

CHAPTER 4

FIFTH-FREEDOM COMPETITION

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INTRODUCTION

Applicants' evidence

4.1 The Applicants have previously submitted that fifth-freedom carriers do impose, and will continue to impose, a significant competitive constraint on the Applicants in the Tasman market because:

- fifth-freedom carriers already account for approximately 25% of total capacity on the Auckland-Sydney route and 44% of total capacity on the Auckland-Brisbane route;
- fifth-freedom services are usually provided at low fares recognising their ability to take advantage of marginal pricing since there is minimal opportunity cost in terms of the use of the aircraft (it would otherwise sit on the ground in Australia); and
- there are numerous carriers with fifth-freedom rights and, accordingly, the ability to expand on to the Tasman.

4.2 The Applicants also noted that the ACCC has previously recognised that fifth-freedom carriers impose constraint in the Tasman market¹:

“The constraint imposed by Fifth Freedom carriers was recognised by the ACCC in its submission to the Australian Productivity Commission where it commented:

“...on the Australia - New Zealand route, fifth freedom carriers have provided strong competition (e.g. Continental Airlines in the 1980s). In these cases the fifth freedom carriers have provided a countervailing force to the third/fourth freedom carriers and been a significant determinant in setting prices.”²”

Commission's preliminary view

4.3 In the Draft Determination, the Commission reached the preliminary conclusion that fifth-freedom carriers do not impose a competitive constraint on the Tasman, apparently on the basis that:

- fifth-freedom carriers lack sufficient frequency to constrain the Applicants (citing Origin Pacific's submission) and that that capacity is limited and not as flexible as the Applicants' claim; and
- fifth-freedom carriers' share of total passengers is low.

¹ Section 58 Application for Authorisation, 9 December 2002, paragraph 305.

² ACCC's, "Submission to the Industry Commission Inquiry into International Air Services", 20 April 1998, page 5

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- 4.4 The Commission cited the Applicants' statement that fifth-freedom carriers accounted for 25% of total capacity on the Auckland-Sydney route and 44% on the Auckland-Brisbane route, with a proportion of fifth-freedom capacity being involved in carrying through traffic rather than Tasman origin/destination (**O/D**) traffic.
- 4.5 In the Applicants' view, the Commission's preliminary analysis is incorrect and its reliance on views expressed by third parties is misplaced. In reaching its preliminary view, the Commission has ignored the evidence put forward by the Applicants and preferred, uncritically and without explanation, submissions made by third parties. The Commission has ignored evidence of the ability of fifth-freedom carriers to fly the Tasman at marginal cost. Accordingly, the Commission has overlooked the fact that the ability of fifth-freedom carriers to fly at or near marginal cost (i.e. with no contribution to aircraft costs) gives them considerable scope to be a significant constraint on the Applicants.

Overview of fifth-freedom chapter

- 4.6 The chapter addresses the issues raised by the Commission in its Draft Determination in response to the Applicants' submissions concerning the constraint imposed by fifth-freedom carriers. In addition, this chapter provides further information that reinforces and evidences the constraint that fifth-freedom carriers impose on the Applicants on the Tasman. Read together with Chapter 3 of this submission, which demonstrates that VBA entry on the Tasman is virtually certain, it is difficult, if not impossible, to agree with the Commission's preliminary view that the Applicants would not face significant competitive constraints if the Alliance is approved.
- 4.7 This chapter is separated into three substantive sections. Following this introduction, the next three sections in turn:
- describe existing competition in the Tasman;
 - chart the additional constraint imposed by near entrants and other potential fifth-freedom entrants in the Tasman market, including an examination of barriers to entry and the economic incentives faced by a fifth-freedom carrier in deciding whether to enter the Tasman market; and
 - provide evidence that fifth-freedom carriers constrain the Applicants in practice.

EXISTING COMPETITION ON THE TASMAN

Existing competitors in the Tasman

- 4.8 Competition on the Tasman is fierce:

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"I definitely dispute that there's going to be no competition if the merger goes through....[w]e're here and there are several others who can take you to Australia".³

4.9 There are nine airlines currently competing in the Tasman market:⁴

Australasian carriers:

- Air New Zealand (including Freedom); and
- Qantas; and

Fifth-freedom carriers:

- Thai International Airways on Sydney – Auckland;
- Malaysian Airlines on Brisbane – Auckland;
- Garuda Indonesia on Brisbane – Auckland;
- Lan Chile on Sydney – Auckland;
- Aerolineas Argentinas on Sydney – Auckland;
- Polynesian Airlines on Sydney – Auckland; and
- Royal Tongan Airlines on Sydney – Auckland.

There are seven fifth-freedom carriers currently operating in the Tasman

Tasman market shares

4.10 Fifth-freedom carriers have a significant share of the Tasman market whether measured in total market terms or when measured in terms of Tasman O/D passengers only.

4.11 In reaching the preliminary view that existing (and potential) fifth-freedom carriers do not sufficiently constrain the Applicants, the Commission cited the Applicants' view that fifth-freedom carriers accounted for 25% of total capacity on the Auckland-Sydney route and 44% on the Auckland-Brisbane route and noted that these capacity figures included through traffic in addition to Tasman O/D traffic.

Fifth-freedom carriers carry []% of SYD - AKL O/D passengers

4.12 The Applicants do not accept that it is appropriate to only consider through traffic because those through passengers who travel on fifth-freedom carriers would otherwise travel on Air New Zealand or Qantas flights. However, even when only O/D passengers are considered, fifth-freedom carriers have a significant market share. In the 12 months to January 2003, fifth-freedom carriers carried []% of total Sydney - Auckland O/D passengers and []% of total Brisbane-Auckland O/D

³ Tim Malone (New Zealand Manager Aerolineas Argentinas) quoted in *Travellers exploit transtasman scrap*, New Zealand Herald 11 June 2003, page A3.

⁴ Application for Authorisation, paragraph 308.

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passengers. The respective route shares of the Sydney – Auckland and Brisbane - Auckland O/D routes are set out below.

Sydney - Auckland

Carrier	Seat share	O/D route share
Qantas	45.4%	[]%
Air New Zealand	28.9%	[]%
Thai International Airlines	17.1%	[]%
Aerolineas Argentinas	3.0%	[]%
Lan Chile	2.8%	[]%
Polynesian Airlines	2.5%	[]%
Royal Tongan Airlines	0.3%	[]%

Source: Market share ABS origin/destination Australia/New Zealand passengers travelling on Tasman

Brisbane – Auckland

Carrier	Seat share	O/D route share
Air New Zealand	28.2%	[]%
Qantas	34.6%	[]%
Garuda Indonesia	10.9%	[]%
Thai International Airlines	9.4%	[]%
Malaysian Airlines	15.0%	[]%
Freedom	2.0%	[]%

Source: Market share ABS origin/destination Australia/New Zealand passengers travelling on Tasman

4.13 Accordingly, fifth-freedom carriers do carry a significant proportion of the O/D passenger segment, and fifth-freedom carriers' share of this segment is likely to grow as further marginally costed fares become available from new entrant fifth-freedom airlines such as Royal Brunei Airlines (**Royal Brunei**) and Emirates Airlines (**Emirates**) as discussed below.

Fifth-freedom carriers carry []% of BNE - AKL O/D passengers

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4.14 Indeed, as illustrated by Figure 1 below, there is substantial scope for fifth-freedom carriers to capture O/D passengers because a substantial proportion of passengers on the Auckland – Sydney and Auckland – Brisbane routes are Tasman O/D. Figure 1 illustrates that []% of Air New Zealand's and []% of Qantas' Auckland – Sydney and Auckland - Brisbane traffic has its O/D in Auckland and Sydney or Auckland and Brisbane. In addition, a further []% of Air New Zealand's and []% of Qantas' Auckland – Sydney and Auckland - Brisbane traffic is Tasman O/D (i.e., originates and ends in New Zealand and Australia. For example, Blenheim – Wellington – Sydney). Accordingly, since there is a large pool of Tasman O/D passengers, there is sufficient room for a fifth-freedom carrier to attract O/D passengers on Tasman routes.

Approximately 60% of the Applicants' AKL – SYD and AKL – BNE traffic is O/D. Therefore, there is a significant passenger pool that fifth-freedom carriers can compete for on a marginal cost basis

Figure 1

[CONFIDENTIAL]

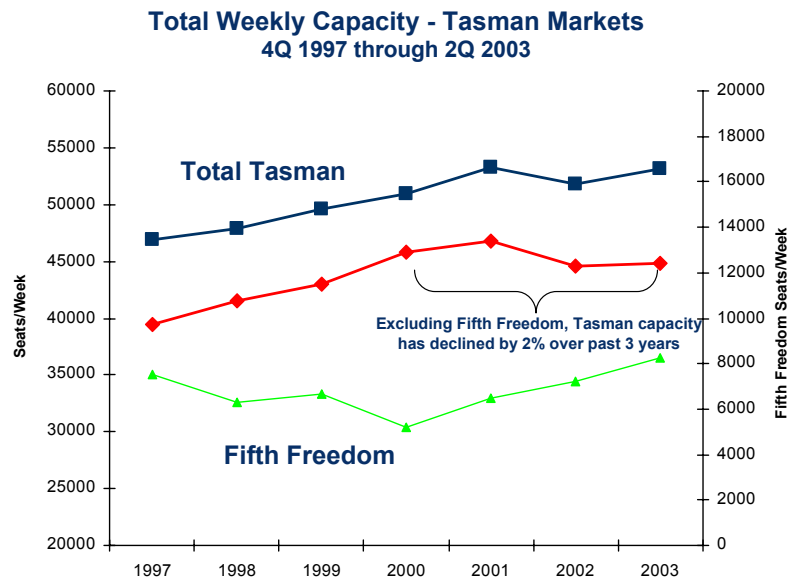
Recent trends in Tasman capacity

4.15 Following September 11 and the collapse of Ansett, Air New Zealand re-evaluated its Tasman schedules. This re-evaluation led Air New Zealand to conclude that its Tasman services were unlikely to generate an adequate return based on the schedules it was operating. As a result, Air New Zealand reduced capacity to increase profits in the short term. In the long-term, Air New Zealand regarded these capacity reductions as a problem because they increased the potential for competitors to add capacity in the future.

Since 2000, fifth-freedom capacity has increased by 59% while total Tasman capacity has increased by only 4%

4.16 At the same time as Air New Zealand reduced its capacity, fifth-freedom carriers added capacity to the routes where Air New Zealand had removed capacity. This is illustrated by Figure 2 below, which shows that fifth-freedom capacity has increased by 59% between the second quarter in 2001 and the third quarter in 2003.

Figure 2

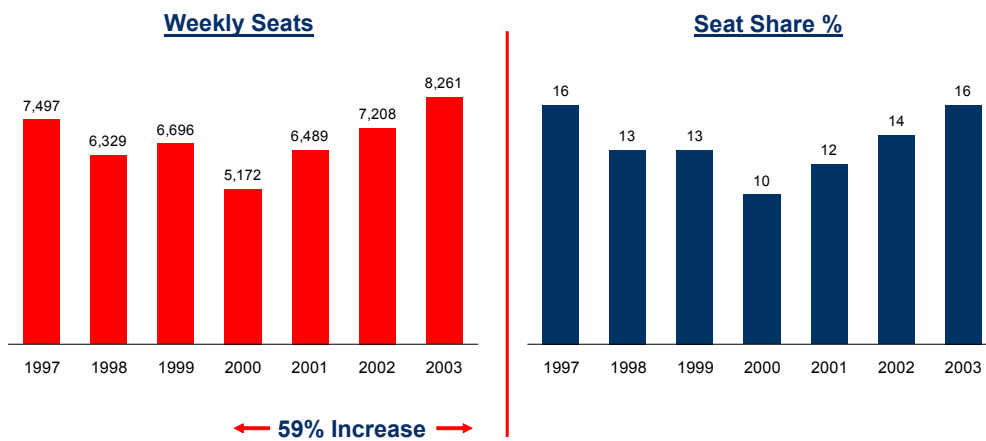


Source: OAG

- 4.17 The fall in fifth-freedom capacity in 2000 resulted from United Airlines decision in the first quarter of 2000 to cease its daily Melbourne to Auckland service. However, in the second quarter of 2001, United Airlines ceased its daily Los Angeles to Melbourne service. Accordingly, to obtain a connection from Melbourne to Los Angeles, United Airlines reinstated its daily Auckland to Melbourne service.
- 4.18 Figure 3 demonstrates the recent growth in fifth-freedom capacity in terms of weekly seats and seat share.

Figure 3

5th Freedom Carrier Seats and Capacity Share in the Tasman



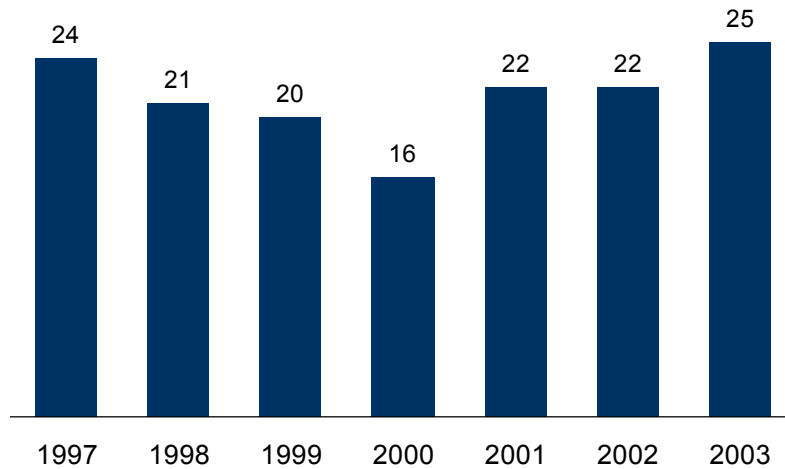
Source: OAG

4.19 In terms of capacity share from Auckland, as shown in

4.20 Figure 4, fifth-freedom carriers' capacity share is currently 25%.

Figure 4

5th Freedom Carrier Capacity Share in AKL-Australia (%)



Source: OAG

POTENTIAL FIFTH-FREEDOM COMPETITION

4.21 In addition to the constraint imposed by current fifth-freedom competitors, the Applicants are significantly constrained by the imminent entry of Emirates and Royal Brunei and the threat of entry by in excess of 10 fifth-freedom carriers with unutilised fifth-freedom rights on the Tasman. Emirates and Royal Brunei are near entrants as defined in the Commission’s *Practice Note on Business Acquisitions*.⁵

4.22 The Applicants consider that the capacity offered by fifth-freedom carriers as shown in Figure 2, Figure 3 and

4.23 Figure 4 above is evidence of the dynamic nature of the aviation industry. While the Applicants’ acknowledge that Tasman fifth-freedom capacity does change commensurate with demand, supply and the schedule of flights into and out of Australia and New Zealand, in the Applicants’ view, such decisions demonstrate the flexibility that fifth-freedom carriers have and how easily they can effect entry and expansion decisions.

Near entrants

4.24 The factual schedules provided in the NECG Report, dated 9 December 2003, provided for future growth of fifth-freedom capacity. This prediction has proved correct. As stated above, since the Draft Determination, Emirates and Royal Brunei have publicly announced that they will enter the Tasman market.

⁵ Page 19.

Emirates

- 4.25 Emirates, which has the absolute right to operate Tasman services into New Zealand under New Zealand's bilateral agreement with the United Arab Emirates, undertook sustained lobbying of the Australian Government for the ability to operate fifth-freedom services on the Tasman. On 29 May 2003, the Australian Government granted Emirates the absolute right to operate Tasman services from any Australian city.⁶
- 4.26 In response, Emirates' Chairman, HH Sheikh Ahmed bin Saeed Al Maktoum announced on 9 June 2003 that Emirates will commence daily flights from Melbourne and Sydney to Auckland from 1 August 2003.⁷ This will provide 14 return trips per week. In addition, Emirates will commence daily flights from Brisbane to Auckland from October 26. This will provide an additional 7 weekly roundtrips.
- 4.27 To put Emirates capacity in context, Air New Zealand and Qantas operate the following services on Auckland – Sydney, Auckland Melbourne and Auckland – Brisbane using, in the main, smaller B737 and B767 aircraft:
- Air New Zealand and Qantas each operate 5 daily flights on Auckland – Sydney;
 - Air New Zealand and Qantas each operate twice daily flights on Auckland – Melbourne; and
 - Air New Zealand and Qantas each operate daily flights on Auckland – Brisbane (with Freedom operating 4 services per week on this route).
- 4.28 Emirates plans to operate the services using larger B773 aircraft, which have 18 first class seats, 42 business class seats and 320 economy class seats on Melbourne-Auckland and Brisbane Auckland and A345 aircraft with 12 first class seats, 42 business class seats and 259 economy class seats on Sydney-Auckland. Accordingly, the deployment of Emirates will add 2660 seats per week between each of Melbourne-Auckland and Brisbane-Auckland and 2191 seats between Sydney-Auckland. 5230 .
- 4.29 By November, Emirates entry will have almost doubled current fifth-freedom capacity from approximately 8200 (see Figure 3) weekly seats today to approximately 15,000 weekly seats in each direction. Even assuming that only 30% (see section Figure 5, which shows that 30% of current Tasman fifth-freedom passengers are O/D) of these additional seats are available for Tasman O/D traffic, there would be

Emirates' entry on the Tasman will add an additional 2240 economy class seats each way per week on AKL-MEL and AKL-BNE and an additional 1813 economy class seats per week each way on AKL-SYD

⁶ Hon. John Anderson, Media Release *Tourism Benefit from Australia and United Arab Emirates Deal*, 29 May 2003.

⁷ Emirates Press Release, 9 June 2003, available at: http://www.emirates.com/AboutEmirates/EmiratesNews/news_20363.asp?ComponentID=20363&SourcePageID=955#1

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approximately 4500 additional weekly Tasman seats to and from Auckland.

4.30 However, the Applicants note that the schedule that Emirates proposes to operate on Melbourne to Auckland indicate that Emirates does not believe that it needs connecting traffic beyond Melbourne to make this service viable (Emirates' flight arrives in Melbourne at 00:35 but does not depart for Auckland until 08:30). Accordingly, Emirates must consider that there is significantly more capacity available for Tasman O/D traffic than the 30% figure used above. Indeed, Emirates' Melbourne-Auckland flights are well timed for the business traveller.

4.31 Today, fifth-freedom carriers' seat share on the Tasman is 18% (Figure 3). All else being equal, and ignoring Royal Brunei's planned entry, following Emirates entry, fifth-freedom's seat share will increase to approximately 35% on the Tasman. When VBA entry to the order of 5 B737 aircraft is taken into account, the seat share of the Applicants on the Tasman is reduced to 66%.

Royal Brunei

4.32 In Royal Brunei's case, it has confirmed that it will operate four services per week between Brisbane and Auckland from October 2003 and is currently selling seats on these services.⁸ The entry of Royal Brunei will add between 792 and 996⁹ seats to the Auckland – Brisbane route, which (ignoring Emirates' entry) represents an increase of between 9.5% and 12.1% of total current fifth-freedom Tasman seats. Even assuming that only 30% (see section Figure 5) of these additional seats are available for Tasman O/D traffic, there would be between 237 and 298 additional weekly seats on the Auckland – Brisbane route.

Royal Brunei's entry on BNE – AKL will increase fifth-freedom capacity by between 9.5% and 12.1% in the Tasman

Other potential competitors

4.33 In addition to the nine carriers already present in the Tasman market and the imminent and announced entry of Royal Brunei and Emirates, the majority of airlines servicing New Zealand from Asian points have fifth-freedom rights, and could elect to exercise these in response to the necessary incentive. These additional airlines include:

- Singapore Airlines;
- United Airlines;
- British Airways;
- Air China;
- Air France;
- Lufthansa;

In excess of 10 carriers have unexercised fifth-freedom rights on the Tasman

⁸ See www.bruneiair.com.

⁹ Based on a B767 with capacity of either 198 or 249 seats.

- Cathay Pacific;
- Air Macau;
- Mandarin Airlines;
- Continental;
- Delta; and
- American Airlines.

Barriers to entry

4.34 Fifth-freedom carriers currently represent 18% of seat capacity on the Tasman (including 25% of seat capacity to and from Auckland) and are able to expand capacity if conditions in the market are sufficiently attractive as evidenced by the imminent entry of Emirates and Royal Brunei. In this regard, the Applicants' refer the Commission to the Court of Appeal's judgment in *Southern Cross*:

“whatever the size of the merged entity's market share, it is elementary that its market power will not be insufficiently constrained unless there are barriers to entry or expansion which protect it from effective rivalrous reaction to the exercise of its market power”¹⁰.

4.35 As evidenced by Emirates announced entry, fifth-freedom carriers with idle aircraft in Australia do not face any material barriers to expansion in the Tasman market. Accordingly, regardless of the Applicants' market share, the Applicants' ability to impose a supra-competitive price increase will be constrained by the ability of fifth-freedom carriers to mount an effective rivalrous response. There are now so many existing and potential fifth-freedom carriers who do or could exercise their rights on the Tasman – in excess of 19 – that fifth-freedom carriers are an important and constraining segment of the market that the Applicants do take into consideration in making capacity and pricing decisions.

Fifth-freedom carriers do not face any material barriers to entry in the Tasman

Tasman flights represent an attractive opportunity for fifth-freedom carriers

4.36 The Commission quoted the submissions of Origin Pacific and STA Travel that stated that Tasman flights are a low priority for fifth-freedom carriers.

4.37 In the Applicants' view, these submissions are incorrect. The economics of network airlines and the need for a fifth-freedom carrier to stimulate demand for flights to and from Australia to its home base (an **Australia to hub flight**) dictate that, in fact, Tasman legs are important to fifth-freedom carriers. As the Commission itself noted in respect of incumbent response to VBA entry, and which the Applicants submit

¹⁰ *Commerce Commission v Southern Cross Medical Care Society* CA 89/01, 21 December 2001, paragraph 86 per Richardson P and Tipping J.

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applies to FSAs to a greater extent, a difference of six or seven passengers can turn an unprofitable flight into a profitable flight:

“Airlines operate on margin and thus it is the last few passengers who generate the profit for a VBA. If an FSA can drain away five to seven passengers, it can affect the profitability of the new FSA”.¹¹

4.38 Further, while the Applicants note that fifth-freedom Tasman capacity is limited at a point in time due to the number of aircraft available, this is equally true of the Applicants’ capacity. Further, such a statement ignores the dynamic nature of the airline industry and underestimates airlines’ ability to shift capacity in response to market opportunities. Indeed, by its nature, an aircraft is one of the most moveable types of assets available. For a fifth-freedom carrier to operate a Tasman service requires only two ingredients:

- that the carrier has capacity available at an Australian or New Zealand airport; and
- that the flight be economically viable on a marginally costed basis.

Available capacity

4.39 In the Applicants’ view, a fifth-freedom carrier could operate on the Auckland – Sydney route if it had a nine hour window on the ground in Auckland or Sydney, the Auckland – Brisbane route if it had a nine and a half hour window on the ground in Auckland or Brisbane and the Auckland – Melbourne route if it had a nine and three-quarter hour window on the ground in Auckland or Melbourne. In addition to Emirates and Royal Brunei, the following fifth-freedom carriers could offer services in the Tasman by making only minor schedule changes:

- United Airlines, which has one B747-400 daily with 9 hours on the ground in Sydney;
- Singapore Airlines, which has one B777-200 daily with 8.5 hours on the ground in Brisbane; and
- Malaysian Airlines, which has one B777-200 daily with 8.5 hours on the ground in Melbourne.

Economic viability

4.40 The second driver for fifth-freedom capacity on a route is that the Tasman leg must be economically viable on a marginally costed basis. From an economic perspective, fifth-freedom carriers operate Tasman flights because:

- through traffic from New Zealand adds demand to the Australia to hub flight;

Fifth-freedom carriers will operate a Tasman flight if they have idle aircraft and an economic incentive

At least three fifth-freedom carriers could commence Tasman services with little schedule adjustment

¹¹ Draft Determination, paragraph 355.

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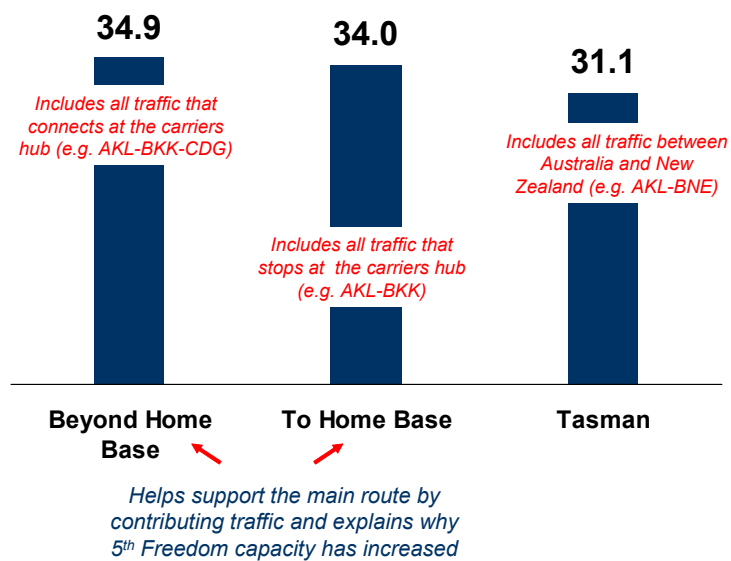
- Tasman flights improve aircraft utilisation; and
- Tasman flights allow the carrier to service both New Zealand and Australia with only one aircraft.

Contribution of through traffic

4.41 Tasman legs provide support to fifth-freedom carriers' Australia to hub flights. As shown by Figure 5 below, approximately two-thirds of fifth-freedom passengers on the Tasman are through passengers. In Figure 5, 'Tasman' refers to passengers who fly, for example, the Auckland - Brisbane leg only. 'To Home Base', refers to passengers who travel from Auckland to Brisbane to Bangkok, and 'Beyond Home Base' refers to passengers who travel from Auckland to Brisbane to Bangkok to London.

Figure 5

Traffic Distribution For 5th Freedom Tasman Capacity (%)



Source: MIDT and APG analysis

4.42 A fifth-freedom carrier would find it economically viable to introduce a Tasman leg provided that the New Zealand origin had sufficient traffic to cover the marginal cost of the flight, and, accordingly, contribute to the fixed costs of the Australia – hub flight. This traffic comes from both additional through passengers and through price sensitive Tasman O/D passengers.

4.43 Although fifth-freedom carriers currently only operate to and from Auckland, in the Applicants' view fifth-freedom carriers would see Christchurch as a viable destination. Christchurch is the natural gateway to the South Island and, as such, many foreign tourists would find a flight to Christchurch appealing. In addition, Christchurch is likely

Fifth-freedom carriers are likely to view CHC as an attractive destination

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to be able to make a significant contribution in terms of through traffic from New Zealand.

- 4.44 While the current level of Tasman O/D passengers on fifth-freedom carriers is approximately 31%, this proportion would increase if the Applicants attempted to act in a supra-competitive fashion. The correct competition analysis is to consider the constraint faced by the Applicants if they raised prices. If the Applicants attempted to raise prices, O/D passengers would be able to switch to a fifth-freedom carrier. This increase in O/D passengers would enhance the fifth-freedom carriers' expected marginal revenue, while, at the same time, the marginal costs of each incremental passenger declined. This would make the Tasman even more attractive to fifth-freedom carriers than it already is.

Tasman flights improve aircraft utilisation

- 4.45 Tasman flights allow a fifth-freedom carrier to improve its aircraft utilisation by flying a Tasman leg when, otherwise, its aircraft would be sitting idle. As well as providing additional through traffic, the Tasman flight allows a fifth-freedom carrier to spread its fixed costs.

Tasman flights improve aircraft utilisation and do not increase fixed costs

Conclusion

- 4.46 Accordingly, the Applicants are further constrained by potential fifth-freedom entrants and Royal Brunei and Emirates are examples of such airlines making use of fifth-freedom rights. Potential fifth-freedom carriers have the opportunity to exploit any market opportunity offered by the Applicants. Any increases in price or withdrawal of capacity by the Applicants will result in existing or potential entrant fifth-freedom carriers taking up the opportunity to provide additional capacity or provide a constraining price option. Accordingly, passengers can and do substitute from the Applicants to existing (or would substitute to entrant) fifth-freedom carriers.

Potential fifth-freedom carriers have the opportunity to exploit any market opportunity offered by the Applicants

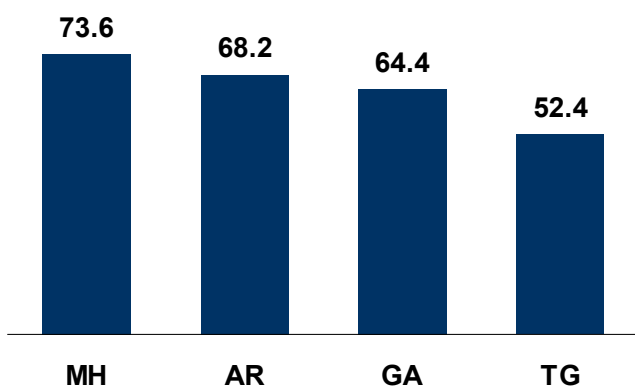
EVIDENCE OF CONSTRAINT

Fifth-freedom carriers offer sufficient frequency to constrain the Applicants

- 4.47 The Commission noted Origin Pacific's concern that fifth-freedom carriers lack sufficient frequency to be a constraint on the Applicants. While the Applicants acknowledge that fifth-freedom carriers do not provide the same frequency of service provided by the Applicants, due to the demand characteristics of Tasman O/D travellers, fifth-freedom carriers do not need to match the Applicants' frequency to provide a competitive constraint. Indeed, fifth-freedom carriers already provide a constraint in the Tasman market.
- 4.48 As set out in Figure 6, the majority of Tasman O/D passengers who travel on fifth-freedom carriers are low yield, price sensitive travellers.

Figure 6

Percent of Traffic Booked in Lowest Booking Class
Largest 5th Freedom Carriers



5th Freedom carriers use local traffic as filler to supplement traffic to their hubs. As such, most of the traffic tends to be low yielding leisure.

Source: MIDT and APG analysis

4.49 In the Draft Determination, the Commission noted that VFR travellers have different demand characteristics to business passengers. The Commission noted that VFR travellers are typically:

- “- not time sensitive
- like stopovers, particularly backpackers
- price is primary factor in choice of airline – elastic demand
- not so concerned with air-points, full service, etc.”¹²

Fifth- freedom carriers attract O/D passengers on price without matching the Applicants’ frequency

4.50 Further, the Commission stated:

¹² Draft Determination paragraph 162.

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“The Tasman routes are primarily OD and VFR, which makes them ideal for VBA entry”¹³.

4.51 The Applicants agree with the Commission’s comments. For VFR travellers, price is the most important factor in choosing an airline. Further, because VFR travellers are not time sensitive, they do not regard frequency as a critical feature of airline service. Accordingly, just like a VBA, a fifth-freedom carrier can attract VFR travellers on the basis of price without having to match the frequency offered by the Applicants. A lack of matching frequency does not prevent a fifth-freedom carrier from imposing a competitive constraint.

Evidence of Applicants’ response to fifth-freedom capacity

4.52 The Applicants pricing policies are influenced by fifth-freedom capacity through their impact on forward bookings and through their impact on passenger perceptions of appropriate fare levels. The overall impact of the constraint imposed by fifth-freedom carriers on the Applicants’ pricing policies is evidenced by the narrow range of fares currently being offered by competitors on the Auckland to Sydney route:

- Air New Zealand: \$499;
- Qantas: \$505;
- Thai International Airlines: \$529;
- Polynesian Airlines: \$469;
- Lan Chile: \$399
- Aerolineas Argentinas: \$299; and
- Royal Tongan Airlines: \$399.¹⁴

Forward bookings

4.53 The Applicants’ pricing policies are determined to a large degree by the strength of their forward bookings. The greater the number of forward bookings, the less capacity the Applicants have and accordingly, the higher the price. Fifth-freedom carriers influence the Applicants’ pricing by affecting the Applicants’ forward bookings.

4.54 An increase in fifth-freedom capacity, all else being equal, reduces the Applicants’ forward bookings. When forward bookings are weak, the Applicants undertake sales initiatives. The impact of the increase in fifth-freedom capacity can be deduced from Air New Zealand’s 2003 sales strategy. So far in 2003, Air New Zealand has run the New Year Sale in January, Be Everywhere in March and Be Together in April/May.

Fifth- freedom carriers’ activity affects Applicants forward bookings and hence, Applicants’ pricing decisions

¹³ Draft Determination, paragraph 293.

¹⁴ *Travellers exploit transtasman scrap*, New Zealand Herald 11 June 2003, page A3.

Passenger perceptions of fare levels

- 4.55 In addition to the impact that fifth-freedom carriers' capacity decisions have on the Applicants forward bookings, fifth-freedom carriers also affect the Applicants' pricing policies more directly, by setting the benchmark for promotional fare levels on the Tasman.
- 4.56 For example, if travel agents are able to sell fifth-freedom Tasman capacity at NZ\$399, this NZ\$399 price sets the benchmark price in the Tasman O/D segment of the market. That is, the Applicants' price must be comparable to the NZ\$399 price in order for the public to view the Applicants price as a "good deal". Although the Applicants may be able to get some premium for their product, to stimulate the market, the Applicants' price cannot be far from NZ\$399 benchmark.
- 4.57 This 'perception' impact flows beyond merely the Auckland O/D routes that fifth-freedom carriers currently serve to other New Zealand and Australian O/D points. For example, the market would not tolerate a significant fare differential between Auckland – Sydney services and Wellington – Sydney services.

Fifth-freedom carriers' Tasman pricing sets Tasman pricing benchmarks

CONCLUSION

- 4.58 In the Applicants' view, fifth-freedom carriers currently impose, and will continue to impose, a significant competitive constraint on the Applicants in the Tasman market. Not only are there seven fifth-freedom carriers currently operating in the Tasman market with, collectively, a significant share of the Tasman O/D market but, in addition:
- since the Draft Determination, two fifth-freedom carriers have indicated an intention to enter the Tasman market, each adding a significant number of seats per week; and
 - there are in excess of 10 other potential fifth-freedom carriers with the right to operate fifth-freedom services in the Tasman.
- 4.59 Fifth-freedom carriers' ability to price at, or near to, marginal cost allows them to target price sensitive Tasman O/D passengers. Such activities impact on the Applicants' pricing and capacity decisions through the affect of fifth-freedom carriers' activities on the Applicants forward bookings and benchmark pricing. Given this intense price and capacity competition, it is not open to the Applicants to increase prices or decrease capacity without facing a substantial and constraining reaction from fifth-freedom carriers and from Tasman O/D passengers.