EXECUTIVE SUMMARY[1]

Proposed Alliance Between Air NZ and Qantas

1. On 9 December 2002 the Commerce Commission (the Commission) received two interdependent applications for authorisation from Air New Zealand Ltd (Air NZ) and Qantas Airways Ltd (Qantas).

2. The first application by Qantas, made under section 67(1) of the Commerce Act, relates to a proposed "share purchase agreement" whereby Qantas would acquire 22.5% of the voting equity in Air NZ.

3. The second application by Air NZ and Qantas, made under section 58 of the Commerce Act, relates to the proposed implementation of a "strategic alliance arrangement" between Air NZ and Qantas. The strategic alliance arrangement would, among other things, require the two airlines to:

    - create a "Joint Airline Operation". Every Air NZ flight and those Qantas flights to, from, and within, New Zealand would make up the Joint Airline Operation. Its commercial activities would be managed by Air NZ, and which would be overseen by a strategic alliance advisory group comprising three representatives of each airline;

    - coordinate all aspects of the Joint Airline Operation including passenger fares and freight rates, flight schedules, the amount of passenger and freight capacity provided on each sector, code-sharing, marketing, frequent flyer programmes and profit-sharing; and

    - cooperate in relation to other airline operations outside the scope of the Joint Airline Operation.

4. The contractual documents that give effect to the overall commercial arrangements are conditional upon the creation of the alliance under the strategic alliance arrangement. In this executive summary and in the Determinations, the share purchase agreement and the strategic alliance arrangement are collectively referred to as "the proposed Alliance".

5. In addition, Air NZ and Qantas have proposed that Qantas would have the right to be represented by two directors, which it would appoint to Air NZ's board of directors.

[1] This Executive Summary is provided for the assistance of readers of the Commission's determinations. It does not purport to completely encompass all details of the Applications, the Commission's investigation of the facts, the Commission's analysis of those facts, the reasons for the Commission's determinations or the determinations themselves. Readers are referred to the body of the reasons for the Commission's determinations for a complete picture.

In turn, Air NZ would have the right to be represented by one director, which it would appoint to Qantas's board of directors.

Framework for Consideration of the Applications for Authorisation

6. For the purposes of the applications before the Commission, the proposed Alliance can be seen in two parts, the proposed share purchase agreement and the proposed strategic alliance arrangement. As stated, the Applicants have advised that these are interdependent and together comprise one business plan, so that one would not occur without the other. The Commission determined to consider the applications together as they are interdependent. Air NZ and Qantas have also sought and agreed to that approach.

7. The two applications represent the proposed Alliance. Therefore, for the most part, the analysis of each application centres upon the same considerations. These include: the factual matrix; the market definitions; the competitive outcomes in the counterfactual and the factual; and the detriments and benefits arising from the business plan, all of which will be determinative of the applications. Nevertheless, the Commission is required to make separate determinations with respect to the proposed share purchase agreement and to the proposed strategic alliance arrangement.

8. In relation to the proposed share purchase agreement, the Commission must determine whether, in any of the markets affected, the proposed share purchase agreement would have, or would be likely to have, the effect of substantially lessening competition and, if so, whether the proposed share purchase agreement would result, or would be likely to result, in such a benefit to the public that it should be permitted.

9. In relation to the proposed strategic alliance arrangement, the Commission must determine whether, in any of the markets affected, the proposed strategic alliance arrangement would result in a lessening, or a deemed lessening, of competition and, if so, whether the proposed strategic alliance arrangement would, in all the circumstances result, or be likely to result, in a benefit to the public which would outweigh the lessening in competition that would result, or would be likely to result or is deemed to result, such that it should be authorised.

10. The Commission considers that a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on such gains and losses being measured in terms of economic efficiency. If the Commission is satisfied that the public benefits outweigh the detriments in each case, it must authorise the proposed Alliance. If the Commission is not so satisfied, then the proposed Alliance must be declined authorisation.

11. The Commission has estimated single-year benefits and detriments, based on year three of the proposed Alliance, but has also considered how detriments and benefits may accrue over an initial five year period under the proposed Alliance. The Commission considers that year three may be regarded as representative of the relative sizes of benefits and detriments that would accrue in one year under the proposed Alliance. The Commission also notes that benefits and detriments may extend beyond a five-year period, but considers that projections beyond this time horizon are too uncertain to be of any value.

Commission Processes

12. In making these Determinations, the Commission has considered and given weight to information and analysis from a wide range of sources. Following its Draft Determination issued on 10 April 2003, the Commission received written submissions from 24 parties, and subsequent cross-submissions from 12 parties.

13. The Commission conducted a conference over six days, beginning on 18 August 2003, to hear oral submissions on the Draft Determinations from 14 parties, and to ask questions of submitters. Much additional information was provided to the Commission at the conference from parties both supporting and opposing the applications for authorisation.

14. During its examination of the applications for authorisation, the Commission has received and taken account of advice received from its own economic and legal experts - Professor Gillen of the Wilfred Laurier University of Ontario, Professor Zhang of the University of British Columbia, Dr M Berry, barrister and Mr H Rennie QC, along with experts employed by Air NZ, Qantas, Infratil and Gullivers Pacific.

15. Having completed its investigation, research, modelling and conference processes, the Commission subsequently weighed and reviewed all the information and analysis it had received during its examination of the applications before reaching its final determinations.

16. Set out below is a summary of the Commission's key reasons for the final Determinations reached.

The Factual and Counterfactual

17. The Commission takes a comparative, rather than an absolute, approach to its consideration of the competition impacts that would be likely to result from a proposed acquisition or arrangement. In doing so, it compares the extent of competition in both the factual and the counterfactual.

18. The factual is the situation likely to arise in the future if the proposed Alliance were to proceed. The counterfactual is the future situation likely to arise in the absence of the proposed Alliance. The counterfactual is not necessarily a continuation of the status quo. Rather, it encapsulates the Commission's pragmatic assessment of what is likely to happen in the absence of the factual.

19. The factual and counterfactual give rise to different states of competition in each of the relevant markets. The Commission carries out a comparison between the factual and the counterfactual in order to make a judgment as to the impact of the proposed Alliance on competition. If a substantial lessening of competition, in the case of an acquisition, or a lessening of competition, in relation to an arrangement, were to arise in any market, the proposed Alliance would require an authorisation in order to proceed.

20. In that case, the lessening of competition in the factual relative to the counterfactual allowed the Commission to determine the amount of detriment that would arise from the proposed Alliance. As explained above, this detriment would have to be set against the benefit likely to flow from the proposed Alliance, in order to arrive at a conclusion as to whether authorisation was warranted.

The Factual in this Case

21. The Commission considers that in the factual the proposed Alliance between Air NZ and Qantas would take place, and that its key characteristics would be:

- Qantas would subscribe for 22.5% of the voting equity in Air NZ for a consideration of $550 million. The cross-appointment of directors would occur. The Joint Airline Operation would commence, the commercial aspects of which would be managed by Air NZ;

- Air NZ and Qantas would coordinate pricing, capacity, schedules and all other aspects of normal business on both the Joint Airline Operation and on other routes. This would lead to the elimination of the competition currently existing between Air NZ and Qantas;

- Virgin Blue[2] would enter the Tasman market, and subsequently the New Zealand main trunk market, but to a limited extent in the Commission's timeframe;

- competition from other international carriers flying between Auckland and Australia as part of longer international flights would continue; and

- the competition on New Zealand provincial routes offered by Origin Pacific would be reduced due to the cessation of its code-sharing arrangement with Qantas which would cause Origin Pacific to retrench.

[2] Or its New Zealand-based subsidiary, Pacific Blue.

The Counterfactual in this Case

22. The Commission considers that the key characteristics of the likely counterfactual are that:

- there would be a gradual recovery in the financial position of Air NZ, and its ongoing financial viability over the short- to medium-term. The Government would continue to be a shareholder in Air NZ. There is uncertainty as to whether sufficient new capital would be available, or whether its retained earnings would be sufficient, to allow the airline to pursue its preferred national/international network strategy;

- Air NZ and Qantas would continue to be competitors on domestic New Zealand, Tasman, Pacific Island, Asian and North American routes, with the capacity of each being expanded in line with market growth;

- there would be entry and gradual expansion by Virgin Blue on Tasman and New Zealand main trunk routes;

- competition from other international carriers flying between Auckland and Australia, as part of longer international flights, would continue; and

- Origin Pacific would remain in its code-sharing relationship with Qantas, and would continue to provide competition on provincial New Zealand routes.

Differences Between the Factual and the Counterfactual

23. From a competition perspective, the main differences are that Air NZ and Qantas would operate as one airline in the factual but not in the counterfactual, that Virgin Blue would gain a smaller market share in the factual, and that Origin Pacific would have a reduced competitive effect in the factual vis a vis the counterfactual.

Market Definition

24. The markets that the Commission considers are relevant to its examination of the competitive impacts of the proposed Alliance are the following:

- the New Zealand main trunk passenger air services market, comprising flights between Auckland, Wellington and Christchurch;

- the New Zealand provincial passenger air services market, comprising New Zealand domestic flights other than those on the main trunk routes;

- the Tasman passenger air services market, comprising all flights between New Zealand and Australia;
- the New Zealand to Asia passenger air services markets, comprising both direct flights from New Zealand, and indirect flights from New Zealand via Australia, to and from Japan, Taipei, Hong Kong and Singapore;
- the New Zealand to the Pacific Islands and beyond passenger air services markets, comprising flights between New Zealand and Fiji, Samoa; Tonga, and Tahiti; between Fiji and Los Angeles, between Samoa and Tonga; and between Tahiti and Los Angeles;
- the New Zealand to the United States air passenger services market, comprising flights between Auckland and Los Angeles;
- the other international passenger air services markets, comprising flights between New Zealand and Europe;
- the domestic freight market;
- the Tasman belly-hold freight market;
- the international belly-hold freight markets for the conveyance of freight between New Zealand and Asia, the Pacific Islands, the United States and other international destinations; and
- the national wholesale travel distribution services market.

Competition Analysis

25. The competition analysis carried out by the Commission is a comparison of the likely state of competition in the factual under the proposed Alliance, with that in the counterfactual without the Alliance. The Commission carried out a qualitative analysis of competition in each market. In addition, economic modelling also assisted the Commission by providing a quantitative estimate of the likely increase of airfares from any lessening of competition between the factual and the counterfactual in each market. The results of the Commission's qualitative and competition analysis of the proposed Alliance are summarised below.

26. The Commission considers, on the balance of probabilities, that there is likely to be a substantial lessening of competition in each of the markets listed below for the reasons given. The Commission also finds that the strategic Alliance arrangement provides for the two competing airlines to agree the price of their air fares. Thus, the strategic Alliance arrangement is an agreement to fix prices. As such it is deemed to

substantially lessen competition in each of the relevant markets under s30 of the Commerce Act.

- The New Zealand main trunk passenger air services market: the proposed Alliance would result in the two major suppliers joining forces, and having a market share approaching 100%. It would lead to a reduction in the limited existing competition from Origin Pacific, through its likely retrenchment. Further, the Commission considers that while the entry of Virgin Blue into the market is likely to a limited extent in both the factual and the counterfactual, its entry in the factual would be more limited because of the superior ability of the proposed Alliance to respond to discourage entry and expansion.

- The New Zealand provincial passenger air services market: Air NZ already has a very large share of this market, and the proposed Alliance would result in a reduction in the existing competition from Origin Pacific, through its likely retrenchment. The Commission considers that Virgin Blue would not enter this market in other than a “cherry picking” manner, perhaps to tourist destinations only that could be served by its jet aircraft.

- The Tasman passenger air services market: the proposed Alliance would result in the two major suppliers joining forces, and having a high market share. There would be little constraint from fifth freedom competitors in either the factual or the counterfactual. Like the main trunk market, the Commission considers that the entry of Virgin Blue into this market would be limited in extent, and would not significantly constrain the proposed Alliance.

- The NZ – Asia passenger air services markets: the Alliance would have the effect of removing the existing competitive constraint on Air NZ of indirect flights to Asian destinations on Qantas via Australia. The proposed Alliance would not be constrained by existing competition, or the threat of entry, on the routes between New Zealand and Japan and Taipei. The proposed Alliance would continue to face competition on the routes between New Zealand and Hong Kong and Singapore. However, as the strategic alliance arrangement is a price-fixing agreement it is deemed to substantially lessen competition on those latter routes through the operation of s 30 of the Commerce Act.

- The NZ – Pacific and beyond passenger air services markets: the proposed Alliance would result in an aggregation in market share between Air NZ and Air Pacific (in which Qantas has a substantial shareholding), and would also have a further competitive effect on other small Pacific carriers, such as Polynesian Airlines, through the loss of Qantas as a code-share partner. As a result the proposed Alliance would not be constrained by existing competition, or the threat of entry on the routes to Fiji, Samoa, Tonga and Tahiti from New Zealand, or on the routes from Fiji to Los Angeles and from Samoa to Tonga. The Alliance would continue to face competition on the Tahiti to Los Angeles route in the factual from Air Tahiti Nui and Air France. However, as the strategic alliance arrangement is a price fixing agreement it is deemed to substantially lessen competition through the operation of s 30 of the Commerce Act.

- The NZ-US passenger air services market: the proposed Alliance would bring together the only two existing competitors, and would be insufficiently constrained by potential competition, with no entry likely within the time period considered by the Commission.

- The international passenger air services markets: the proposed Alliance would be likely to face competition from a number of strong international carriers. The strategic alliance arrangement is, nevertheless, deemed to substantially lessen competition under s 30 of the Commerce Act.

- The Tasman belly-hold freight market: the proposed Alliance would have the effect of substantially lessening competition for the same reasons as set out above under the Tasman air passenger services market.

- The international belly-hold freight market: the proposed Alliance would have the effect of substantially lessening competition for the same reasons as set out above with respect to the NZ-Asian air passenger services markets, the NZ-Pacific and beyond passenger air services markets, the NZ-US passenger air services market and the international passenger air services market.

- The national wholesale travel distribution market: the proposed Alliance would have the ability to restrict access to services, in terms of air fare rates, to independent travel wholesalers. Competition at the airline level would be insufficient to address these concerns, even allowing for the entry of Virgin Blue. As a result the wholesalers owned by the proposed Alliance members would be able to lever stronger market positions.

27. In most of these markets the main competition effect stems from the reduction in the number of competitors either from three to two or from two to one, between the counterfactual and the factual. The existing active competition in the counterfactual between the two major participants, Air NZ and Qantas—which currently have a combined market share in various markets of up to 100%—would be eliminated in the factual.

28. Therefore, the Commission's qualitative analysis leads to its conclusion that the proposed Alliance would be likely to result in a substantial lessening of competition in the relevant markets.

29. The Commission's quantitative economic modelling of individual markets generated likely average fare increases under the proposed Alliance, relative to the counterfactual, that were consistent with its qualitative conclusions on the substantial lessening of competition in those markets. Table One below shows the expected air

fare increases[3] for year three of the proposed Alliance. An ability to raise prices to the extent shown in Table One below suggests the proposed Alliance would achieve a substantial degree of market power, resulting in a substantial lessening of competition. The increases for the last two markets in the Table were not modelled, but were estimated to be at least 5% on the basis that a substantial lessening of competition had been found.

Table One
Expected Average Air Fare Increases in the Factual Compared with the Counterfactual
(year three)

Market	Average Air fare increase
New Zealand Main Trunk	17%
New Zealand Provincial	16%
Tasman	16%
Auckland – Los Angeles	14%
Auckland – Nadi	11%
Nadi – Los Angeles	19%
Auckland – Asia	5%+
Other Pacific Routes	5%+

Detriments

30. The Commission found that a substantial lessening of competition would occur in a number of markets as a result of the proposed Alliance. A lessening of competition would be expected to result in economic detriments to the public of New Zealand, in terms of a loss of economic efficiency.

31. To the extent possible, the Commission must attempt to quantify such detriments, and it did so under the headings of allocative, productive and dynamic inefficiency.

Allocative Inefficiency

32. Allocative inefficiency arises from the impact of reduced competition, which in the present case is expected to cause the market price (air fares and freight rates) to be increased above, and market output (number of aircraft seats and volume of freight capacity provided) to be reduced below, the level that would prevail in the absence of the proposed Alliance.

33. In these circumstances, a loss arises from:

[3] Expressed as a percentage of the weighted average air fares supplied by Air NZ and Qantas.

- the value lost by travellers who would have made flights but no longer do so under the proposed Alliance; and

- the loss of profits of the airlines by not providing those flights.

34. In addition, the higher airfares result in a transfer of income from consumers, who pay the higher fares, to the airlines, who receive them as higher profits. These transfers are not generally counted as a detriment by the Commission. However, the purpose of the Commerce Act is to promote competition for the benefit of New Zealand consumers. Consequently, where such transfers are from foreign consumers to a New Zealand supplier, such as Air NZ, they are considered to be a benefit. Similarly, where New Zealand travellers would pay a higher fare to an overseas-based supplier, such as Qantas, that is considered a detriment. By its nature, air travel involves the supply of services to consumers both from within and outside New Zealand. Accordingly, the economic modelling of allocative inefficiencies in this case took these beneficial and detrimental transfers into account.

35. The respective merits of three economic models were thoroughly reviewed during the Commission's process, both by the Commission's expert consultants and also by the parties' expert consultants. These models have all been useful to varying degrees, but they have also exhibited a number of problems in design and configuration. The Commission is confident that its own model is the most appropriate for the quantitative analysis of allocative inefficiency in the markets at issue.

36. The Commission's economic modelling revealed that the level of allocative inefficiency and transfers associated with the proposed Alliance, resulting from the impact of reduced competition, was likely to be in the range from $83 million to $110 million in year three with the most likely value being $90 million. This is a measure of the extent to which New Zealand air travellers and producers would be directly adversely affected by the proposed Alliance.

Productive Inefficiency

37. Productive inefficiency measures the extent to which a business's costs are above the minimum necessary to produce a given output. This loss is real in the sense that resources are being wasted that could be used elsewhere in the economy to produce valued outputs, which are foregone because of their unproductive use by the inefficient firm. The excess costs are treated as a welfare loss.

38. A firm in a market suffering from a substantial lessening of competition would be under less pressure to minimise costs and to avoid waste than one in a more competitive market. This is called "slackness" or "x-inefficiency". In addition, the higher profits generated by market power may encourage "rent-seeking" behaviour on the part of its labour force and other input suppliers, which would be reflected in the form of higher remuneration or reduced effort. This form of waste is measured by the

value of the resources devoted both by groups in rent-seeking activities, and by the company in attempting to combat such activities.

39. Both carriers indicated that they suffered from "legacy costs", and both have recently announced plans to substantially reduce costs. This suggests that costs have been excessive in the past, and indicates an intention by both to reduce them in the future. In addition, traditional carriers internationally appear to have suffered from rent-seeking by well-organised employee groups. The Commission also appreciates that where product market competition is weak, other forces may encourage efficiency, such as the threat of takeover (not relevant in this case), and managerial concern that career prospects and reputation could be sullied by association with a poorly managed company.

40. Based on its assessment of the likely outcomes in the factual and counterfactual, the Commission considers that productive inefficiency would be likely to arise in all markets in which there would be a substantial lessening of competition. The Commission has pragmatically settled on the conservative range of 1% to 5% of the estimated variable operating costs of the proposed Alliance's New Zealand-based resources as being an appropriate approximation of the likely range of productive inefficiency that would arise by year three.

41. The Commission considers that this sets the range of $18 million to $91 million (for that one year) for productive inefficiency, within which the most likely outcome is $55 million.

Dynamic Inefficiency

42. Dynamic inefficiency arises when a business or industry is less innovative than it might be. Innovations bring benefits to consumers either through the introduction of improved new products that buyers value more highly ("product innovations"), or through the use of new, lower cost ways of producing existing products ("process innovations"). The proposed Alliance is expected to have a negative impact on dynamic inefficiency because of the reduction in the competitive spur to innovate, compared to the more competitive situation likely in the counterfactual. The removal of competitive pressure on the Alliance would lessen its incentive to innovate in order to match or keep ahead of rivals. Innovation in aviation markets in the past has often been stimulated by competition, often from new entrants.

43. As aviation is a dynamic industry, the Commission is concerned that these losses could be significant. It has three particular areas of concern:

- the lessening of dynamic efficiency generally on the part of the Applicants through the reduction in competition;

- the loss caused by Air NZ's prospective switch between global alliances; and

- the loss resulting from the likely reduced value of accumulated air points holdings.

44. The Commission has quantified the first and last of these detriments by assuming airline costs higher than they would otherwise be in the range of 0.5 to 1.5% per annum in year three. On the basis of Air NZ's total revenues of $3.6 billion, this would give a loss of between $18 million and $54 million. In addition, the Commission anticipates that there would be substantial losses arising from the transition costs when, as a result of the proposed Alliance, Air NZ would exit the Star Alliance and join the oneworld Alliance. The exact amounts of this component, allowing calculation of the whole range of dynamic inefficiency loss, are confidential.

45. Overall, the Commission considers the losses from dynamic inefficiency would be of the order of $50 million per annum in year three.

Conclusion on Detriments Arising from the Proposed Alliance

46. Table Two below summarises the relevant values by providing the range and the most likely outcome for each category of detriment, and for the aggregate. The Commission considers that the range for total detriments is between $[ ] million and $[ ] million per annum, with the most likely outcome (not necessarily at the midpoint of the range) being $195 million, all measured as at year three.

Table Two
Summary of Annual Detriments, Year Three ($million)

Item	Detriments	
	Range	Most Likely
Allocative inefficiency and transfers	110 – 83	90
Productive inefficiency	91 – 18	55
Dynamic inefficiency[4]	[ ]–[ ]	50
Totals	[ ] – [ ]	195

Benefits

47. The Commission has concluded that significant detriments arise from the proposed Alliance. However, if the Commission is satisfied that any public benefits also arising from the proposed Alliance outweigh the detriments, it must authorise the proposed Alliance. Therefore, the Commission must also determine the likely levels of public benefit.

[4] The Commission's estimate is an intermediate point in a range partly bound by an estimate derived from confidential information. Consequently, the range cannot be disclosed for the purposes of balancing public benefits and detriments.

48. Public benefits are any gains to the public that are in accord with the following main principles that the Commission adopts to determine benefits:

- the benefits must be shown to be dependent on the proposed Alliance;

- the assessment of benefits will focus particularly on efficiency gains. These include economies of scale and scope, better utilisation of capacity and cost savings (productive efficency). Efficiencies can also include social and intangible benefits, if these can be shown to be socially efficient;

- net benefits, not gross benefits, are counted. Transfers of wealth are generally not counted; and

- the "public" is the public of New Zealand; benefits to foreigners are counted only to the extent that they also involve benefits to New Zealanders.

49. The Commission examined the benefits that Air NZ and Qantas claimed would arise from the proposed Alliance. These benefits, in descending order of claimed magnitude, are as follows:

- cost savings;
- additional numbers of tourists in New Zealand;
- the continuation of Qantas's purchase of aircraft engineering and maintenance services from Air NZ at existing levels;
- improved aircraft schedules;
- improved freight services;
- new direct flights; and
- other benefits not quantified by Air NZ and Qantas.

50. Qantas would pay Air NZ $550 million as consideration for its 22.5% of the shares of Air NZ. The Commission does not consider such an injection of capital into New Zealand would be a benefit. That is because, in effect, Qantas would purchase a future on-going dividend stream from Air NZ in exchange for that amount. The Commission considers that that dividend stream would net off any beneficial effect from the capital injection.

Cost Savings

51. The Commission is of the view that it is appropriate to make allowance for potential cost savings of the kind claimed by Air NZ and Qantas. As their estimate of cost savings is based on the numbers of aircraft utilised by Qantas and Air NZ and their observable costs, it is a useful starting point for estimating cost savings.

52. The Commission's approach recognised that under the proposed Alliance the coordination of their combined aircraft fleets would provide Air NZ and Qantas with

a degree of flexibility in their management of resources, in addition to that which they would possess in the counterfactual. The Commission considered that it is appropriate to assume that, in pursuing higher profits under the proposed Alliance, the airlines would be able to co-ordinate resources in such a way as to accommodate a proportion of natural market growth using their current aircraft capacity.

53. For the purposes of assessing the public benefits of the proposed Alliance, the Commission's view, on the balance of probabilities, is that cost savings would likely be about $30 million per annum. This estimate is based on analysis of a range of data, including confidential data.

Additional Numbers of Tourists in New Zealand

54. Air NZ and Qantas claimed that the proposed Alliance would provide an opportunity for the airlines to co-operate to increase tourism to New Zealand. The spending by these additional tourists is claimed to benefit suppliers to the tourism industry, whose own spending would induce further economic activity. The Applicants claimed to have identified opportunities for increasing tourism in New Zealand by:

- aligning the expertise and reach of Qantas Holidays with Air NZ's services and brands;
- providing a greater incentive for Qantas Holidays to sell Air NZ seats and promote New Zealand tourism; and
- more effective Air NZ and Qantas joint promotion of New Zealand travel.

55. A summary of their calculation of that number is shown in Table Three below. Air NZ and Qantas acknowledged that air fare increases as a result of the proposed Alliance would deter some inbound tourists. However, Air NZ and Qantas claimed that this reduction is countered by 63,277 additional tourists. When these two effects are netted out, Air NZ and Qantas claimed that there would be more than 60,000 additional in bound tourists in New Zealand each year.

Table Three
Calculation by Air NZ and Qantas of Increased Tourism in New Zealand Resulting from the Proposed Alliance

Item	Air Tourist Numbers
Australian tourists deterred by higher air fares under the proposed Alliance	-33,229
Other foreign tourists deterred by higher air fares under the proposed Alliance	-54,485
New Zealanders holidaying at home because of higher air fares under the proposed Alliance	+84,848
Net effect of these price impacts	-2,866
Increased foreign tourists as a result of Qantas Holidays incentive to sell NZ under the proposed Alliance	+50,000
Increased foreign tourists as a result of more effective joint promotion	+13,277
Net effect of improved tourism	+63,277
Net overall effect on tourism	+60,411

56. As can be seen, the additional 60,411 tourists in New Zealand, estimated by Air NZ and Qantas, would result from the net effect of:

- Australian and other foreign tourists being deterred from international travel to New Zealand by higher air fares resulting from the proposed Alliance;
- New Zealand tourists being deterred from holidaying overseas and instead staying in New Zealand; and
- increased foreign tourism due to Qantas Holidays and the airline jointly promoting New Zealand.

57. The Commission considers it is sensible to look at the impact of the Alliance on inbound tourists as a group before moving to separately consider the issue of New Zealanders deterred from overseas travel by high air fares. To do this , the Commission has set out the information provided by Air NZ and Qantas in what it regards as a more appropriate manner, in the first column of Table Four below. This clarifies that the estimate of Air NZ and Qantas that the proposed Alliance would result in 24,437 fewer foreign tourists visiting the country in year three, despite the increased tourism efforts of Air NZ and Qantas. A positive tourism effect is generated only by adding the large number of New Zealanders discouraged from holidaying abroad by higher air fares.

Table Four
Calculation by the Commission of Increased Tourists in New Zealand Resulting from the Proposed Alliance

Item	Tourist Numbers (Air NZ and Qantas's values)	Tourist Numbers (Commission values)
Australian tourists deterred by higher air fares under the proposed Alliance	-33,229	-138,003
Other foreign tourists deterred by higher air fares under the proposed Alliance	-54,485	-34,833
Increased foreign tourists as a result of Qantas Holidays incentive to sell NZ under the proposed Alliance	+50,000	+28,800
Increased foreign tourists as a result of more effective joint promotion	+13,277	+10,622
Subtotal: net effect of these price and promotional impacts on in-bound tourism	-24,437	-133,414
New Zealanders deterred from holidaying overseas because of higher air fares under the proposed Alliance	+84,848	+189,003
LESS those who spend on other than domestic tourism	0	-162,543
Subtotal: balance of those who spend on domestic tourism	+84,848	+26,460
Net overall effect on tourism	60,411	-106,954

58. The second column in Table Four above gives the revised tourist numbers that the Commission consider are more appropriate than those provided by Air NZ and Qantas.

59. The difference between the estimated tourist numbers of Qantas and Air NZ and those of the Commission arise as a result of the following factors:

Numbers Variance

- the Commission's modelling shows that price increases under the proposed Alliance would be larger than those estimated by Air NZ and Qantas. Consequently, the effect on inbound foreign tourists and outbound New Zealanders would be larger than Air NZ and Qantas have estimated;

- Air NZ and Qantas assume that all New Zealanders deterred from overseas tourism under the proposed Alliance due to higher air fares will consume tourism domestically. The Commission's modelling has predicted that 189,003 New Zealanders will be deterred from travelling overseas as a result of the higher air fares resulting from the proposed Alliance. The Commission assumes that 14% of New Zealanders deterred from overseas tourism would consume tourism locally, giving a net increase of New Zealanders holidaying at home of 26,460;

- Air NZ and Qantas assume that all Australian tourists deterred from travelling from New Zealand to an overseas, non-Australian destination would consume tourism in New Zealand. The Commission has assumed that the proportion of Australians deterred from travelling beyond New Zealand who would substitute New Zealand tourism is 16%;

- the estimates of Air NZ and Qantas include the assumption that Qantas Holidays' increased efforts would attract 14,000 additional Australians and 36,000 additional other foreign tourists. The Commission estimated that Qantas Holidays would attract no additional Australians and 28,800 other foreign tourists;

- Air NZ and Qantas assumed that enhanced promotional effectiveness would attract 13,277 other foreign tourists. The Commission assumed that enhanced promotional effectiveness would attract 10,622 other foreign tourists;

Impact on Public Benefit

60. Air NZ and Qantas assume that the spending that New Zealanders deterred from overseas travel would have spent on tourism would be entirely spent on tourism within New Zealand. The Commission assumes that New Zealanders who do spend their money on tourism locally would spend 100% of what they might have spent overseas. However, the Commission also assumes that the 86% of New Zealanders deterred from overseas tourism, who do not spend their money on domestic tourism, would spend 28% on imports. Imports do not represent an increase to the economic welfare of New Zealand producers; and

61. Air NZ and Qantas use a computable general equilibrium model to estimate the benefits to New Zealand of increased local spending. Their model assumed variable employment, and implied that the net benefits to the economy are around 61% of gross expenditure. The Commission has adopted a partial equilibrium approach, and has calculated that the net detriments to the New Zealand tourism industry, and the net benefits to other domestic producers, to be within the range of 2% to 10% of the change in gross expenditure.

62. The Commission acknowledges that some benefits will arise from New Zealanders, deterred from overseas holidays by higher air fares under the proposed Alliance, nevertheless spending their "overseas tourism dollars" on either less expensive travel within New Zealand, or on other types of domestic consumption. The Commission considers the values of such benefits range between $5 million and $20 million in year three.

63. Nevertheless, the Commission does not accept the claim of Air NZ and Qantas that New Zealanders being deterred from overseas travel due to increased air fares under the proposed Alliance, by itself, can be considered, by itself, as leading to an overall benefit to the public of New Zealand.

64. The Commission considers that, rather than there being a public benefit due to increased number of tourists visiting New Zealand, under the proposed Alliance there would be is a net reduction of inbound tourists of 133,414 per year. This would result in a net loss to New Zealand of between $4 million and $18 million per annum in year three.

65. The Commission's welfare estimates given in the tourism section represent only gains and losses to New Zealand tourist suppliers from a change in spending on their products. There remains the issue of the additional welfare loss suffered by New Zealanders who are deterred from overseas travel. New Zealanders whose first preference (overseas tourism) would become too expensive under the proposed Alliance would suffer a welfare loss from having to substitute less-preferred local consumption. However, New Zealanders' welfare losses are partly counted in the section on allocative efficiency. There may be additional detriments suffered by New Zealanders deterred from overseas tourism that have not been represented in the Commission's modelling of the allocative efficiency effects of higher airfares.

Continuation of Qantas's Purchase of Aircraft Engineering and Maintenance Services from Air NZ at Existing Levels

66. Air NZ and Qantas claimed that under the proposed Alliance, Qantas would direct 80% of its subcontracted external engineering and maintenance work to Air New Zealand, compared to 10% absent the proposed Alliance.

67. The Commission accepted that strategic incentives would change under the proposed Alliance, and that this change in incentives could potentially be reflected in Qantas's external purchases of engineering and maintenance services. However, while strategic concerns might increase in importance when Qantas considers which supplier to choose, that did not mean that the importance it attaches to price, proximity, quality and urgency would diminish.

68. For the purposes of calculating net public benefits, the Commission considers that the public benefits attributable to Qantas's engineering and maintenance work carried out by Air NZ as a result of the proposed Alliance would fall within the range $5 million to $10 million per annum in year three. The Commission's estimate of the welfare effects of the engineering and maintenance claim was obtained by reducing Air NZ and Qantas's estimate of a change in gross spending on Air NZ Engineering Services' contracts by 50% to eliminate resource costs. The Commission then reduced the benefit by a further amount of between 20% and 40% because it does not consider,

Air NZ and Qantas have correctly stated the difference in Qantas's spending on these services.

Improved Aircraft Schedules

69. The Commission agrees with the submissions of Air NZ and Qantas that the proposed Alliance would result in scheduling benefits arising from improved flight frequencies, enhanced connectivity and additional direct services. The airlines argued that under the proposed Alliance they would schedule their flights more evenly throughout the day at times more suited to a significant number of travellers. They claimed these travellers would benefit from being able to travel at times they prefer, rather than at times dictated by airline competition for the average passenger.

70. In examining this matter, the Commission assumed that on average, business and leisure travellers would receive a 20% gain[5] (applied to an assumed opportunity cost of $100 and $20 per hour for business and leisure travellers respectively) as a result of more conveniently scheduled flights. The application of these values for time savings to the more convenient schedules proposed by Air NZ and Qantas under the proposed Alliance, led the Commission to estimate that scheduling benefits would be about $500,000 per annum in year three.

Increased Freight Services

71. These benefits were claimed by Air NZ and Qantas to result from proposed additional freight services, along with improved scheduling, cost savings and the possibility that the proposed Alliance could operate joint freighter services.

72. The Commission considers that:

- there is no certainty that the proposed additional freight capacity would be realised in practice. The Commission notes that the two airlines made the provision of additional freight service subject to the market supporting the additional capacity. The Commission considers that if the market wished to support additional freight capacity, then increased freight services would be currently provided by Air NZ, Qantas or others. The proposed Alliance would not, in itself, increase the demand for freight services; and

- the reduced competition under the proposed Alliance might result in increased freight rates.

73. As a result, the Commission attaches no public benefits to the proposal, under the Alliance, to provide increased freight services.

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[5] This compares with the 100% gain assumed by Air NZ and Qantas.

New Direct Flights

74. Air NZ and Qantas claimed that the proposed Alliance would result in benefits from travellers' time savings, due to the introduction of new direct flights in addition to the current indirect flights between Auckland and Adelaide, Auckland and Hobart, Auckland and Canberra, and Wellington and Canberra.

75. However, the Commission considers that competition in the counterfactual would also allow one or both airlines to service these direct routes, if it were possible to do so under the proposed Alliance. Based on this uncertainty concerning the relationship between the proposed Alliance and the economic viability of these new direct services, the Commission has assigned nil public benefits to this claim.

Other Benefits

76. Air NZ and Qantas claimed that the proposed Alliance could offer on-line benefits, such as more on-line flight options (which tend to be cheaper than interline flights), a more seamless travel experience for air travellers, shorter journey durations, and improved scheduling. The Commission accepts the Applicants' claim that online benefits would be positive under the proposed Alliance, but considers that their quantification is problematic. Consequently, the Commission will not ascribe an explicit welfare measure to online benefits.

Conclusion on Benefits Arising from the Proposed Alliance

77. Table Five below summarises the ranges and the most likely outcomes for each category of benefit, and for the aggregate, for year three. The Commission considers that the range for total benefits is between $22.5 million and $56.5 million, with the most likely outcome (not necessarily at the midpoint of the range) being $40.5 million.

Table Five
Summary of Annual Benefits, Year Three ($million)

Item	Benefits to the Public	
	Range	**Most Likely**
Additional numbers of tourists[6]	(18) – (4)	(11)
Domestic spending by New Zealanders deterred from overseas travel	5 – 20	13
Cost savings	30	30
Qantas's purchase of engineering and maintenance from Air NZ	5 - 10	8
Improved aircraft schedules	0.5	0.5
New freight services, new direct flights, other benefits	0	0
Totals	22.5 – 56.5	40.5

Balancing the Detriments and the Benefits

78. The determination of the Applications requires a balancing of the public benefits against the detriments. Only where, on the balance of probabilities, the detriments are clearly outweighed by the public benefits could the Commission be satisfied that the proposed Alliance should be authorised. The nature and quantification of the benefits and detriments are summarised in Table Six below. The Commission has estimated single-year benefits and detriments, based on year three of the proposed Alliance.

79. The quantification of benefits and detriments is a process designed to inform the Commission, and to assist it in the application of its judgement. However, in this case there is no overlap in the two ranges of benefits and detriments, and so the quantification process has strongly confirmed the Commission's judgment based on its qualitative assessments.

80. Table Six shows that the proposed Alliance would be likely to generate net detriments in the range $**[ ]** million to $**[ ]** million per annum in year three. The Commission considers that the proposed Alliance would result in overall net detriments of $154.5 million per annum in year three.

6 Negative benefits arise from tourism and these figures are shown in brackets.

Table Six
Summary of Annual Net Public Benefits ($million) (Year Three)

Item	Range	Most likely
(Detriments)		
• allocative inefficiency and transfers	(110) – (83)	(90)
• productive inefficiency	(91) – (18)	(55)
• dynamic inefficiency[7]	([ ]) – ([ ])	(50)
Sub-total	**([ ]) – ([ ])**	**(195)**
Benefits		
• tourism	(18) – (4)	(11)
• domestic spending by NZers deterred from overseas travel	5 – 20	13
• cost savings	30	30
• engineering & maintenance	5 – 10	8
• scheduling	0.5	0.5
• new freight services, direct flights, online benefits and miscellaneous	0	0
Sub-total	**22.5 – 56.5**	**40.5**
TOTAL NET BENEFITS/(DETRIMENTS)	**([ ]) – ([ ])**	**(154.5)**

Conditions and Undertakings

81. To the extent that the Commission is satisfied that the proposed Alliance would, or would be likely to, result in a substantial lessening of competition and that the benefits of the strategic alliance arrangement did not outweigh the detriments, the Applicants offered conditions relating to:

- access to facilities and aircraft;
- restrictions on the operations of Freedom Air;
- the establishment of a capacity floor;
- the establishment of a price cap on Tasman services;

[7] The Commission's estimate is an intermediate point in a range partly bound by an estimate derived from confidential information. Consequently, the range cannot be disclosed for the purposes of balancing public benefits and detriments.

- the Applicants commencing services on certain new direct routes;
- a commitment to spend a specified amount on implementing the Qantas Holidays' business plan;
- the operation of back of the clock freight services; and
- the establishment of an independent third party to monitor the Applicants compliance with conditions.

82. The Commission considered that a number of the conditions would be difficult or impossible to enforce and those imposing behavioural constraints required an unacceptable on-going level of oversight and monitoring by the Commission.

83. To the extent that the suggested conditions might have been acceptable to the Commission, the Commission considered on the balance of probabilities that they would not be sufficient to materially reduce the competitive detriment arising from the strategic alliance arrangement and nor would they deliver such public benefits so as to mitigate the lessening in competition that would result, or would be likely to result from the strategic alliance arrangement.

84. The Commission did not consider any structural undertakings to divest assets or shares as none were offered by the Applicants.

Overall Conclusion

85. The Commission's conclusions in respect of the benefits and detriments are based on its qualitative analysis of the relevant markets in the factual and the counterfactual, supported by its quantitative economic modelling.

86. On the basis of all of its analysis, the Commission has concluded that the detriments from the proposed Alliance would heavily outweigh the benefits, and as a result that there would be a net loss to the public of New Zealand if the proposed Alliance were to proceed.

87. While some ranges of detriments are confidential, the Commission notes that if the balancing of benefits and detriments is examined in the best possible light, from the point of view of Air NZ and Qantas, by taking the lower end of the detriment range and comparing it to the higher end of the benefit range, a substantial gap remains.

88. The Commission concludes on the balance of probabilities that it is satisfied that:

    - the proposed share purchase agreement would be likely to have the effect of substantially lessening competition in a number of relevant markets, and would not be likely to result in such a benefit to the public that it should be permitted; and

- the proposed strategic alliance arrangement would result in a lessening of competition, or a deemed lessening of competition (by operation of s 30 of the Commerce Act), in a number of relevant markets, and would not be likely to result in such a benefit to the public that would outweigh the lessening or deemed lessening of competition such that it should be authorised.

DETERMINATION

89. Pursuant to s 67(3)(c) of the Act the Commission determines to decline the application by Qantas for authorisation of the subscription by Qantas of up to 22.5% of the voting equity in Air NZ pursuant to a share purchase agreement between Air NZ and Qantas.

90. Pursuant to s 61(1)(b) of the Act, the Commission determines to decline the application by Air NZ and Qantas for authorisation under s 61 of the Act to implement the terms of a strategic alliance arrangement.