Inbound Tour Operators Council of New Zealand

Comments to the New Zealand Commerce Commission on the Proposed Air New Zealand/Qantas Alliance

February 2003

About our organisation

ITOC was founded in 1971 and is the Trade Association representing inbound tour operators and their suppliers. ITOC have 55 full member tour operators and 190 allied supplier members. Full members process 50% of holiday visitor arrivals and working with allied supplier members process the majority of holiday visitor arrivals to New Zealand.

Over two million overseas visitors arrive in New Zealand each year and these visitors are worth over $5.5 billion per annum in foreign exchange.

Full member tour operators meet strict membership and financial criteria including –

- Staff qualifications
- Meeting the financial criteria and annual financial assessment undertaken by the independent ITOC Financial Assessor
- Adhering to the ITOC Code of Ethics and Practice and Common Pledge
- Adhering to the ITOC Constitution and Rules

Our Association is dedicated to customer satisfaction and safety, quality performance and promoting New Zealand as a quality visitor destination and experience.

ITOC welcomes the opportunity to comment on the proposed alliance between Air New Zealand/Qantas as has been submitted for consideration to the New Zealand Commerce Commission, and the Australian Competition and Consumer Commission.

This submission consists of the following:

- Summary of the ITOC position on the Alliance proposal
- A broad statement on the key requirements for an efficient and effective airline industry that support a successful tourism industry
- A statement on the tourism industry's vision for an optimal airline industry in New Zealand
- A review of the recent history of service in the airline industry in New Zealand and the key issues being faced by that industry
- A statement on the key public good issues our industry believes should be taken into account by the Commission as it assesses the Alliance proposal
- An assessment of the proposals compared to the status quo and how they might impact on pricing, service standards (including overall levels of competition), innovation, returns, and the overall public good, and distribution

Summary of the ITOC position

The Alliance proposal involves the co-ordination of pricing and scheduling, and also provides for the co-ordination of sales, marketing and customer service functions in the future.

ITOC is concerned that this proposal would lessen competition, lead to declining service standards and restrict the ability of new suppliers to enter the market. This will also result in insufficient capacity that fails to meet the needs of the market, with negative net impacts on the consumer, the wider industry and the country as a whole.

A regulated option would be a new policy approach in New Zealand but this potentially provides a bridge between the status quo and the Alliance proposal.

ITOC believes this would improve the sustainability of returns from new entrants. This scenario would also encourage new entrants into the market while preventing temptation towards predatory pricing that over the long-term is counter-productive to suppliers, consumers, the industry and New Zealand as a whole. This approach has been followed by the United States Department of Transportation's conditional approval of the Delta, Continental and Northwest Alliance. This option is set out in detail in the body of our submission.

In order for ITOC to support any Alliance as contained in the proposal, we strongly submit that appropriate conditions be imposed on the parties to the proposal to ensure any risks of market dominance, or intent to lessen competition are fully removed.

The Tourism and Travel industry and the Airline Industry

The airline industry, both domestic and international is critical to the success of the New Zealand tourism industry as almost all international visitors fly to New Zealand. The domestic airline main trunk routes, and provincial routes enable both international and domestic tourists to access all parts of the country, and this has enabled tourism to provide economic development benefits to all regions of New Zealand. This is in addition to the need for an airline industry that forms a useful component within a wider transport system that is essential to the movement of people in a modern, developed economy (including the movement of New Zealanders overseas).

One country's inbound business is another country's outbound business. And outbound business is necessary to support inbound business. Therefore, the two must be considered in tandem.

To be successful, the tourism and travel industry requires the following:

- Main trunk network services using world-class aircraft and service levels
- A diverse regional network using appropriate modern aircraft

- City-to-city service standards that support business and non-business customers within a business day (0630-2100)

- Service pricing at a level that ensures a return on capital employed at a cost of capital (coc) that is internationally competitive, i.e. a premium over the risk-free rate (government stock) that reflects the risk of patronage (e.g coc between 8-11%)

- Supporting infrastructure that enables pre/post flight efficiency, minimal waiting and transit time, ample facilities for transport, appropriate rest facilities for service users, catering etc. The standards for these services should reflect those of tourism suppliers in the United States, the United Kingdom, Europe and Japan.

- Competition within the distribution system to support a competitive airline industry and to ensure that overseas visitors are able to be provided with information to enable them to choose between competing products and services.

The tourism industry's vision for an optimal airline industry in New Zealand

ITOC believes that the travel and tourism industry and New Zealand as a whole would be served by a domestic and inbound airline industry that is characterised by the following:

- Several inbound/outbound airlines committed to schedules and networks that competitively deliver up to 2.5 million, high value visitors annually. Originating countries include: Australia, United Kingdom, United States, Europe, Japan and Asia. These airlines take over 1 million New Zealanders overseas annually, on holiday and on business.

- A choice in trunk routes for business/domestic travellers, sustainable competition (relating to prices, service levels and capacity and distribution channels) and benchmarked to international practice

- A strong Air New Zealand that is internationally competitive (prices, service levels, capacity, on-ground services, and infrastructure). It has sound linkages to regional centres. It continues to provide at least existing leverage to New Zealand's current offshore marketing budget of $55 million per annum.

- Competition within the distribution system to support a competitive airline industry and to ensure that overseas visitors are able to be provided with information to enable them to choose between competing products and services.

ITOC's submission and the analysis contained within it supports the attainment of this vision.

Recent airline history in New Zealand

Recent airline history in New Zealand has been characterised by a number of new entrants to the New Zealand market providing some notable benefits to the consumer and the wider public.

The entrance of Ansett New Zealand into the domestic market in 1987 provided the catalyst for:

- Short-term consumer choice as far as tariffs were concerned
- Extensive upgrades to airport infrastructure including the construction of new terminals
- Improvements in ancillary infrastructure such as transport services, terminal services and roading
- The introduction of on-line service information systems
- Improved onboard service, including a full meal service and the option of travelling business class
- Better route/time convenience, especially to regional parts of the country.

In addition to Ansett New Zealand, the 1990s saw the arrival of Kiwi Air, Freedom Air (as a subsidiary of Air New Zealand) and Origin Pacific. Kiwi Air and Freedom Air brought cut-price fares to the Trans-Tasman routes and introduced the Value Based Airline (VBA) Model to New Zealand. Origin Pacific and the domestic operations of Freedom Air introduced cut-price services within the domestic market and Freedom Air is now flying as a VBA on the Tasman route.

The gains from airline competition over the 1987-2001 have also come at a significant cost to the industry. TIANZ calculates that the combined Ansett New Zealand/Qantas New Zealand losses were in the vicinity of $500 million over this period. The collapse of Ansett Australia also affected Air New Zealand and in 2001 the airline was virtually bankrupt incurring a loss of shareholder value in the order of $1.5 billion.

While the gains from improved airport-based infrastructure endured beyond the lives of the airlines that ceased operations, pricing has become relatively standardised, with limited competition based on routes/timing remaining within the current market.

We understand from the Air New Zealand Alliance proposal that Qantas's New Zealand domestic operations continue to lose money.

This past history illustrates that:

- A relatively unregulated market readily attracts new entrants however the life of these new entrants has tended to be short
- New entrants force upgrades or/and in some cases new infrastructural services, i.e. airport terminals and these tend to endure beyond the life of the new entrant

- In the short-term, a competitive "price war" develops but over the long-term prices increase and become standardised. Restricted competition based on routes/time and minor differences in in-flight service evolves (such as the difference between the full service provided by Qantas on domestic routes, versus the Air New Zealand Express service) but at a cost to profits and returns for both the new entrants and incumbent airlines but to the benefit of the consumer

- There has been a shift towards some suppliers selling directly (usually internet or call centre based) to consumers and bypassing the travel agent/inbound tour operator distribution channels. In most cases this has been accompanied by a reduction in remuneration, thus taking away any incentives for travel businesses to involve themselves in the distribution process.

- Airlines that survive struggle to earn returns that enable them to reinvest in new capital, or even earn a rate of return that has any premium over the risk-free rate. This leaves the future of airlines such as Air New Zealand vulnerable to further price wars with VBAs entering the New Zealand market, or predatory strategies from overseas based airlines such as Qantas. If Air New Zealand fails, the marketing benefits that New Zealand gains from Air New Zealand's offshore marketing will disappear, unless an overseas airline is contracted to undertake this marketing.

Public good issues

The branding of New Zealand

As a remote, non-hubbed destination, New Zealand receives considerable leveraged marketing benefits from Air New Zealand's marketing efforts. If Air New Zealand ceased to operate, New Zealand would need to contract an overseas airline (that primarily promoted its own country of origin) to promote New Zealand offshore.

Tourism's new objectives

New Zealand's marketing direction is focused on generating value of tourism business as opposed to volume of business. Therefore, all estimates of increasing capacity need to reflect the 'worth' of targeted customers.

The New Zealand airline market must be able to sustain several (including one New Zealand owned and managed) in-bound carriers that operate to service levels that are consistent with the expectations of overseas visitors that New Zealand is actively targeting.

Dependency

Almost all incoming visitors arrive in New Zealand by air. Similarly, almost all outbound travellers leave by air.

Necessary questions to ask are: can New Zealand afford not to ensure a diversity of choice of services to Australia, the United Kingdom, Japan, the United States and Europe? What mechanisms will ensure longer-term air access to key markets?

ITOC strongly suggests that the regulatory issues surroundings the Alliance proposal (and any other options that are available) must also be considered with these public good issues in mind.

Choice

The consumer (both within New Zealand and overseas) should always have the ability to have a choice of competitive services. Distribution systems should facilitate the ability for consumers to make a choice. This is essential to ensure that competition in the New Zealand airline industry remains robust and that service providers continue to operate within a market that expects international standards of service quality.

Options for the future

ITOC is aware of three clear options for the future that merit consideration. Two of these options include the status quo and the proposed Alliance. In addition to these two options, ITOC also proposes a third option involving a managed competition option.

In summary form, these scenarios are as follows:

Status Quo

Continue head-to-head competition where new investors seek a sustainable market share.

The proposed Alliance

An Alliance of suppliers to provide the majority of domestic and Trans-Tasman and Pacific services.

Regulations to safeguard against a lessening of competition (Domestic/Trans-Tasman/Pacific)

This option would comprise the Alliance proposal but would incorporate robust restrictions on dominant carriers so as to encourage diverse competition. This agreement might contain restrictions/prescriptions for rates of return and also require minimum levels of service based on international benchmarks.

The option would also require:

- Value Based Airline (VBA) operations run by Full Service Airlines (FSAs) to be ringfenced or even sold as a going concern to ensure that VBAs remain a strong source of competition

- Airlines would be prevented from co-ordinating sales channels, i.e. combining call centres and internet booking services

- Regulations to prevent airline collusion that lessens competition in the marketplace.

The three options analysed

TIANZ has analysed the potential impact of these three scenarios on pricing/capacity, service standards, innovation, returns, and public good. This analysis is found below.

Status Quo

Price/Capacity

There will be some sustainability until a duopoly situation is reached. In the short-term, there will be intense competition on both pricing and capacity. In the medium to long-term, pricing and capacity will become more or less standardised.

Service standards

Improvements until a duopoly is reached. At that point, service will become standardised and may then gradually reduce over time.

Innovation

Improvements until a duopoly is reached. At that point, service will become standardised and may then gradually reduce.

Distribution systems

There will be ongoing pressure for suppliers to reduce the costs of distribution, especially with new VBAs entering the market. However some competition will prevail. Most airlines will maintain links and provide positive incentives with travel agencies and ITOC tour operators in the marketplace that enable consumers to make a choice about purchase decisions.

Returns

Low and possibly negative.

Public good

The collapse of Ansett Australia has resulted in government intervention and public guarantees of approximately $850M. Job losses within the airline industry from entrant failure, capacity reduction, ongoing restructuring and the disruption caused by this change, ultimate reduction in service standards and airlines cost-cutting. Customers enjoy short-term gains at the expense of the government and private shareholders. There is little possibility of a sustainable market share building up. Constant flux within the ancillary industries such as airport services.

Proposed Alliance

Price/capacity

Increases in prices predicted. There will be a consolidation of capacity. New entrants will be disadvantaged.

Service standards

Declining standards of service, capacity and routes.

Innovation

Static unless standards are benchmarked.

Distribution systems

Air New Zealand managing JAO networks is of concern to ITOC. This will lead to dominance in the market especially as Air New Zealand and Qantas have different models for remunerating the travel agent.

ITOC anticipates a lessening of competition in the marketplace.

If direct distribution systems are used in such a way as to significantly reduce the travel agent's role, the outcome will be to reduce consumer choice.

Returns

Improve dramatically. There is the risk that airlines will sustain a higher level of profitability at the expense of agents/tour operators/the distribution system with the loss of welfare to the country as a whole.

Public good

New Zealand's government could possibly recoup some of its capital from its 2001 intervention. Private returns are uninhibited by competitors. ITOC can find no obvious, credible or demonstrable experience elsewhere to show that this approach will provide consumers with world-class service at world class prices. There is scope for extraordinary profit and price escalation as airports drive service prices upwards as a percentage of airline income.

Regulations to safeguard against a lessening of competition (Domestic/Trans-Tasman/Pacific)

Price/capacity

Prices would rise to match capacity and return needs but capped returns would still maintain an environment of 'managed' competition

Service standards

These would be static as costs would be strictly monitored. New entrants might be advantaged.

Innovation

Some innovation as required to meet benchmarking.

Distribution systems

A travel agent/tour operator distribution system to any dominant carriers (including an Alliance) would be required to prevent collusion and to ensure continued remuneration for travel agencies/inbound operators to provide information and a choice of services that support a competitive market.

Returns

Regulated returns for two or more parties of around 8%.

Public good

The New Zealand government recoups some of its capital with profits and the tax returns from a successful cluster of providers. Prices rise, retaliatory practices are regulated out. Restraints to encourage longer-term mutual prosperity and an overall risk reduction would improve public good.

Analysis

The analysis behind our submission also recognises that there are substantial issues that are facing the airline industry in New Zealand and there appears to be a gap between the tourism industry's vision for a sustainable airline industry, and the current market conditions.

The Alliance proposal involves the co-ordination of pricing and scheduling, and also provides for the co-ordination of sales, marketing and customer service functions in the future.

Overall, we draw the following conclusions from our analysis:

- Pricing collusion and the loss of competition in the domestic market will result from the proposed Alliance. Market dominance by the largest carriers will create barriers that will make it harder for new carriers (including VBAs) to establish themselves in the New Zealand market.

- The Alliance proposal would provide some attractive benefits to the parties to the proposed Alliance, including a greater consolidation of activities (resulting in less duplication of resources), and the possibility of greater returns to suppliers. This option would also enable the New Zealand government and the New Zealand taxpayer to gain a reasonable return from the considerable public investment made in Air New Zealand in 2001. At the same time, we expect there to be pricing collusion and the loss of competition in the domestic market. ITOC is concerned that this proposal would lessen competition, lead to declining service standards and restrict the ability of new suppliers to enter the market. This will also result in insufficient capacity that fails to meet the needs of the market, with negative net impacts on the consumer, the wider industry and the country as a whole.

- A regulated option would be a new policy approach in New Zealand but this potentially provides a bridge between the status quo and the Alliance proposal.

- ITOC believes this would improve the sustainability of returns from new entrants. This scenario would also encourage new entrants into the market while preventing temptation towards predatory pricing that over the long-term is counter-productive to suppliers, consumers, the industry and New Zealand as a whole. This approach has been followed by the United States Department of Transportation's conditional approval of the Delta, Continental and Northwest Alliance.

- The conditions of the approval are as follows: "*the carriers may not co-ordinate or agree among themselves on matters such as fares, route entry or exit, or capacity; at their hub airports and at Boston, the carriers must at the airport authority's request return gates that are used less than six turns per day; restrictions will be placed on the carriers' ability to offer joint bids to corporate customers and travel agencies; the carriers must request that their services be listed under no more than two codes in computer reservations systems (CRS) until the department completes its pending revision of the CRS rules; the carriers may not enforce any provisions in their agreements that would restrict a partner's ability to enter into a marketing relationship with any other airline after the agreements have been terminated.*

- This scenario could meet ITOC's public good objectives and ensure that the local and Trans-Tasman/Pacific markets in particular remained competitive. This approach would also prevent market domination which would lead to a control of the distribution system, lessening competition in the New Zealand inbound and outbound airline industry.

Conclusion

In conclusion, in order for ITOC to support any Alliance as contained in the proposal, we strongly submit that appropriate conditions be imposed on the parties to the proposal to ensure any risks of market dominance, or intent to lessen competition are fully removed.

ITOC
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