Submission to the New Zealand Commerce Commission
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From Bruce Tulloch 11 Trafford Street CHRISTCHURCH 8005

AIR NEW ZEALAND / QANTAS ALLIANCE

Having recently retired from Air New Zealand after forty-four years in the airline and travel industry and having observed and noted developments over that period I wish to pass on some points to be borne in mind when assessing the Air New Zealand / Qantas proposal.

My background - Joined NAC in 1959. Employed in passenger reservations, airport traffic (passenger processing, aircraft weight and balance calculation and despatch, tarmac coordination), domestic and international air freight, and since 1970 as an international travel consultant, arranging air travel, accommodation, tours, cruises, rental vehicles, coach and rail bookings, insurance and other services.

I have no personal interest or benefit involved in the decision of the Commission, but I have followed the effects of past decisions on employment, efficiency and economic health in aviation and I believe that for the wellbeing of the country it is important that you have as much relevant information as possible. What follows may assist.

The format is coverage of changes in the airline industry since deregulation in the USA, the current situation, and lessons to be learnt. My conclusions are on Pages 8 and 9.

Competition undeniably has great benefits, the evidence is overwhelming. It also can have great costs but the evidence for this tends to be ignored or concealed when it contradicts the received wisdom or fashionable theory. In the case under consideration, the future form of New Zealand air transport, it is essential to remember that competition is a means to an end, not the end itself. As has been stated, the Commission's role is to measure the competitive impact of the proposal *and measure it against the benefits for New Zealand.* It is therefore vital that the commissioners have a clear knowledge of what has actually happened in the airline industry, and what may be reasonably extrapolated from past performance.

It is extremely important to look at the reality of airline operations and competition over the recent years. The actuality has not always coincided with public perception or the pronouncements of politicians and others with a particular interest to promote. Myths and theories need to be disentangled from the facts. Air transport is a glamour industry, often involving strong emotions and egos. Rational economic considerations have not been particularly evident.

The post September 11 situation is extremely difficult, airlines as reputable as Swissair have folded and others are in a serious state. It is, however, essential to look at the industry's position before the 2001 terrorist attacks to understand the longer-term situation, to examine the system that had evolved under normal operating conditions. This will illuminate some of the factors to be considered in your deliberations.

In 1978 the USA deregulated its domestic airline industry. Before then carriers had to apply for traffic rights and these were allocated and regulated by the Civil Aviation Board with the aim of providing a balanced and reliable national air transport system.

It was stated that deregulation would increase competition and thereby allow market forces to determine results. Goals set by the US Congress included the stimulation of lower airfares, prevention of market domination, encouragement of new entrants, protection of services to smaller centres, prevention of anti-competitive practices and the maintenance of an efficient and profitable industry.

At that stage there were eleven major airlines controlling some 60% of the traffic with a considerable number of smaller regional carriers taking the balance. Net profit margins averaged 5.2%, in the six years before deregulation US carriers earned US$2.5 billion and paid US$1 billion in taxes.

There was a surge of new entrants and considerable turbulence as established companies fought to adapt.

Within ten years the number of major carriers had dropped to six. These, though, controlled a much higher proportion of the total business through takeovers or linkages with smaller airlines. More than half the airlines operating at the time of deregulation were no longer in business and of the twenty-four started since twenty-three had failed. By1987 the net profit margin was 1.1% and in the preceding four years US$500 million in tax refunds had gone to the major carriers alone. (Above information from AIRLINE BUSINESS December 1985, TIME 29 September 1986, BUSINESS TRAVELLER January 1987, Official Airline Guide FREQUENT FLYER October 1988)

Fares did drop dramatically on the busy routes, although the benefits were unevenly spread as airlines, no longer required to operate a balanced network, pulled out of the smaller cities or dropped frequencies or ceased running direct services. It is relatively easy to make a profit between main centres with large aircraft, high load factors and regular demand. Serving peripheral points with less demand, smaller aircraft and shorter sectors is inherently more expensive and tough competition on the more profitable routes will reduce the ability to cross-subsidise others. This is relevant for New Zealand and Australia - the smaller centres are disadvantaged as new entrants concentrate on the big markets.

Deregulation and encouragement of market forces became politically fashionable through the 1980s and '90s. There was a great deal of promotion of the merits of this, and scorn poured on past practices. Unfortunately not much notice was taken of what was actually happening.

In New Zealand the Labour Government under Roger Douglas and Richard Prebble decided that major domestic airline competition would be a good thing. Newmans Air was not doing well in competition with Mount Cook Airlines and Air New Zealand. Australia's Ansett was keen to expand into New Zealand.

Richard Prebble, Minister of Civil Aviation, made a Ministerial statement on 30 June 1986 declaring that "An open competitive aviation industry offers great benefits …. It will lead to greater competition, efficiency, and the associated benefits that this carries will be obtained by New Zealand and New Zealanders.There are real benefits to the aviation industry through the injection of overseas expertise and capital."

The Overseas Investment Commission was to decide on any application by foreign investors wishing to purchase more than 25% of a New Zealand domestic airline.
Mr Prebble went on to say that two conditions would apply to protect New Zealand's interests - that shell companies would not be authorised, those with all essential elements of its operations imported in and profits repatriated out, "Any domestic aviation company must be essentially a New Zealand company", and that "Until New Zealand airlines are able to invest in their country of origin the Government proposes to restrict investment by an overseas airline to no more than 50% of the total equity of a New Zealand company. Such a restriction will give the Government the ability to seek reciprocal rights for New Zealand airlines which wish to invest overseas."

At that stage Chile was the only other country in the world allowing substantial foreign investment in a domestic airline.

The Overseas Investment Commission was to consider factors including:

> "the promotion of New Zealand's economy growth;
> the added competition to local industry;
> the lower prices and greater efficiency;
> the creation of job opportunities."

Given what was happening overseas and the limited size of the market in New Zealand it seemed obvious to many in the industry that adding significantly more capacity would be unlikely to meet these criteria and that the real costs of extra competition would be very likely to outweigh the benefits to the country as a whole.

The Overseas Investment Commission appeared to agree - it declined to rule on Ansett's application to buy into Newmans Air and passed the matter on to the Government for it to make the decision. On 18 August 1986 Richard Prebble and David Caygill announced that the application had been approved by the Minister of Finance, Roger Douglas. Interestingly, on 22 August Mr Prebble was quoted in the "Dominion" as saying that the Government had made no studies on the effect of the new airline and that a new venture should be judged not by the Government but by the market place.

Anset New Zealand was promptly set up, with 50% shareholding by Ansett Australia, 22.5% by Newmans and 27.5% by Brierley Investments and began flights in July 1987.

By February 1988 the airline was in deep trouble. Costs were becoming unsustainable for the New Zealand shareholders, Brierley's having lost $16 million, and both it and Newmans were forced to pull out. This was a major embarrassment for the politicians who had shortly before promised so many benefits. To avoid the real consequences of excessive competition here, replicating what had already been happening overseas, the two safeguards Mr Prebble had said would protect New Zealand's national interest were quietly dropped. Ansett Australia took over total ownership of Anset New Zealand and any leverage New Zealand had for entry into Australia's domestic market was thrown away.

Without the constraints of New Zealand shareholders wanting a profit Anset NZ continued to compete against Air New Zealand by selling fares at less than cost, steadily making losses year after year. By 1999 it was admitting total losses exceeding NZ$300 million and in March 2000 the airline was sold to a group of New Zealand and Australian investors for $36.46 million. Renamed Qantas NZ, by 20 April 2001 this operation had accumulated debts of over $100 million. It collapsed into bankruptcy and ceased operations.

So Qantas Australia moved in and are now running a domestic service in New Zealand at what appear to be uneconomic fares, for strategic reasons - continuation of the predatory internal competition New Zealand has faced for the past fifteen years.

On the international scene cut-throat competition affected virtually all airlines. Profitability was described by the chief economist of IATA, the International Air Transport Association, as "marginal even in the best of years". Professor Nawal Taneja, chairman, Department of Aerospace and Engineering, Ohio State University, addressing IATA delegates at an Information Management meeting in Orlando last year stated that "From 1947 to 2000 the airline industry has made 0.08% profit. Despite the industry's continued growth airlines are profitless. We have been giving away the product for too long". (Air Transport & Travel Information Systems Newsletter 3 May 2002)

Airlines had a very difficult time through the early 1990s. The Gulf war affected business severely and as margins were very thin the downturn had immediate impact, however there was a gradual improvement in the later '90s. Fuel prices dropped, which helped profitability, and load factor (the percentage of seats filled) rose steadily from 1994.

Unfortunately yield did not rise as hoped. At the IATA Airline Financial Summit in 2000 it was stated that US revenue per passenger mile had declined by an average of 1.6% annually over the past twenty-five years and that yields worldwide were expected to continue to decline given the level of competition.

In the twelve months to May 2000 traffic on the US carriers and on the international routes of major European and Asian airlines had dropped below that of the previous year (Boeing Current Market Outlook 2002). By August 2001 British Airways operating profit was little more than half the preceding year's.

On 11 September 2001 the terrorist attack on the USA using airliners as weapons threw the world's airline industry into chaos. It was, however, an impact on an already very fragile edifice.

At the 58th IATA AGM in June 2002 the Director General said in his speech "In retrospect, and looking at the deteriorating situation even before September 11, we would be forced to conclude that this industry was ill-prepared to successfully weather even a fairly mild regular economic cycle". He went on to highlight the desperate need to raise yield. Sadly, he was saying very much the same ten years ago, (FLIGHT INTERNATIONAL 28 April 1983), when he identified overcapacity and unrealistic fares as the major problem facing the airlines of the time.

Commissioners will be aware of the present situation. The world's biggest carrier, American Airlines, citing unsustainable losses and a long-term need to restructure is calling for US$1.8 billion in annual savings through reduced labour costs. Standard and Poor report that the airline is currently losing around US$5 million per day. The second biggest, United Airlines, is in Chapter 11 bankruptcy having lost US$3.2 billion in 2002. Between 9 and 31 December it was losing US$7.2 million daily. The three next US airlines, Delta, Northwest and Continental are looking at means of cooperation to reduce their losses.

The Gulf War of 1990 had a disastrous effect on the airlines, and on the tourist industry of many countries. Today's uncertainty over the US / Iraq confrontation makes forecasting extremely difficult and an outbreak of hostilities with the prospect of consequent terrorist retaliation would be catastrophic. It is no time for actions, which on past evidence are likely to make the airlines even more vulnerable. Relaxation can come later if judged wise. Adding extra capacity and the fare cutting, which inevitably follows, would be a huge risk at this stage.

Why does New Zealand need a reliable airline service? We are a very small country at the far end of the World's lines of communication. Our markets for tourism and, to a large extent for exports and imports, depend on regular and consistent air transport. The effects of any significant disruption are immediate and very serious. We have no alternatives.

We have built up and maintained, in the face of very heavy competition, a New Zealand based airline capability, which has served the country very well. There has been a great deal of propaganda from those with an ideological or commercial interest to foster to claim that New Zealand airlines have not been up to standard and need more competition to make them so or replace them. No company is perfect, but the record shows that our airlines have done very much better than the average.

Newmans Air found that Mount Cook and Air New Zealand domestic business was not as easily siphoned off as they expected. Australia's Ansett came in full of confidence to show New Zealand how to run an airline and not only failed to survive here but collapsed at home. Qantas NZ took over from Ansett and in turn failed even more dramatically.

On the trans-Pacific routes the record is instructive. Over the years we have had services by Pan American, Continental, American Airlines, Canadian Pacific, Hawaiian Airlines, UTA, and United. Competition was vigorous and in most cases backed by immense resources. Air New Zealand not only stood up to this, it survived while the other carriers found the going tough and eventually the staying impossible.

In 1985 FLIGHT INTERNATIONAL, one of the most respected aviation trade journals, conducted an examination of airline efficiency, using ten measures of staff and aircraft productivity based on figures from the International Civil Aviation Organisation Digests of Statistics. Results were published in the issue of 2 November that year. Of the fourteen airlines examined the top three were American carriers, in part because of the nature of their networks and the economies of scale. Fourth was Air New Zealand, ahead of Lufthansa, British Airways, United Airlines, Scandinavian Airlines, Air Canada, Air France, Japan Airlines, Pan Am. Not a bad showing, although it did not carry much weight with those who had ideological reasons for denigrating local abilities.

In the June 1986 issue of NORTH & SOUTH the then Opposition transport spokesman Winston Peters claimed New Zealanders paid some of the highest domestic air fares in the world and blamed this on Air New Zealand having a monopoly. Comparing air fares across different countries is an inexact exercise however on checking basic economy class fares for similar distances, as published in the International Air Tariff, and converting these to NZ cents per kilometre Air New Zealand came out very well, being cheaper than Australia, Canada, The USA, Japan, the UK, and all Western European countries except Greece. Very significantly cheaper in most cases. When queried as to the evidence for his contention Mr Peters was unable to provide an answer. Incidentally fares from New Zealand to Australia also compared very well with overseas equivalents.

These are historical examples now, but they do show the need to look for the reality rather than just accept unsubstantiable statements and reflex responses.

Who calls for more competition in New Zealand aviation, why do they do so and how much knowledge of the ramifications and real consequences do they have?

Some will do so on philosophical grounds, as did Richard Prebble, Roger Douglas, Mike More and some others back in the mid 1980s. These people were told of what was happening overseas and (very accurately as it turned out) of the likely consequences of their policies. They preferred not to believe evidence which did not fit their theology.

Others will do so because they fear (realistically) that without the past levels of competition their fares or freight rates will go up and services may be less freely available. This is a reasonable concern from their point of view. The question that must then be asked is whether they are in fact paying a fair price for the service received? If not, who is really paying the balance of the cost and is this equitable or sustainable?

The answers are fairly clear.

In 1986 American Airlines Senior Vice President for Airline Planning W. G. Kaldahl said "While deregulation is billed as pro-consumer it is also profoundly anti-labour. The goal of deregulation was to achieve lower ticket prices and that has happened. However we must realise that lower ticket prices have occurred primarily because there has been a massive transfer of wealth from airline employees to airline passengers." (Air Transport World June1986). In a labour intensive industry wages were an immediate target. There were massive layoffs. Hiring of new or replacement staff was at much reduced levels.

In New Zealand the pressure to cut costs to survive against the subsidised competition from Ansett forced Air New Zealand to cut staff costs. Ansett in turn used their non-profitability to keep their staff on minimal wages.

At Air New Zealand the burden fell particularly on longer-service staff who were often on higher wages, had more leave entitlement and may have been in company-supported superannuation schemes. The fact that they also were in many cases those with valuable experience and people who had earned better wages by personal efforts to develop skills the industry needed made little difference. Full time careers were replaced by part-time jobs and temporary workers. Non-core divisions such as domestic cargo and catering were sold off or contracted out. Passenger accounting staff in Auckland were laid off and the work transferred to Mexico! Good New Zealand jobs were destroyed or replaced by work at lower wages and poorer conditions. Just as overseas.

This did not benefit New Zealand – it merely transferred the costs away from the airlines to the individuals sacked or to the taxpayer. Or to other businesses in New Zealand when ex-airline employees no longer had the same disposable income to spend.

Not only employees lost out. In New Zealand as overseas, shareholders lost savagely, governments lost the taxes once-profitable airlines paid and suffered the extra welfare costs of job losses, creditors lost as airlines went bankrupt (Qantas NZ were reported to have over $130 million in creditors' claims against some $27 million available to pay them, NZ Business Herald, 28 June 2001).

In 1989 Air New Zealand was privatised and sold off by the NZ Government for $660 million, with the usual rhetoric about greater efficiency etc etc. Shares were sold at $2.40.

The company gradually passed into effective foreign control. In 2001 the airline announced a loss of $1.4 billion (Christchurch Press 17 September). Shares had dropped to $0.29. To preserve a vital strategic industry the New Zealand Government had to come up with a rescue package of $885 million, $300 million as a loan, the rest in equity for 82% ownership.

We, the New Zealand taxpayers, joined the previous shareholders of Air New Zealand and of Ansett NZ and Qantas NZ as the people who paid the difference between what the airlines had charged their customers and what the services really cost. Those calling for more competition to keep prices down should explain who they now want to subsidise their travel and freight carriage.

The third party calling for more competition is other airlines wishing to fly into or within New Zealand. Their motives are clear – profit at the expense of existing carriers. Since these airlines will not be New Zealand owned any profits would go overseas while the costs would be paid in New Zealand. Given the evidence of the massive damage from predatory competition in the past and the desperate need to conserve foreign exchange and New Zealand jobs there would need to be concrete evidence of very great benefits before allowing this.

Would-be new entrants promise cheaper fares and more choice – attractive bait, but these enticements have been offered worldwide since 1978 and by now we have gained enough evidence from real results to be able to compare the surface promise with the hidden costs. Gullibility is no longer excusable.

It is also important to look at the loyalty to the New Zealand market of overseas airlines. All the North American carriers that used to fly here pulled out, mostly at fairly short notice, as did Ansett. Our tourism and export/import industries cannot survive without a reliable and sustainable air service. In such a capital and labour intensive industry if the technological skills and highly specialised engineering capabilities were lost in New Zealand we would never be able to rebuild them. It was the immense strategic importance of keeping control of our air links, which forced the Government to divert so much money to keep Air New Zealand viable.

CONCLUSIONS

A reliable, safe, affordable and sustainable air service is vital to New Zealand's economic and social wellbeing.

Competition is desirable to ensure consumers are not exploited and efficiency is encouraged, however for long-term continuity of supply it is essential that all stakeholders in the industry be considered and that all bear a reasonable share of the costs as well as the benefits.

The history of totally uneconomic competition in the industry, the inexorable concentration of ownership and control and the ability of large or better-resourced companies to take over or squeeze out competitors puts the New Zealand industry at severe risk. To risk placing the future of this country's air transport in the hands of overseas companies or owners who can shift resources out of the country or charge whatever they think fit is to abandon control of our own economy and our own destiny.

Economies of scale apply. Canada, much bigger than New Zealand, can only support one major airline. Australia only has one providing extensive domestic and international coverage. The USA has seen massive consolidation and further reduction in carriers seems inevitable. International groupings such as the Star Alliance and One World seek the benefits of mutual support. The Ansett NZ experiment has proved that the globally tiny market in New Zealand cannot sustain more than one large domestic airline and the lack of profitability on international routes mitigates against extra competition being beneficial to this country. Air New Zealand's ongoing survival against low-cost Asian carriers and massive US airlines already proves its operating efficiency. Financial results show the cost of this.

Closer involvement of Air New Zealand with Qantas is not ideal, given the long history of Australian attempts to control or dominate the Australasian industry. Qantas have made it clear that unless New Zealand co-operates it will face extremely strong competition. Weakened by the previous Australian incursion Air New Zealand would not be well placed to survive.

Some form of alliance is, however, probably inevitable given both this prospect and the need for critical mass. In the global scene Air New Zealand and Qantas are small airlines and New Zealand and Australia are small countries. Faced with relentless foreign competition we have much to gain from sharing resources and joint strengths. The example of SAS, the joint airline of Denmark, Sweden and Norway is relevant. Other European countries are seeking similar solutions as small national airlines fight to survive.Holland's KLM, Italy's Alitalia, Switzerland's Swissair, Belgium's Sabena and others have sought co-operation rather than conflict. The alternative is extinction.

Given this, two considerations apply –

It is absolutely essential that New Zealand retains control of its own air services. Integration to the point where a divergence of Australian and New Zealand interests could see us lose control of our internal and external links could be fatal. It is important to be aware that Qantas has a high proportion of foreign ownership and is seeking relaxation of present limits. New Zealand (or Australian) national interests would not necessarily carry much weight with overseas owners only interested in profit maximisation. Aircraft are an extremely portable resource.

Secondly, competition as a control mechanism has proved corrosively impractical. Users of airline services have benefited disproportionately at the expense of all other stakeholders. As quoted earlier, "*From 1947 to 2000 the airline industry has made 0.08% profit.*" Despite huge increases in efficiency yield has steadily dropped and airlines are being virtually run into the ground. Adding competition and hence capacity has proved economically suicidal. Therefore alternative methods of protecting consumers must be considered.

Monopoly or oligopolistic power in private hands is highly undesirable. The only option appears to be government oversight. As Air New Zealand is now largely back in government ownership this should not prove impractical. The company's record when originally in public ownership was good by international standards; it is not ownership that matters as much as management. The performance of the airlines in the USA is not a compelling endorsement for the superiority of private ownership. Singapore Airlines is a very successful airline, predominantly owned by the Government of Singapore and run for the benefit of that country as a whole. It is an exceedingly good model for a revived Air New Zealand.

I trust the information above will be of assistance to the Commissioners. As mentioned earlier, there are a lot of myths about airline matters - it is vital to look beyond these to the reality.

A final quote is perhaps appropriate, from Barbara Tuchman's "The March of Folly: From Troy to Vietnam", writing of King Philip II of Spain ……

> No experience of the failure of his policy could shake his belief in its essential excellence".

I hope the airline industry and all those influencing it are more capable of learning.

Bruce Tulloch