SUBMISSIONS TO THE COMMERCE COMMISSION REGARDING APPLICATIONS MADE BY QANTAS AIRWAYS LIMITED AND AIR NEW ZEALAND LIMITED

18 FEBRUARY 2003

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2 These submissions relate to two applications filed by Qantas Airways Limited ("Qantas") and Air New Zealand Limited ("Air New Zealand") (together, the "Applicants"):

2.1 the application (the "Equity Application") filed at the Commerce Commission (the "Commission") on 9 December 2002 by Qantas to subscribe for up to 22.5% of the voting equity in Air New Zealand (the "Equity Proposal"); and

2.2 the application (the "Alliance Application") filed at the Commission on 9 December 2002 by Qantas and Air New Zealand to enter into a strategic alliance agreement (the "Alliance Agreement")

(the Equity Application and the Alliance Application are together referred to as the "Applications". In addition, unless defined otherwise, capitalised terms have the meaning in these submissions given to them in the Applications.)

Executive Summary

3 The Transactions should not be authorised on the basis that:

3.1 the Applicants' approach of "pooling" the benefits and detriments arising in respect of both Applications fails to discharge the Applicants' onus under the Commerce Act to prove that *each of* the Alliance Application and the Equity Application warrants authorisation in accordance with the different legal tests applicable to each application;

3.2 benefits do in fact attach specifically and separately to the Equity Application and the Alliance Application. Taking the benefits and detriments estimated by NECG at face value, and attributing them to each application, reduces the claimed net benefit by about half (by removing double counting);

3.3 benefits that may be attributed to the Equity Application, primarily the claimed tourism increases and increased engineering and maintenance have been substantially overstated;

3.4 no commercially reasoning is established for Qantas Holidays to spend an additional $14 million per annum, nor have the applicants substantiated that the expenditure would result in a sustained increase of 50,000 tourists each year. The claimed benefit is not supported by the analysis and should be excluded from the Commission's assessment;

3.5 the best current estimate of the benefit arising from any increase in subcontracted heavy maintenance must be the difference between expected future revenue and current revenue. This would result in a benefit of approximately $5 million;

3.6 with these adjustments, the detriments of the Equity Application would exceed the benefit and the Commission should decline to authorise the Equity Application;

3.7 the primary benefits identified by NECG and which can be attributed to the Allliance Application are cost savings ($627 million); scheduling gains ($47 million); new direct services ($58 million); freight ($11 million);

3.8 NECG estimate the claimed cost savings as the difference between the wasteful actions the Applicants say they will engage in if the Allicance is not approved and actions they will take if the Alliance proceeds. A more realistic counterfactual would reduce these cost savings substantially, if not eliminate them;

3.9 while there may be gains to Qantas and Air New Zealand from scheduling arrangements, there is also likely to be at least an equivalent loss due to the loss of other code sharing opportunities under the Star Alliance for Air New Zealand or OneWorld for Qantas;

3.10 if a new direct service can viably be provided by one airline, normal competitive behaviour should result in the most efficient airline providing that service;

3.11 it is unclear how NECG derive 5.43% additional freight capacity compared with a counterfactual that they claim would result in substantial (uneconomic) increases in capacity;

3.12 many of the assumptions used by NECG in modelling the detriments (deadweight losses and transfers) are at best questionable. In addition, NECG discuss but do not quantity a number of detriments, including productivity losses and losses in innovation, detriments to New Zealand provincial routes, and increases in rent seeking;

3.13 as the analysis in this paper shows, on the basis of the information provided to the Commission so far, the conclusion must be that the Applicants have not demonstrated that the benefits of the Alliance would, "in all circumstances", outweigh the detriments;

3.14 the contraction of Air New Zealand's network in the face of a "war of attrition" is not the relevant counterfactual. In particular, the Applicants have failed to take sufficient account of:

(a) structural changes to Air New Zealand's business model;

(b) the improved financial performance of Air New Zealand in recent months; and

(c) the significance of Air New Zealand's participation in the Star Alliance; and

3.15 the relevant counterfactual instead sees Air New Zealand continuing to compete effectively under its refined business model while remaining in a position to effectively evaluate other opportunities as and when the arise.

Merged applications inadequate

4 Qantas states in the Equity Application (at paragraph 45) that:

> *… the proposed acquisition cannot be considered in isolation because the Strategic Alliance and the Equity Proposal are interdependent and conditional on each other. For this reason, the analysis of the likely competitive detriments and likely public benefits… of the Transactions cannot be separated.*

5 This approach is fundamentally flawed. While the Commission has agreed, as a matter of *process*, to hear both the Equity Application and the Alliance Application together, at law they remain separate applications with different legal tests and procedural rules applying in each case. The Applicants therefore need to satisfy the Commission that in *substance* each application warrants authorisation in accordance with the legal tests applicable to that particular application. In particular, the Applicants must demonstrate:

5.1 in the case of the Equity Application, that the acquisition will result in such benefit to the public that it should be permitted; and

5.2 in the case of the Alliance Application, that, in all the circumstances, the resulting public benefit outweighs any lessening in competition.

6 The Commission must consider the Applications in discrete terms and the onus lies with the Applicants to assist the Commission in respect of *each* Application to:

6.1 isolate competitive effects;

6.2 attribute benefits and detriments;

6.3 in the context of the Equity Application, disregard any undertakings that are not structural in nature; and

6.4 in respect of the Equity Application, take cognisance of the fact that Qantas and British Airways are "associated persons" in terms of the Commerce Act.

7 In this regard, the Applications (and particularly the Equity Application) are manifestly inadequate. The Applicants have effectively "pooled" the competitive effects, public benefits and detriments of the transactions underlying both Applications and have proposed that the Commission assume that if the sum of the parts is positive (a matter which we consider in paragraphs 16 to 45 below), then the parts themselves must each be positive. Of course, as a matter of logic, one does not necessarily follow from the other.

8 The approach taken by the Applicants has ensured that the Commission is unable to assess the individual merits of each Application. Accordingly, the Applications should be rejected outright, with the Applicants having the opportunity to re-file the Applications in a form giving:

8.1 the Commission the opportunity to test accurately the assumptions of each Application; and

8.2 other interested parties an appropriate platform from which to consider, and provide submissions on, the material presented.

9 Qantas suggests that, if it were to undertake any analysis as to which competitive effect and which benefit/detriment is relevant to which Application, the likely result would be:

> *… any detriments and benefits would arguably flow from the Strategic Alliance, in which case the Commission could grant clearance in respect of this Application on the basis that the Equity Proposal would have no further substantial competitive effects.*

10 This reasoning is demonstrably flawed. For example, it is the Equity Proposal, not the Alliance Agreement, which would enable Qantas to appoint directors to Air New Zealand's board of directors. Such board representation would lead to a loss in competitive dynamism between Qantas and Air New Zealand due to Qantas gaining access to Air New Zealand's otherwise commercially sensitive information board level initiatives. We consider further, in paragraphs 16 to 30 and 42 to 45 below, possible areas where benefits and detriments could and should, at least in part, be attributed to the Equity Proposal.

11 In any case, the Equity Proposal and Alliance Agreement each have different implications in respect of the competitive landscape going forward. For example, in respect of the Alliance Application, the relevant arrangements could be revisited by the parties at any time, most obviously at the end of any contractual term. Any re-negotiation of the terms of the Alliance Agreement is likely to require Commission approval. However, the effect of the Equity Proposal is that Air New Zealand would be effectively permanently foreclosed from pursuing other potentially more lucrative opportunities, perhaps with other airlines (which may deliver greater

benefit to consumers), particularly at the point the Alliance Agreement expires.

12 Ultimately, the Equity Application relates to structural ownership changes, with permanent effects, regardless of the market conditions which may prevail in the future. Qantas' acquisition of an equity stake in Air New Zealand structurally entrenches the arrangements contemplated in the proposed Alliance and this is a profoundly different scenario than that of the Alliance in isolation. Most airline alliances (often existing under US anti-trust immunity arrangements or other comparable arrangements, which require the presence of competitors in affected markets) do not involve an equity component and yet those arrangements allow the relevant airlines to achieve a high degree of integration.

13 Any "behavioural" undertakings (such as that to promote New Zealand as a destination through "Qantas Holidays" and to increase spending on maintenance) are only relevant in the context of the Alliance Application and then only to the extent that they are included as "conditions" of the granting of authorisation by the Commission. By way of contrast, in the context of the Equity Application, all behavioural undertakings are of no consequence and must be completely disregarded in the Commission's analysis. The fact that the ACCC may accept behavioural undertakings is of little relevance due to the fact that:

13.1 the ACCC itself does so in exceptional cases;

13.2 the Commission would have no ability to require the enforcement of such undertakings;

13.3 the ACCC will not be concerned with the long term interests of New Zealand consumers and, in any event, has itself expressed concern that, in certain circumstances, it may have difficulty enforcing such undertakings; and

13.4 the ACCC is subject to certain powers of direction from the Australian Government.

14 In addition, if an authorisation is granted in respect of the Alliance Application, the Commission retains a mechanism through which to protect the long term interests of consumers going forward using mechanisms not available in the context of the Equity Application. In particular:

14.1 the Commission could impose conditions on the grant of authorisation under section 61(2) of the Commerce Act;

14.2 the authorisation would be limited to the duration of the arrangements; and

14.3 the authorisation would be subject to the ongoing jurisdiction of the Commission under section 65 of the Commerce Act to revoke or amend an authorisation if there has been a “material change of circumstances since the authorisation was granted”.

15 The “volatility” of the airline industry (acknowledged in the Applications) means that a “material change in circumstances” is a distinct possibility. If such a change results in the need for the Commission to amend or revoke its authorisation in respect of the Alliance, a “default alliance” in the form of Qantas’ continued equity holding in Air New Zealand would persist regardless of its effect on competition or the extent of the detriment accruing to the public in the materially different circumstances.

Attribution of benefits and detriments as between transactions

16 As noted earlier, the Applicants have “pooled” the competitive effects, public benefits and detriments of the transactions underlying both Applications. This ”pooling” makes it difficult for interested parties to comment on the merits of each Application. Pending a re-filing of the Applications by the Applicants, this section attempts an initial allocation of the benefits and detriments estimated by NECG in its report filed in support of the Applications, using where possible the arguments advanced by NECG. It begins by separating from the ”pool” those benefits and detriments that are attributable to the Equity Proposal.

17 NECG do not identify any public benefits from cost savings usually associated with mergers and acquisitions, such as cost savings arising from economies of scale. They conclude that the net impact of scale economies will be neutral once the cost of securing those economies is taken into account (page 135).

18 NECG do, however, argue that equity participation reinforces incentives for joint optimisation, for example of scheduling and aircraft selection, as the gains accrue to each party (page 9). Benefits might therefore derive from the Equity Proposal should the Alliance Application prove incomplete in terms of governing opportunities for joint optimisation. Neither NECG nor the Applicants identify any inadequacies in the Alliance Agreement, nor do they suggest that shirking would reduce the benefits attributed to the Alliance Agreement. Hence, the material presented to the Commission by the Applicants provide no basis for attributing a general benefit to the Equity Proposal.

19 NECG do, however, estimate two specific benefits that might be attributable to the Equity Proposal. First, Qantas Holidays says it will spend $14 million each year promoting New Zealand as a holiday destination, leading to an additional 50,000 tourists visiting New Zealand. There is no obligation within the Alliance Agreement for Qantas Holidays to spend this money. Presumably, NECG believe that Qantas Holidays will be induced to spend this money (over and above what they would spend absence the Alliance)

because Qantas will share in any additional profit earned by Air New Zealand. Hence this claimed benefit would seem attributable to the Equity Proposal.

20 Secondly, Qantas argue that they will increase the proportion of planes they service in New Zealand should the Alliance proceed. However, it does not appear to be a requirement of the Alliance Agreement that additional planes are serviced in New Zealand. NECG appear to attribute the suggested increase in work awarded to New Zealand as resulting from the equity share (page 161).

21 NECG identify a limited range of detriments arising from increases in market concentration levels, which result in price increases and demand decreases. These detriments would appear to apply equally to both the Equity Proposal (as associated persons, both Qantas and Air New Zealand would be considered dominant in the market) and the Alliance Agreement (price fixing arrangements are deemed to substantially lessen competition).

22 Taking at face value the estimates of costs and benefits produced by NECG and attributing them to the Equity Application and the Alliance Application respectively would produce the following summary:

NECG's estimates allocated between Alliance Application and Equity Application

		Alliance Application	**Equity Application**
Benefits	Cost savings	$627m	
	Scheduling	$47m	
	New direct service	$58m	
	Tourism		$645m
	Engineering and maintenance		$174m
	Freight	$11m	
Detriments	Deadweight loss – Net Transfers	-$129.9m	-$129.9m
Net Benefit		**$613m**	**$689m**

23 Attributing the benefits and detriments estimated by NECG to each Application reduces the claimed benefit by about half (by removing double counting). The following section assesses the reasonableness or otherwise of each key estimate.

Quantification of Equity Application benefits and detriments

24 The major benefits in the NECG report which appear attributable to the Equity application are:

24.1 Tourism increases from Qantas Holiday promotion.

24.2 Engineering and maintenance work increases in New Zealand from Qantas.

25 Each of these claimed benefits is discussed in turn below.

Tourism

26 The claimed benefit of $645 million from increased tourism seems improbable for the following reasons:

26.1 NECG do not explain why the Equity Proposal (or the Alliance) would make additional expenditure by Qantas Holidays commercially viable. For instance, if the return (on travellers that choose to fly Air New Zealand) is to come from Qantas' 22.5% share of Air New Zealand's profits, each additional traveller would need to contribute over $1,850 to net profit before tax (using Qantas' 50,000 additional tourists estimate).[1] This seems implausible as the contribution to profit required per passenger exceeds Qantas' average revenue per passenger for its Tasman, Pacific, and Los Angles routes (see table 32, page 196, NECG report).

26.2 The claim that spending $14 million per annum would result in an additional 50,000 tourists each year is unsubstantiated. The number comes from an 'instruction' to NECG from Qantas Holidays. NECG do not explain why other airlines and stakeholders in the tourism industry would not have commercial incentives to target these customers if significant unmet demand exists for tourism into New Zealand.

26.3 Given the relatively long distances associated with travelling to New Zealand from most parts of the world, airfares would represent one of the main costs for travellers from overseas. If the agreements are to have the impact of raising the price of airfares, then it seems as though this would be likely to have, ceteris paribus, a negative impact on inbound tourism to New Zealand.

27 In short, the material provided to the Commission by the Applicants does not support the claimed benefit and it should be excluded from the quantification of benefits and detriments.

Engineering and maintenance

28 NECG attribute a benefit of $175 million as a result of Qantas saying they will direct 80% of its subcontracted heavy maintenance to Air New Zealand if the Alliance proceeds, and as little as 10% if it doesn't. However, NECG

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[1] $14m /50,000 = $280 per new tourist. Net profit of $1,857, less tax at 33% = $1,244; 22.5% * $1,244 = $280.

also state that Qantas directed 43% of its requirement to New Zealand in 2001/02 and plans to direct 78% of its requirement to New Zealand in 2002/03 (in the absence of the Equity Proposal). In the absence of any other information, the best estimate of the public benefit would be the difference between expected future revenue and current revenue. That is, an increase from 78% to 80% of subcontracted heavy maintenance. This would result in a benefit of approximately $5 million.

Summary of Equity Proposal Benefits

29 The discussion above would suggest that the Equity Application would give rise to the following benefits:

Benefit	**NECG claim**	**Reasonable estimate**
Tourism	$645	-
Engineering and maintenance	$174 million	$5 million
Total Benefits	$819 million	$5 million

30 As the detriments conceded by NECG of $129.9 million substantially exceed the benefit of $5 million arising from the Equity Proposal, the Commission must decline to authorise the Equity Application. This result is evident even before considering the detriments not identified by NECG and the understatement of detriments it did identify (discussed further below).

Quantification of Alliance Application benefits and detriments

31 The primary benefits identified by NECG which can be attributed to the Alliance Application are as follows:

31.1 Cost savings $627 million

31.2 Scheduling gains $47 million

31.3 New direct services $58 million

31.4 Freight $11 million

Cost savings

32 NECG claimed that cost savings of $627 million would be achieved through better capacity utilisation – 82% of these savings are to come from the North American and Singapore routes in year 3 (page 138). NECG argue these savings are possible because its counterfactual schedule involves significant under-utilised capacity. That is, the savings are possible because the Alliance would avoid the wasteful actions the Applicants say they will engage in if the Alliance is not approved.

33 There are a number of problems with these propositions. First, it is not self-evident that the Applicants would engage in wasteful capital duplication in the absence of the Alliance. These points are considered in the discussion of alternative counterfactuals below. Cost savings under a more realistic counterfactual would be reduced substantially if not eliminated.

34 Secondly, NECG do not explain adequately why the Applicants could not achieve better capacity utilisation in the absence of the Alliance. For example, the only reduction in flights predicted by NECG for Air New Zealand in its North American and Singapore routes over the three-year modelling period (for the factual) is the Sydney to LAX route. NECG expect these flights to cease in year 3 of the Alliance. Air New Zealand announced last week that it was withdrawing from this route – that is, it was securing the cost saving by unilateral action three years ahead of the timetable predicted by NECG under the Alliance. The only change predicted by NECG for the Auckland-Singapore route is a change in aircraft type in year three – NECG does not explain why Air New Zealand could not make such a change without the Alliance.

35 Thirdly, NECG's use of historic financial accounting data in estimating operational cost savings would overestimate the unit costs, and thus operating cost savings, as they do not reflect the effects of competition and changes in technology. Fourthly, it is questionable as to whether NECG have accounted fully for the reduced market share and revenue that would come from fare increases and capacity reductions. And the calculation of market shares for simulation based on route capacity seems questionable.

Scheduling gains

36 NECG argues that the Alliance would allow tourists to optimise their travel better on certain routes. For example, tourists travelling on Qantas from Hong Kong, spending time in Australia and flying out of New Zealand would (assuming relevant code sharing rights allow such arrangements) avoid having to double back across the Tasman for a return flight with Qantas (pages 153-156) by travelling on a code shared Air New Zealand flight.

37 While, there may well be gains to Qantas and Air New Zealand from such arrangements in terms of expansion of the combined network and greater convenience for travellers in certain areas, there is also likely to be at least an equivalent loss due to the loss of other code sharing opportunities under one or other of Star Alliance for Air New Zealand or OneWorld for Qantas. This, of course, assumes that, in the context of the Alliance, one of those two existing arrangements will eventually be terminated.

38 In this regard, it is likely that continuing with both arrangements must be ultimately incompatible with the scheme of the Alliance Agreement and further that, given Qantas' major shareholder British Airways'

significant position within OneWorld, Air New Zealand's membership of Star Alliance is the most likely to be terminated. The Applications are silent on this matter of the ongoing status of the Star Alliance and OneWorld alliances under the Alliance and the effects of dismantling one of those existing relationships. Accordingly, we are not in a position to comment in detail.

39 In any case, we submit that this matter will have an important bearing on the relative merits of the Applications and should be subject to rigorous scrutiny by the Commission. If it is the case that, under the Alliance, Air New Zealand is set to sever its Star Alliance relationship, then this further compromises Air New Zealand's ability to re-evaluate the Alliance on an ongoing basis in the future, further foreclosing any possible competition and welfare enhancing realignment of Air New Zealand's business in the future.

New direct services

40 NECG's belief that the Alliance would facilitate new services is presumably based on NECG's assumption that, without the Alliance, the Applicants would compete unprofitably to provide new services. This seems implausible. If a direct service can viably be provided by one airline, normal competitive behaviour should result in the most efficient airline providing that service.

Freight

41 It is unclear how NECG derived 5.3% additional freight capacity under the Alliance and a yield of $36.01 per tonne kilometre. If the additional freight capacity comes from relocating the current existing capacity, there is no reason why the airlines could not relocate such existing capacity without the Alliance. In addition, the benefit arising from any additional capacity depends on the level of competition in the affected routes.

Quantification of detriments

42 NECG has only quantified and included the following detriments:

42.1 deadweight loss associated with the price increases; and

42.2 transfers from consumers to producers.

43 Many of the assumptions used by NECG in its modelling are at best questionable. These include:

43.1 The use of average fares tends to understate the impact of the Alliance on prices.

43.2 It is unclear whether the assumption that the cost of a new VBA entry is 20% lower than that of an FSA is due to operational efficiencies or capacity. The lower the cost of a VBA entry, the lower the impact of the Alliance on price.

43.3 The assumption of both price and capacity elasticities seem to be at the lower end of plausible estimates. These elasticise should be directly estimated from Qantas and Air New Zealand's data.

43.4 The assumption of a linear demand curve by NECG is important in limiting the estimate of the deadweight loss. Any other of the commonly assumed demand curves (e.g. log-linear, semi-log, trans-log) would probably have led to much greater deadweight loss estimates.

43.5 It is unclear whether NECG has included and estimated all components of producer and consumer surplus and how the transfers of consumer surplus to producers are calculated among New Zealand, Australia and other countries. It is plausible that NECG may have missed the producer profit loss component arising from output reductions.

Detriments not estimated

44 NECG discuss, but do not quantify a range of detriments. These include:

44.1 Productivity losses because the Alliance will face little competition in the market and will be under less pressure to minimise costs. The Commission has previously estimated these effects in a range of 1% to 10% of current costs (Decision 278 refers).

44.2 Innovation losses because the Alliance will reduce rivalry. Possible orders of magnitude for loss of innovative efficiency might fall in the range of 1% to 2.5% of productivity growth loss. NECG argue that the Alliance would improve innovation, because dominant entities could more easily secure the benefits from such innovation.

44.3 Detriments on provincial New Zealand routes.

44.4 Detriments relating to global alliances. Air New Zealand is currently the local arm of the 14-strong Star Alliance, the world's largest airline grouping.

44.5 Rent seeking. The degree of influence that the two companies would have on the regulatory process would be considerable.

45 The analysis above is summarised in the table below. On the basis of the information presented to the Commission so far, the conclusion must be that the Applicants have not demonstrated that the benefits of the Alliance would outweigh the detriments.

Summary of costs and benefits of Alliance Agreement

		NECG claim	Reasonable estimates
Benefits	Cost savings	$627m	Modest to nil
	Scheduling	$47m	Nil to negative
	New direct service	$58m	Nil
	Freight	$11m	Source of gains not clear
Detriments	Deadweight loss – Net Transfers	-$129.9m	Significantly higher
	Productive efficiency loss	Not quantified	Not quantified
	Dynamic efficiency	Not quantified	Not quantified

The counterfactual

46 In paragraphs 90-115 of the Alliance Application, the Applicants address the counterfactual (and relevant alternative counterfactuals) they consider most likely to arise if the Equity Proposal and Alliance Agreement do not eventuate. In our view, the counterfactual submitted by the Applicants as being the relevant counterfactual for the purposes of the Commission's analysis is not in fact the counterfactual most likely to apply. We set out our reasons for this conclusion in paragraphs 48 to 89 below.

47 In any case, even in respect of the Applicants' chosen counterfactual (which, again, we do not concur would in fact eventuate), a number of the assumptions underlying the examination of likely events in that counterfactual scenario are defective. We set out an example of this defective reasoning in the Appendix to this submission. In our view, our analysis demonstrates that the intellectual credibility of the Applications as a whole is questionable.

Sustainability of more than one FSA network carrier

48 The Applicants state that "history has illustrated that the Australasian markets will not support more than one locally based full service network carrier", and that "this is even more so since the integration of the Single Aviation Market which now permits carriers to consider New Zealand, the Tasman and Australia as one market".

49 While it is true that the open skies agreement between New Zealand and Australia allows Australasian airlines to operate freely within and between (as well as beyond) each other's country, this does not lead automatically to the conclusion that the three parts of the combined markets are undifferentiated. While there is evidence to support the view that the small size of the New Zealand domestic market makes it very difficult for two full service airlines (FSAs) to operate profitably, the same conclusion cannot be drawn with reference to the Tasman or domestic Australia.

50 In Australia, the failure of Ansett was due to a range of factors – the varied and aging nature of its fleet, inattention to the need to reduce costs, defects in its maintenance systems, to name a few, as well as the entry of a value based airline (VBA), Virgin Blue. The final blow came when the New Zealand Government failed to deal promptly with Air New Zealand's recapitalisation proposal involving Singapore Airlines and allowed the process to be disrupted by Qantas and the Australian Government.

51 Meantime, Air New Zealand's results over the past year, and forecasts for the current year, especially with the remodelling that has occurred with Express (and Freedom), challenges the assertion by the Applicants that, in current conditions, it is not possible for two locally based network carriers to generate long-term economic rates of return.

52 Whether or not the Tasman routes have been unable consistently to cover the cost of capital – a situation by no means unique in world aviation – it is one of the world's densest international sectors. Consequently, it has long been an important provider of cash-flow for Air New Zealand and Qantas and, especially for Qantas, which benefits from its 6th freedom position, an important feed for its broader international network.

53 The Applicants have failed to demonstrate that two FSAs cannot be viable if each is based and operates in Australia and New Zealand, respectively, as well as on the Tasman, a pattern of operations that has survived for decades, including, in more recent years, exposure to competition from 5th freedom carriers serving Auckland.

The adopted counterfactual

54 The Applicants argue that by operating more aggressively with increased capacity in the New Zealand domestic market and on Tasman routes, Qantas will force the contraction of Air New Zealand's network and thereby undermine its viability, possibly leading to the airline's eventual demise. The strategy appears to be to present a counterfactual that is so dire for Air New Zealand that the Equity Proposal and Alliance Agreement will be viewed more favourably than would otherwise occur.

55 The Applicants partly base their case on Qantas' view that New Zealand forms part of its home market and that its New Zealand operations are vital for connectivity purposes in relation to its wider network. This argument

would be more convincing were it not for the fact that Qantas currently operates greater trans-Tasman capacity than does Air New Zealand and that it serves all three major international gateways. Smaller, provincial centres are served by way of code-sharing with the expanding Origin Pacific.

56 Thus, allowing for the catchment areas of the international gateways, Qantas provides direct international services for over 60% of New Zealand's population, while its code-sharing partner serves most of the remainder. Around a third of the country's population falls within the catchment area of Auckland International Airport, which is by far Qantas's major trans-Tasman destination as well as its terminal for trans-Pacific services.

57 The Applicants' argument that Air New Zealand would be forced to increase domestic capacity to match Qantas under-estimates the significance of Air New Zealand's Express service, which provides lower fares without sacrificing connectivity and some other features of a full-service airline. Air New Zealand has recently announced that Express has brought about an overall increase of 20% in the traffic the airline carries. Contrary to the assertion of the Applicants, this suggests that should there be a VBA entry – which the Applicants think is more likely if the Alliance proceeds – Qantas would be more vulnerable to the low-cost competition than Air New Zealand.

58 Acceptance of the dire predictions set to result in the counterfactual from the "war of attrition" requires acceptance that airlines will behave in a manner that is commercially illogical and that would invite charges of predatory practices. It is doubtful that Qantas' board and shareholders would accept continued and therefore mounting losses on its New Zealand services. This is especially so since, simultaneously, the airline would be under pressure in Australia as Virgin Blue continues to increase its share of the domestic market on which Qantas depends for most of its profit. Of course, Qantas would also remain subject to the prohibitions contained in the Commerce Act.

59 Moreover, to the extent that one might accept such a situation, the assumption must be that the Government, as Air New Zealand's principal shareholder, would fail to provide the financial backing needed to withstand increased competition from Qantas and prevent the airline from collapse. As evidenced by the Government's bail-out of Air New Zealand in 2001, the political and economic consequences that could be expected from such a debacle would be such that it is extremely unlikely that a government would be prepared to let it happen.

60 The Applicants have failed to present a convincing case for their prediction of a "war of attrition" that would fatally damage Air New Zealand.

Examination of other scenarios

61 Under the following headings, the Applicants set out four other scenarios that they say might be advanced by others:

61.1 Status quo.

61.2 Cosy duopoly.

61.3 Alternative alliance.

61.4 Equity injections.

62 In the Alliance Application, these are each subjected to "straw man" analysis. Not surprisingly, each possibility is dismissed. In our view, an alternative counterfactual (outlined in paragraphs 71 to 89 below) would in fact prevail, combining features of most, if not all, the alternatives presented. Significantly, under this scenario, a reasonable level of competitive tension would remain in relevant markets.

Background to Air New Zealand decision regarding Qantas alliance

63 Qantas has long and consistently followed a defensive strategy in respect of Air New Zealand of seeking a cornerstone shareholding itself or, as a corollary of this objective, preventing any other major airline from doing so. Accordingly, Qantas won out over British Airways when Air New Zealand was privatised, although the situation did not work well in the years 1989-1996 as the two carriers increasingly competed, board representation became dysfunctional and Qantas finally sold its shareholding.

64 Qantas CEO, Geoff Dixon, has conceded that the earlier shareholding was a "hostile" move – and it was seen as such by Air New Zealand management – but he has argued that the situation is now different. A close alliance would be in the mutual interest of the two carriers. However, the commercial advantages for Qantas in the Transactions include effectively "blocking" the possibility of another bid of the kind made by Singapore Airlines in 2001.

65 Qantas appears to have achieved that goal if the Alliance proceeds. Hon Dr Michael Cullen, Finance Minister, has made it known (as reported by One News on 20 December 2002) that, under the Transactions, Qantas will gain an effective veto over the Government selling down its shareholding. In particular, this would prevent any other shareholder gaining more equity than Qantas.

66 For Air New Zealand, the Alliance appears also to be mainly a defensive move – in its case, to avoid the possibility of facing a "war of attrition" that it may not win - while also seeking to maximize commercial advantage, and thereby also the return to the Government, the carrier's principal shareholder.

67 The Government's recent release of documents relating to the run-up to its in-principle and conditional approval of the Alliance in December reveal that discussions between Air New Zealand and the Government concerning a renewed approach by Qantas began as early as March 2002. Negotiations continued over the following months and the end goal appears to have been unaffected by Air New Zealand's recovery from the grim financial situation of the early months following the government's crisis recapitalisation of the airline, nor by the steady improvement in the airline's performance that followed, leading to an enhanced financial forecast.

68 The precise circumstances in which Air New Zealand proceeded to deal with Qantas early last year are not clear from the Alliance Application, public statements by Air New Zealand, or the documents recently released by the Government. For example, the Air New Zealand directors may or may not have been advised by the shareholding minister, through the Chairman, that they could not rely on continued government financial backing. Certainly, in the last week of June – in the course of a televised election debate – Dr Cullen responded to a question about a Qantas approach by saying: "If we decide to compete head on with Qantas in full competition, why do we assume that Air New Zealand is going to win that competition, and how deep do you think the public pockets should be to keep that competition moving along?" Financial analysts are reported to have been given a similar message at an earlier and private, post-budget briefing.

69 If the directors did receive such advice, they may have felt constrained in the degree of discretion they could reasonably exercise, and the time available to them, for exploring alternative options to an alliance with Qantas. If so, this might help explain why, as the airline's performance improved, serious consideration appears not to have been given to the airline continuing to operate independently for rather longer in order to be better placed to assess longer-term options. This might eventually have led to serious deliberation on another course.

70 In any case, now, with the passing of time, and the continuing improvement in Air New Zealand's performance, the counterfactual relevant now may be different to that quite properly considered most likely by the Air New Zealand directors when the deal was done with Qantas – the possible collapse of Air New Zealand. We outline this alternative counterfactual, which we submit should form the basis of the Commission's analysis, in paragraphs 71 to 89 below.

Alternative counterfactual

71 Instead of rushing into an alliance with its principal competitor, which Air New Zealand concedes would be anti-competitive, a more prudent and potentially more beneficial approach would be for the airline to take more time to settle on a long-term strategy. This would see Air New Zealand proceeding with its remodelling plans, which it announced last year could include extending its lower-cost "Express" service across the Tasman and

possibly to South Pacific destinations. A review of its long-haul services was also planned.

72 The airline might need to receive the Government's financial backing but, given Air New Zealand's much improved performance over the past year, this would not necessarily be for long – perhaps only a year or two. Meantime, a rights issue to help meet capital needs would provide the opportunity to test the view expressed by a number in the financial community that the domestic capital market would support efforts to raise increased equity within New Zealand.

73 Aside from serious defects in the Applicants' case for authorisation of the Alliance Agreement, there are a number of factors that we believe favour Air New Zealand taking more time in reaching a decision that could be vital to its autonomy and success in the long-term. We set these out in paragraphs 74 to 83 below.

74 As shown by its monthly operating statistics, Air New Zealand's performance has significantly improved over the past year. The following table summarises the relevant operating data:

	Increases over previous period	
	December 2002	**Financial Year to date**
Domestic services		
Passengers carried (000)	10.9%	0.7%
Revenue Passenger Kms (m)	14.0%	1.5%
Passenger load factor (%)	11.2 points	4.9 points
International services		
Passengers carried (000)	11.1%	5.1%
Revenue passenger kms (m)	14.5%	8.0%
Passenger load Factor (%)	6.0 points	7.1 points
Total Group		
Passenger carried (000)	11.0%	2.4%
Revenue passenger kms (m)	14.4%	7.2%
Passenger load factor (%)	6.6 points	6.9 points

<u>Note</u>: Domestic traffic increases to 23.3% for December if Freedom Air's domestic services, which ceased in September, are excluded for comparative purposes.

75 Similarly, on 20 December, Air New Zealand announced an increase in its profit forecast for the financial year ending June 2003. As indicated at the airline's annual general meeting in November, profit before unusuals and tax was expected to be around $200 million. Yet in the following month this forecast was increased by 15% to $230 million. This was very close to

the EBIT figure of $230.2 million not expected until the 2004 financial year in the Five-year Financial Plan prepared by Air New Zealand's management team in November 2001 (cited in the *Independent Advisor's and Appraisal Report* prepared for the company's shareholders by Grant Samuels & Associates, page 31).

76 Although full-service airlines in the United States and UK-Europe have suffered huge losses over the past two years, and the outlook for some is still problematic, their situation results largely from events and trends peculiar to their trans-Atlantic and other international markets. Analysis of the 2002 calendar year by the International Air Transport Association (IATA) showed that airlines of the Asia Pacific region (which includes New Zealand) had "bucked world trends" and enjoyed the strongest growth of any region. While total international passenger traffic (RPKs) was virtually flat in 2002 compared with the previous year, growing just 0.06%, in the Asia Pacific region traffic grew by 5.8% - somewhat below the growth achieved by Air New Zealand.

77 Moreover, New Zealand continues to benefit from being perceived as a safe destination by Northern Hemisphere travellers, who constitute most of our major inbound markets – especially the UK, US, Japan, Korea and China. New Zealand's international visitor arrival numbers are growing more rapidly than Australia's – a 20.7% increase for November over the previous year, compared with 16% for Australia. While the Australian Tourist Commission expects overall growth for the 2002 year to remain "flat", the New Zealand increase for the year to November was 5.5%.

78 The withdrawal of United Airlines from the Auckland-Los Angeles route towards the end of March will allow Air New Zealand to increase its market share. It has already announced an extra three return flights per week, bringing the total to seventeen, and under code-share arrangements with its Star Alliance partner will benefit from receiving United passengers as well as additional freight. In addition, Air New Zealand is further strengthening its Los Angeles hub operations at Los Angeles with its recent announcement of an expansion of its code-sharing arrangements with other Star Alliance partners, Air Canada and Lufthansa, to cover flights to and from additional destinations.

79 While it is possible that United will return to New Zealand if it successfully emerges from Chapter 11 protection from bankruptcy, no other US carrier appears likely to fill the gap. Two other major US airlines, American Airlines and Continental, have operated to New Zealand before and pulled out – the latter twice.

80 In announcing on 15 January Air New Zealand's increased flights to Los Angeles, the airline's Chief Operating Officer said the decision was also in consideration of increased demand in general. He added, "overseas markets are demonstrating significant growth due in part to Air New

Zealand's involvement in promoting New Zealand as a destination offshore, particularly with our support for events such as the America's Cup and Lord of the Rings".

81 With its "Express" service on domestic routes and possibly soon on short haul international routes to Australia and the South Pacific, and Freedom Air more strategically focused in its trans-Tasman services, Air New Zealand will be better positioned than formerly to compete with Qantas and Virgin Blue, should it enter these markets.

82 It is still possible that Singapore Airlines will enter the Australian domestic market. In its "Outlook 2003" publication, the Sydney-based Centre for Asia Pacific Aviation noted, in its commentary on the Singapore carrier, that "Unless the Middle east remains a crisis issue, we would expect Singapore Airlines to announce its entry into the Australian market by mid-year". This is still more likely if Australia and Singapore conclude an open skies agreement, a move that has been the subject of preliminary discussion between officials. If Singapore Airlines does eventually operate in Australia, it would provide the important access and feed that Air New Zealand lost with the collapse of Ansett.

83 Although, currently, there may be no other major airline that could become a cornerstone shareholder in Air New Zealand, the international aviation environment is changing so rapidly that if Air New Zealand holds out for a year or two, another partner could well express interest in forming an alliance with Air New Zealand. With the passage of time and in different circumstances, Singapore Airlines (which still has 4.5% equity in Air New Zealand) would be the most obvious candidate, but not necessarily the only one. A revitalised and more efficient United Airlines is another possibility. It was interested in taking up a stake in 2001 but Singapore Airlines, then a 25% shareholder, kept it out.

84 The case in favour of this alternative counterfactual is strengthened not only by the doubts expressed by economists and others concerning the benefits that the Applicants claim can be achieved from the proposed Alliance. As discussed in the next section, directions from the New Zealand Government to Air New Zealand's directors would inevitably affect the extent of such benefits.

Conflict between government direction and achievement of Alliance benefits

85 New Zealand Cabinet papers indicate that the main concern of Ministers about the proposed Alliance related to the ability of Air New Zealand to retain its autonomy and the degree of control that Qantas might achieve. To meet that concern, the Government focused on the ability of Air New Zealand to exit the Alliance if this were considered appropriate at some future time. The Government's view is that the cost involved must be minimised and the exit effected in a way that would allow Air New Zealand

to operate independently within a reasonable time. Accordingly, and at the behest of Cabinet, these requirements were spelt out in a letter from Finance Minister Hon Dr Michael Cullen to the Chairman of Air New Zealand, John Palmer.

86 However, there is a serious conflict between these requirements and the expressed views and intentions of the Applicants. In the section of the Alliance Application dealing with airline alliances, and in particular paragraphs 43-44, the Applicants stress the value of "fully integrated airline networks". To achieve this, they say that:

> *"... the airlines must co-ordinate network-wide activities including prices, schedules, service levels and revenue and capacity management. The level of co-ordination enables the member airlines to present a single network that is centrally controlled by the alliance. The Transactions will create an integrated alliance between Air New Zealand and Qantas."*

87 The Applicants then make the point that "integrated alliances, with their close co-ordination, tend to offer greater benefits".

88 Clearly with a view to maximising those benefits, the provisions of the Alliance Agreement (to the extent revealed in the public version) are designed to achieve the greatest practicable integration and co-ordination of the airlines' operations and management involved in the JAO (Joint Airline Operations) networks, which include all Air New Zealand services and all Qantas services within or touching New Zealand.

89 There is no way that the two airlines can integrate and co-ordinate their operations and management to such an extent and still enable Air New Zealand to "extricate itself from the web", as Dr Cullen has characterised the situation, in a manner that would conform with the Government's requirements. However, if the Applicants' argument about integration is accepted, less integration and co-ordination would, in commensurate degree, dilute the benefits the Applicants claim for the Alliance. It may be safely concluded that the directions of the New Zealand Government can not be reconciled with the provisions of the Alliance and that the consequent reduction in benefits undermines the Applicants' case.

APPENDIX

In the context of the Applicants' favoured counterfactual, the Applicants argue that the inevitable retrenchment by Air New Zealand away from international services will have a cumulative impact on domestic operations. By way of illustration, the Applicants set out likely consequences of Air New Zealand reducing capacity on the Los Angeles to London sector or exiting the sector altogether. The following assumptions underpinning that argument set out in the Alliance Application fail to take all relevant factors into account:

(1) Assumption: Air New Zealand's Auckland-Los Angeles traffic would decrease as passengers flying to/from London would switch to an airline providing services over the whole route.

No airline can operate from Auckland to London without at least one major stop, sometimes of several hours or even overnight. On the Auckland-Los Angeles-London route, no airline other than Air New Zealand currently operates over the full route. Moreover, under the new security arrangements at Los Angeles, through passengers are required to exit through Customs/Immigration and re-check in for the second sector. This removes or substantially reduces the advantages of traveling on one airline even if alternative through services existed. In any case, Air New Zealand could code-share on its Star Alliance partner, United Airlines, for connecting services between Los Angeles and London. This would parallel the connection Qantas currently has at Los Angeles with British Airways, and go a step further commercially as Qantas does not code-share on British Airways' Los Angeles-London service. Air New Zealand already has such code-share arrangements with Star Alliance partner, Lufthansa, over the Los Angeles-Frankfurt sector.

(2) Assumption: Other airlines would commit additional capacity on the Los Angeles-London sector to fill the gap left by Air New Zealand.

This would not matter as long as Air New Zealand had access to another carrier with which it could code share – under current alliance arrangements, with United Airlines.

(3) Assumption: Other airlines would commit additional capacity on the Auckland-Los Angeles sector in response to increased residual demand on the Auckland-London route.

Not necessarily if Air New Zealand maintained its capacity as a result of its onward code-sharing arrangements referred to in (2) above. It is illogical to suggest that another airline would have an advantage when it, too, would have to transfer passengers to a second carrier at Los Angeles.

(4) Assumption: Air New Zealand's share of Auckland-Los Angeles traffic would suffer *secondary* loss as those passengers now travelling on Air New Zealand, Auckland-Los Angeles, terminating in Los Angeles,

have more opportunity to fly with the other airline. Network carriers strenuously avoid creating a situation where a customer diverts to another carrier.

Not so if, as indicated in (3) above, Air New Zealand maintained capacity and code-shared on ongoing flights. In any case, what "other airline"? With United's withdrawal from April, Qantas will be the only other carrier on the route and, as indicated in (1) above, it terminates in Los Angeles, connecting there with British Airways.

(5) Assumption: There are flow-on effects into domestic New Zealand and other parts of the Air New Zealand international network.

These "flow-on effects" are not specified, which is not surprising given the defects in the previous assumptions.