CHAPTER 1

OVERVIEW OF THE APPLICANTS' SUBMISSION

GENERAL

1.1 This submission (the **Submission**) addresses the key concerns raised by the Commerce Commission (the **Commission**) in its Draft Determination. For convenience, the Submission is set out in the form of a series of Chapters that include as appendices supporting evidence, supporting economic reports or other reports that refer to industry literature or other analytical material.

1.2 This overview (Chapter 1) summarises the content of each Chapter of the Submission to provide the Commission with a broad understanding of the submissions and evidence that are presented in support of the Applicants' case.

1.3 In summary, the Applicants submit that the evidence provided to the Commission clearly demonstrates that the benefits to the public resulting from the Alliance substantially outweigh any detriments due to the lessening in competition that might result from the Alliance.

1.4 Where the Submission does not specifically refer to or vary the content of the relevant Applications or subsequent submissions or evidence provided to the Commission to date, then the Applicants rely on their earlier submissions and evidence.

1.5 In addition to officers of the Applicant companies, a number of expert witnesses will give evidence at the Conference in August, including those named in this Overview as doing so.

CHAPTER 2 – STRUCTURAL CHANGE IN THE GLOBAL AVIATION INDUSTRY

1.6 This Chapter demonstrates, that the aviation industry in New Zealand and Australia is not sheltered from the difficulties confronting the global aviation industry including the impacts of liberalisation and the resulting advent of the Value Based Airlines (**VBAs**) model. Nor are New Zealand and Australia sheltered from the effects of exogenous shocks. Chapter 2 refers to and relies on extensive industry literature, analytical material and commentary by industry representatives and independent economists

1.7 A detailed understanding of the forces currently affecting the global aviation industry, including current competitive dynamics, is essential in undertaking the balancing exercise required under the Commerce Act 1986.

1.8 The Chapter examines the forces that led to the emergence and success of the new VBA model and its major impact on the conduct and performance of the aviation industry and in particular on full service airlines (**FSAs**). A more detailed appraisal of VBA entry and its impacts is contained in Chapter 3 of the Submission, described later in this overview.

1.9 Chapter 2 goes on to examine the arrival of the VBA model in Australia and demonstrates that Australasian liberalisation under the Single Aviation Market has made VBA entry into Australasia, as a whole, as easy, logical and likely as anywhere else in the world and more so than in many tightly regulated countries. It notes that the impact of VBA entry is substantially greater than that suggested by VBA entrants' initial market share and that the most likely entrant, Virgin Blue, has highly publicised its plans for:

- entry into the Tasman and domestic New Zealand markets;
- fleet expansion; and

- a share market IPO and listing.

1.10 Finally, the Chapter reviews recent exogenous shocks and discusses the vulnerability of airlines to the impact of those shocks. It also illustrates that Australian and New Zealand market conditions are a microcosm of the global industry. It points to:

- a domestic New Zealand market characterised by logical overlapping expansion by Qantas;
- the continuing effect of external shocks since the events of September 11; and
- the certainty of entry or expansion by a VBA.

1.11 It concludes with a note that Ansett Australia failed due in no small part to the impact of two of these conditions, but that Air New Zealand faces all three.

1.12 The points made in this Chapter are supported by a statement by Dr Michael Tretheway, a Canadian economist with considerable experience in respect of the aviation industry.

CHAPTER 3 - VBA ENTRY

1.13 In this Chapter the Applicants provide empirical support for their views that timely VBA entry, which will materially constrain the Applicants, will occur in both the Counterfactual and in the Factual, It draws extensively from analysis of "real life" examples undertaken by Airline Planning Group (**APG**), a leading United States expert airline consultancy, which counts many major airlines among its clients.

1.14 Chapter 3 explains why it is commercially rational and logical for Virgin Blue to enter the Tasman and domestic New Zealand markets. This is because all of the route characteristics in these markets are conducive to VBA entry and meet the requirements of the VBA business model in relation to:

- population;
- volume of point-to-point traffic; and
- ability to stimulate the market.

1.15 Virgin Blue has made countless announcements that it intends to enter the Tasman and domestic New Zealand segments. In these announcements it has delivered a very consistent message. It has been punctuated only by a plea that the Commission requires the Applicants' to allow it certain commercial advantages as a condition to authorisation of the Alliance. In very simple terms, the new conditions offered by the Applicants' and described in Chapter 14 achieve that outcome for Virgin Blue, although not in the manner Virgin Blue has sought. Virgin Blue's current complaint is simply that the conditions offered do not provide Virgin Blue with the commercial advantage it would prefer.

1.16 The Chapter refers to Virgin Blue's recent application to the IASC and notes that it provides further and even clearer evidence of Virgin Blue's intention to enter the Tasman market. Virgin Blue explains in a press release that six aircraft are available for international service. With only one of them being required to satisfy the Fiji/Vanuatu seat numbers stated in the IASC application, by deduction, that suggests the remaining five aircraft are destined for the Tasman or for domestic New Zealand segments.

1.17 Chapter 3 proceeds to demonstrate, on the basis of international experience, that VBA entry achieving just a 5% market share is sufficient to drive down prices to the same extent as would occur if a VBA held a 30% market share. The arguments that Virgin Blue will enter the Tasman and domestic New Zealand markets only in a small, and hence, unconstraining manner are therefore incorrect.

1.18 The VBA Chapter also demonstrates that low level entry is quite common for VBAs, but that over a period of a few years they steadily increase their capacity and increase their share of the market. Virgin Blue achieved over 30% market share in Australia in less than three years and the Chapter includes, in diagrammatic form, evidence of how it steadily grew in a pattern similar to that of VBA entrants in other markets.

1.19 If (as the Commission claims in its modelling) prices under the Alliance increase by 48% in the Tasman and 56% in domestic New Zealand (conclusions which the Applicants reject and address separately in Chapter 8), then that will, in the Applicants' view, merely encourage early and even more substantial expansion by the VBA entrant.

1.20 In the Applicants' view, it is counter-intuitive to suggest that a VBA that is seeking market entry, h has the available aircraft (excess to its current operating needs) and, on the basis of the Commission's modelling, is apparently faced with incumbents who are intent on driving prices up, will not enter or expand its services in that market. Conversely, it is intuitive that FSAs, with a clear understanding of the competitive impact of Virgin Blue's entry in Australia, will not permit prices to increase, which would issue Virgin Blue with a free ticket into the market.

1.21 Chapter 3 then proceeds to examine barriers to entry and expansion by reference to the Commission's assessment in the Draft Determination. In the Applicants' view, it is incorrect to infer from the fact that there are some costs of entry that entry will not be likely to occur in a particular market. The reality is that entry occurs frequently and on a substantial scale in aviation markets world-wide – despite the fact that in each of those markets, factors of the kind identified by the Commission ensure that entry is not costless. Rather, the reality is that those suggested costs are certainly not such as to deter a VBA, and do not represent the real world relative to an entry into the relevant markets by Virgin Blue.

1.22 The Chapter analyses incumbent response in detail, describing why there is no detriment arising from Air New Zealand's ownership of Freedom and then applies the Commission's LET Test. On this basis, the analysis shows that VBA entry will be likely, of sufficient extent and timely.

1.23 Finally, the Applicants examine the impact of VBA entry concluding that, around the world, including in Australia, every successful VBA entry has resulted in material reductions in fares, substantial stimulation in customer demand and ultimately a steady reduction in the incumbent FSAs capacity. In Australia, it occurred courtesy of the Ansett failure.

1.24 Ultimately, in this Chapter, the Applicants demonstrate that VBA entry in a constraining and timely manner will occur in respect of the Tasman and domestic New Zealand routes.

1.25 Mr David Bental, a director of APG will give evidence at the Conference.

CHAPTER 4 - FIFTH-FREEDOM COMPETITION

1.26 In this Chapter the Applicants demonstrate that fifth-freedom airlines do impose, and will continue to impose, a significant competitive constraint in the Tasman because they:

- currently account for 25% of total capacity on AKL-SYD and 44% of total capacity on AKL-BNE routes;
- currently account for 22.1% % of actual Auckland/Brisbane and 16.7% of actual Auckland/Sydney origin and destination traffic;
- provide services at extremely low fares by virtue of marginal pricing;
- are a steadily growing force in the Tasman market; and
- impact on current Air New Zealand and Qantas revenues.

1.27 The Chapter examines existing fifth-freedom airlines and the potential for further growth. It concludes that there is an absence of barriers to entry or expansion on the Tasman for such airlines. The recent announcements of Royal Brunei and Emirates airlines demonstrate the ease with which fifth-freedom carriers can enter the market and their willingness to do so. The three additional B777 flights each way each day notified by Emirates will include first class, business class and economy class seating, indicating that airline's intention to attract all levels of customers crossing the Tasman. Emirates will also provide air freight services. The ability of Emirates to enter the market on short notice highlights the ease with which New Zealand and Australian airport facilities can be accessed.

1.28 With 22.1% of all Auckland/Brisbane and 16.7% of all Auckland/Sydney origin/destination traffic already being carried by fifth-freedom carriers, it is not possible to justify an argument that these airlines are not a major constraining force across the entire Tasman sector. An examination of comparative pricing contained in Chapter 4 illustrates the accuracy of that statement.

1.29 When coupled with the growth taking place in fifth-freedom capacity on the Tasman, under the Alliance, the Tasman will remain very competitive with the Applicants overall seat share likely to fall to approximately 66% in year 1.

CHAPTER 5 - THE COUNTERFACTUAL

1.30 This Chapter includes an examination of the Commission's preliminary view that the anticipated capacity increase by Qantas in domestic New Zealand is irrational, and unlikely to occur. The Chapter demonstrates that far from being irrational and unlikely, the Qantas expansion plans are consistent with commercially and economically rational behaviour by reference to:

- normal market growth;
- the imperative for Qantas to increase its frequencies and, more generally, city presence in domestic New Zealand; and
- the fact that seeking a strong presence, in terms of offering high levels of frequency out of cities served, is a key element in the competitive strategy of FSAs world-wide.

1.31 Chapter 5 explains that the anticipated "war of attrition" does not arise from a 'dumping of capacity'. Rather it is the result of a progressive growth in Qantas' market share on many of the same sectors as Air New Zealand. This growth will slowly minimise Air New Zealand's network advantage in New Zealand, particularly in respect of city presence and will wear down Air New Zealand's ability to sustain a competitive position in the markets affected. The result of that expansion strategy is to increase both Qantas' yields and its share of revenues in Air New Zealand's traditional home market.

1.32 At the same time, Air New Zealand is facing the entry of Virgin Blue onto those same sectors on which it is already competing with Qantas, producing the "squeeze" effect described in Chapter 2.

1.33 Supporting the submission is a presentation by APG. This presentation demonstrates the impacts that share gaps; where one airline has a greater city presence than the other – have on airline performance, and most notably how they allow the stronger airline to secure higher yields and a greater share of revenues than its capacity share would imply. The result is a strong drive by the secondary airline to reduce the city presence gap, unless it can rely on a substantial cost advantage to remain viable even at low capacity shares as a VBA can.

1.34 Mr David Bental, a director of APG will give evidence at the Commission's Conference.

CHAPTER 6 - CONFIDENTIAL AIR NEW ZEALAND SUBMISSION ON THE COUNTERFACTUAL

1.35 In this Chapter, which is confidential to Air New Zealand, Air New Zealand sets out its view of the likely risks and their likely outcomes if it is unable to enter into the Alliance. It is supported by a full confidential financial evaluation carried out by PricewaterhouseCoopers.

CHAPTER 7 - ECONOMIC REPORTS – MARKET DEFINITION AND COMPETITIVE EFFECTS

1.36 This Chapter briefly examines market definition by reference to the SSNIP test, the reasons why, in relation to air passenger services, considering separate customer markets is incorrect, and the need to take into account Australian market forces when carrying out market analysis.

1.37 The Chapter considers from an economic perspective the Commission's views in relation to entry barriers and concludes with a brief examination of:

- fifth-freedom constraint;
- the New Zealand-Asia market;
- the New Zealand-Pacific market; and
- the New Zealand-United States market.

CHAPTER 8 - ALLOCATIVE EFFICIENCY DETRIMENTS

1.38 In this Chapter NECG examines in detail the modelling of allocative efficiency detriments with particular reference to the analysis undertaken by Professors Gillen and Hazledine.

1.39 The Chapter examines the work carried out by Professor Gillen and the substantial modelling and theoretical errors resulting from that work. It discusses the extensive errors found in Professor Gillen's initial modelling in the Draft Determination and then examines Professor Gillen's response to NECG's criticisms. The Chapter demonstrates that Professor Gillen's revised outcomes (his paper of 28 May) contain further material errors and that when those errors are corrected the welfare detriment for the Tasman and New Zealand markets is not $132 million as originally advanced in the Draft Determination but rather produces public benefits of $154.77 million.

1.40 Subsequently, in a report from the Commission headed - "Air New Zealand and Qantas: - audited calculations"- the Commission, for the third time changes to another a new factual/counterfactual scenario (from that described in the Draft Determination) which results in an increase in the welfare detriment over that originally modelled. However, this increased detriment is gained only by adopting new factual and counterfactual scenarios from Professor Gillen's spreadsheets. This change is achieved by making assumptions that the Applicants believe to be counter-intuitive and without factual or any other valid basis. Those assumptions are :

- that without the Alliance the Tasman market would be almost perfectly competitive, compared to a monopoly on the Tasman with the Alliance;
- fifth-freedom operators impose no competitive constraint on the Tasman at all;
- VBA entry would not occur with the Alliance, even although Professor Gillen himself estimates that an entrant operating on the Tasman would earn a profit of $118 million per year; and
- Air New Zealand and Qantas would operate with an average load factor of only 47% with the Alliance.

1.41 From the model based on these implausible assumptions, Professor Gillen concludes that prices will rise by 48%. No attempt is made to explain how or why Air New Zealand and Qantas can or would operate on the Tasman with fares increases in excess of 48% without existing and potential fifth-freedom airlines drawing from them large volumes of customers and profitably increasing capacity. Nor is there any attempt to explain why the Applicants would operate with average load factors of 47% (airlines simply do not do this) nor why Virgin Blue would not, in such circumstances, enter or expand in these segments.

1.42 Professor Gillen's modelling and errors in the application of economic theory are criticised by NECG. Appended to this Chapter is a review of Professor Gillen's modelling by Professor Robert Willig, a Professor of Economics and Public Affairs at Princeton University. Professor Willig, is an extremely well known and highly respected United States based economist who served on the anti-trust division of the United States Department of Justice as Deputy Assistant Attorney General for Economics between 1989-1991. He has held many other significant positions. Professor Willig endorses all of NECG's criticisms of Professor Gillen's modelling.

1.43 In addition, two expert economic specialists in the aviation industry, Professor Morrison and Dr Winston provide a joint supporting statement demonstrating that the price increases estimated by Professor Gillen's modelling approach are not compatible with international experience in respect of aviation alliances.

1.44 Professor Willig and Dr Winston will provide evidence at the Conference in August.

CHAPTER 9 - DYNAMIC AND PRODUCTIVE EFFICIENCY REVIEW

1.45 In this Chapter the Applicants respond to the Commission's arguments provided in relation to dynamic and productive efficiency. The analysis demonstrates errors in:

- the Commission's interpretation of the concepts of dynamic and productive efficiency;
- the interpretation of the relevant literature;
- the interpretation of the circumstances of the Alliance partners; and
- calculating claimed detriments, including the double (and in one case treble) counting of alleged losses arising from these detriments.

1.46 The analysis demonstrates that when these errors are corrected and proper recognition is given to the specific advantages of the Alliance, the Alliance is more likely to result in productive and dynamic efficiency gains than losses.

1.47 All of this material is supported by extensive analysis of established economic theory and literature.

CHAPTER 10 - NECG DETRIMENT/BENEFIT OVERVIEW

1.48 This revised quantification of the net benefits, arising from the Alliance, demonstrates that those benefits for New Zealand range between $189 million and $256 million dependent on the method of modelling tourism benefits.

CHAPTER 11 - TOURISM BENEFITS

1.49 The tourism Chapter responds to the Commission's findings in its Draft Determination that:

- the Alliance would not provide a sufficient incentive for Qantas Holidays (QH) to market New Zealand tourism;
- QH would be unlikely to be effective in increasing New Zealand tourism by an additional 50,000 tourists to New Zealand;
- any increased promotional effectiveness under the Alliance would not result in additional tourists;
- the negative effects of increased fares and reduced capacity had been under-estimated;
- there may be negative effects as a result of the loss of the Star Alliance in the New Zealand market; and
- the method used to convert increased tourists into a public benefit was not appropriate.

1.50 The analysis develops the case made in the original application in order to demonstrate that the Commission's conclusions are incorrect.

1.51 The analysis explains how the Alliance will increase New Zealand tourism through a number of inter-related factors:

- it will create network enhancements that would not otherwise be available to either Air New Zealand or Qantas, (thereby increasing the range and quality of tourism products available, including dual destination travel and triangulated fares);
- it will provide systems improvements and distribution access that are not currently available to Air New Zealand (i.e. access to QH's Calypso IT platform and extensive network of agents);
- it will give Qantas and QH incentives to promote New Zealand tourism, especially by giving Qantas a financial stake in Air New Zealand;
- it will allow QH access to the Air New Zealand Holidays brand;
- it will enable the parties to co-ordinate their promotion efforts; and
- it will introduce a number of other changes that will positively impact on tourist numbers.

1.52 These enhancements could not be independently achieved by the airlines because they rely on the connection of complementary domestic and international networks. No other airlines are in a position to replicate these enhancements. The Alliance will achieve market growth that would simply not be possible without it.

1.53 The Chapter demonstrates how these factors will increase the number of tourists to New Zealand by at least 63,000 visitors per year as compared to the counter-factual. This would be offset to some extent by differences in fares and capacity levels in the factual and Counterfactual which would be expected to reduce the number of tourists to New Zealand by 2,867. The expected net increase in tourists numbers would therefore be at least 60,400 visitors per year.

1.54 The Chapter describes how this net increase in tourist numbers translates into a benefit to the public under the Alliance. Welfare gains associated with tourism expansion derived using different models range from NZ$66 million to NZ$133 million. The Chapter explains that, conservatively estimated, the net increase in tourist numbers under the Alliance translates into public benefits of NZ$73 million in year 3. The change in public benefit from the original submission is as a result of taking into account suggestions made by the Commission in the Draft Determination, specifically the use of revised welfare multipliers to calculate welfare gains.

CHAPTER 12 - FREIGHT BENEFITS

1.55 This Chapter responds to the Commission's preliminary view that:

- Freight carried in the belly hold of passenger aircraft and by dedicated freighter airlines compete in separate markets; and
- The Alliance will have the effect of substantially lessening competition in the domestic air freight, Tasman belly hold air freight and international belly hold air freight markets.

1.56 By reference to the demand-side and supply-side characteristics of air freight, this Chapter demonstrates that belly hold freight services and dedicated freight services are substitutable and therefore compete in the same market. Specifically, the Applicants note that:

- the standard freight rates for belly hold and dedicated freight are essentially the same;
- most freight can be carried as both belly hold freight and dedicated freight;
- operating costs for dedicated freight are similar to the operating costs of belly hold freight; and
- passenger airlines often operate both belly hold and dedicated freight services and can even utilise fully convertible aircraft.

1.57 The Chapter explains that there can be no substantial lessening of competition in the domestic air freight market because there will be no aggregation as a result of the Alliance (Qantas does not currently compete in this market and all of Air New Zealand's capacity is contracted to NZ Post) and incumbent participants will continue to be constrained by existing and potential competitors.

1.58 In respect of Tasman air freight, when Air New Zealand's move to narrow-bodied A320 aircraft is taken into consideration, the aggregation will be significantly less than that assessed by the Commission. Further, the Alliance will be constrained by both existing and potential freight service providers, including fifth-freedom passenger airlines and dedicated freighters.

1.59 This Chapter demonstrates that, when the ability to transport freight indirectly and the inherent flexibility of dedicated freighters is taken into account, the Applicants will continue to be constrained in the international freight market under the Alliance because of the high number of market participants (many of which are international airlines considerably larger than Air New Zealand and Qantas) and the low barriers to expansion.

CHAPTER 13 - ENGINEERING AND MAINTENANCE BENEFITS

1.60 This Chapter responds to the Commission's preliminary view that the public benefits resulting from engineering and maintenance are nil. The Chapter demonstrates that the Alliance is likely to give rise to substantial public benefits through its impact on Qantas' incentives and Air New Zealand's position to provide an attractive service option. The Chapter demonstrates that:

- the current level of engineering and maintenance work being awarded by Qantas to Air New Zealand is the result of the failure of Ansett;
- Qantas' incentives are significantly different under the Alliance and the Core Counterfactual; and
- the impact of the Confidential Counterfactual on Air New Zealand's engineering operations.

CHAPTER 14 - CONDITIONS

1.61 This Chapter sets out the substantive conditions the Applicants are willing to offer to the Commission. The proposed conditions facilitate substantive new entry on Tasman and domestic New Zealand routes and therefore, will materially reduce any competitive detriment arising from the Alliance. The Conditions also ensure the delivery of other significant public benefits that flow from the Alliance.

1.62 The Conditions offered by the Applicants have been structured into two parts:

- Part A Conditions, which fulfil the Commission's criteria of being simple, easy to police and enforce and costless and

- Part B Conditions, which are more complex and largely form part of the original suite of conditions offered to the Commission following the filing of the Applications.

1.63 The Part A Conditions:

- Facilitate access to facilities;

- Facilitate access to aircraft;

- Place restrictions on the operations of Freedom Air; and

- Place capacity restrictions on the Applicants.

1.64 Part A Conditions are designed to ensure that, under the Alliance, substantive new entry will occur on Tasman and domestic New Zealand routes.

1.65 The proffered conditions are set out in detail in Chapter 14 of this Submission.

APPENDICES

1.66 Appendix 1 - This Appendix responds to the specific questions posed by the Commission by stating whether the Applicants' agree or disagree with the Commission's conclusion and then cross referencing to the relevant portion of the Submission or other submissions and evidence for support.

1.67 Appendix 2 – Glossary of Terms – restated and expanded glossary from the Applications.