirements - for example, if Qantas' fleet was under pressure, an E & M provider that was close to Qantas' home base would be better placed to service Qantas' fleet; and
- other strategic imperatives aligned with the motivation to maximise Qantas' group-wide profitability.

13.10 The relative importance of these various factors changes according to the prevailing conditions in the general aviation market. As a result , the reasons underlying the high level of E & M Work awarded to ANZES reflect the context of the aviation market at that time. In great degree, the key Australasian market condition in this period is the impact of the failure of Ansett.

Impact of Ansett on E & M trends

13.11 The recent level of E & M Work being awarded by Qantas to ANZES is anomalous and represents a recent peak resulting from the Ansett collapse. Following Ansett's failure in 2001, Qantas dramatically increased its Australian domestic services. In turn, this increase in capacity fed a dramatic increase in demand for outsourced E & M Work because Qantas:

- (a) deployed more planes, which all required maintenance; and
- (b) increased the utilisation of its existing planes, which brought forward Qantas' maintenance timetable.

13.12 As a result of increasing aircraft utilisation, the relative importance of the factors that influence Qantas' E & M Work decisions were altered. Qantas was forced to place more emphasis on the location of E & M service providers and the speed with which E & M Work would be completed rather than on the providers engaged.

13.13 In conjunction with Qantas' demand increase, on the supply side, the demise of Ansett reduced ANZES' workload. Accordingly, ANZES provided Qantas with an E & M option

with the benefits of being a close, internationally well regarded and having substantial immediate E & M capacity.

13.14 Given this change in the relative importance of the factors influencing its decisions regarding E & M service providers, and ANZES substantial excess capacity, Qantas determined that its optimal transitional strategy was to direct its immediate E & M Work requirement to ANZES .

Table 1 - Qantas' Australian Fleet E & M Directed to ANZES

	2001 (Manhours)	2002 (Manhours)	2003 (Manhours)	2004 – Budget (Manhours)
Australian B733	19	56,498	69,508	0
Australian B744	136	68,119	114,480	0
Australian B762	0	0	16,187	0
Australian B763	46,475	23,408	181,632	[]
TOTAL	46,630	148,025	381,897	[]

13.15 The impact of these decisions can be seen in Table 1. The level of Qantas E & M work flowing from Qantas' Australian fleet increased by []% between 2001 and 2002 and by an additional []% between 2002 and 2003.

Realignment of Qantas' incentives

13.16 The impact of the Ansett failure is a short term phenomenon. The relative change in importance in the factors affecting Qantas' E & M outsourcing decisions is also a short term phenomenon. In the longer-term, and absent the Alliance, the Applicants expect Qantas' incentives to return to their pre-Ansett state. Indeed, Qantas demand needs have declined, particularly as Virgin Blue has grown to absorb some of the demand in the Australian domestic market. As a result, the relative importance of cost has increased and Qantas' incentives have been realigned. It is in this context that Qantas' incentives in the Factual and the Counterfactual should be assessed.

13.17 Further, all of the Qantas E & M Work awarded to ANZES is (and will continue to be in the Counterfactual) derived from a public tender process, in which ANZES is but one competing service provider. The Qantas E & M Work is undertaken on the basis of an arms length, fully negotiated commercial contract. The tender process is demonstrably robust and has often been difficult. In the Applicants' view, this process will continue under the Counterfactual because, from Qantas' perspective, it ensures a benchmarked competitive product. However, under the Alliance, Qantas' equity stake would give it the incentive to commit - at the CEO/ Executive Committee level - a volume of E & M Work to ANZES. If ANZES was not competitive, a process at the senior level to resolve that issue.

Qantas' incentives in the Counterfactual

13.18 As stated by Qantas in response to a question from the Commission, there are a number of recognised providers of aircraft maintenance services in the South East Asian/Australasian region that can provide E & M services for Qantas' aircraft. In addition to ANZES, Qantas has recently used Singapore Technologies Aerospace (**STA**), which is the largest independent third-party aircraft component repair and overhaul company in the region.

13.19 STA operates out of Singapore's Changi and Paya Laber airports. STA offers the following benefits for Qantas:

- quality of service and an established relationship comparable to that provided by ANZES;
- an attractive cost structure;
- STA is an independent company not linked to any competing airline; and
- STA's base at Singapore means that it is easily accessible if not as close as ANZES' facilities. Qantas operated a hub from Changi airport.

13.20 Once it is realised that Qantas' incentives are dynamic and not based solely on cost, the nature of the differing incentives facing Qantas under the Alliance and in the Counterfactual become apparent. While ANZES offered an attractive option at the time of Ansett's failure, by continuing to direct a significant proportion of E & M Work to ANZES under the Counterfactual, Qantas would be assisting the profitability of Air New Zealand, a direct competitor in a region in which Qantas is trying to gain the upper hand.

Indeed, in the face of an increasingly competitive market, the relative importance of this decision factor will increase.

Table 2 - Qantas' New Zealand Operations E & M Manhours

Financial Year	Qantas New Zealand (Manhours)
2001	0
2002	30,195
2003	121,021
2004 – Budget	[]

13.21 Table 2 demonstrates the increasing importance of Qantas' New Zealand operations to ANZES. Indeed in 2004, Qantas' New Zealand E & M requirements are budgeted to account for []% of total Qantas E & M Work. Accordingly, the removal of some of Qantas' New Zealand E & M Work will have a major impact on ANZES.

Qantas' incentives in the Alliance

13.22 Under the Alliance, supporting a competitor would cease to be an issue. In fact, the opposite would be true, Qantas would have the incentive to ensure Air New Zealand's ongoing viability and profitability.

13.23 Further, as stated in response to a question from the Commission, Qantas would expect the labour and material prices and turnaround time offered by ANZES to be competitive with STA.

13.24 Accordingly, under the Alliance, ANZES would be in a strong position to gain up to 80% of Qantas' E & M Work.

Conclusion

13.25 For the reasons outlined above, the fact that currently Qantas directs 78% of its E & M Work to ANZES is not inconsistent with the Applicants' submission that the level of Qantas E & M Work that will be available to ANZES in the Counterfactual is likely to be as low as 10%.

ALLIANCE INCREASES CERTAINTY FOR ANZES

Qantas E & M Work is highly volatile

13.26 As stated above, in the Applicants' view, the Commission's preliminary analysis has overlooked the fact that the level of Qantas E & M Work directed to ANZES peaked in the 2003 year and overlooked the extraordinary circumstances that led to this outcome. As can be seen from Table 3 below, the value of Qantas E & M Work increased significantly between 2002 and 2003 and is forecast to fall dramatically ([])% in 2004.

Table 3 - Value of Qantas E & M Work

Financial Year	Manhours
2001	78,551
2002	192,250
2003	504,531
2004 – Budget	[]

13.27 Table 3 demonstrates that the level of Qantas E & M Work contracted to ANZES is highly volatile. In Air New Zealand's view, even disregarding Qantas' other incentives, this volatility would continue in the Counterfactual. This volatility does not provide a certain base from which Air New Zealand can plan future investment in ANZES.

Impact of the Alliance

13.28 As outlined above, under the Alliance Qantas will have an incentive to provide a significant and certain level of E & M Work to ANZES. While the dynamic nature of the aviation industry dictates that ANZES will not be able to plan with exact certainty on the level of Qantas E & M Work that it will receive in any given year, because it will be better placed to receive this work, Qantas' demand fluctuations are much less likely to impact on ANZES less. For example, all else being equal, if Qantas demand for E & M Work reduced, Qantas would decrease the level of E & M Work provided to independent E & M providers before it reduced the level of E & M Work contracted to ANZES due to its equity investment in Air New Zealand.

13.29 From Air New Zealand's perspective, the increased certainty provided by the Alliance allows it to plan with more certainty for necessary reinvestment in ANZES. Like any maintenance or engineering business, to retain a quality cost-competitive product

requires continued investment in technology, innovation and human capital. Under the Alliance, Air New Zealand can rely on Qantas E & M Work being contracted to ANZES on a long-term sustainable and more steady basis.

13.30 In the Applicants' view, the Commission's final analysis should reflect the dynamic implications of this increased certainty. Increased certainty of revenue and the resulting ability to reinvest more money into ANZES will allow ANZES to retain its reputation as a leading provider of E & M services. In the long-run, as compared to the Counterfactual, this will improve ANZES ability to compete and win E & M business from new clients.

IMPACT OF THE CONFIDENTIAL COUNTERFACTUAL

Commission's preliminary view

13.31 Air New Zealand considers that, in reaching its preliminary view, the Commission has overlooked the impact on ANZES of the potential for Air New Zealand to scale down its long-haul operations.

13.32 ANZES ability to provide a high quality cost-competitive service would be disadvantaged by any reduction in Air New Zealand's long haul operations and the subsequent reduction in internal E & M Work for the following reasons.

ANZES' ability to smooth revenue

13.33 As stated previously, the aviation market is highly dynamic. As a result, the level of outsourced E & M Work is highly volatile.

13.34 By contrast, internal E & M Work is more certain and accordingly, the income that ANZES derives from its internal E & M service can be more readily ascertained. The certainty that internal E & M Work provides allows ANZES to smooth E & M revenue flows across peaks and troughs resulting from fluctuations in external E & M demand.

ANZES' ability to spread fixed costs.

13.35 Currently, ANZES provide a quality, cost-competitive service. ANZES' ability to provide this cost-competitive service to external clients is driven by its ability to spread its fixed costs across its entire volume of work, both internal and external. Over 50% of ANZES' work is E & M Work for external clients. As a result, any reduction in ANZES' cost competitiveness would adversely affect ANZES' ability to retain these clients or to attract new clients.

13.36 To this end, Air New Zealand notes that following a reduction in Air New Zealand services, the volume of internal work that ANZES would receive would decrease. Accordingly, ANZES total volume of E & M Work would decline. This decline in volume would increase the cost of both external and internal work. The increased cost of external E & M Work would adversely impact on ANZES' cost-competitiveness.

Dynamic impact on ANZES' human capital

13.37 ANZES' ability to service different aircraft types is driven by its staff having the necessary skills and experience to service those aircraft. Much of ANZES current success in obtaining external E & M Work is due to the operational know-how that ANZES has obtained - and continues to obtain - from the internal work ANZES completes on Air New Zealand's core fleet.

13.38 As a result, if Air New Zealand was to reduce its operations (and therefore reduce the internal E & M work needed), ANZES ability to provide the operational know-how necessary to service external clients would also decline. This decline would adversely affect ANZES ability to retain and attract external clients.

CONCLUSION

13.39 The Alliance directly improves ANZES ability to attract and retain Qantas E & M Work and increases Qantas' incentives to award its E & M Work to ANZES. Under the Counterfactual, Qantas' incentives to award its E & M Work to Air New Zealand are dramatically diminished. In addition, the Alliance improves ANZES ability to retain and attract other external E & M clients.