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

20 JUNE 2003

Introduction

1 In the course of considering the applications of Qantas Airways Limited ("Qantas") and Air New Zealand Limited ("Air New Zealand") in respect of a proposed strategic alliance and a proposed merger, the Commission has published a draft determination dated 10 April 2003 (the "Draft Determination"). In the Draft Determination (at paragraph 31) the Commission sought submissions from interested parties in respect of the preliminary conclusions reached.

2 The Draft Determination relates to two applications filed by Qantas Airways Limited ("Qantas") and Air New Zealand ("Air New Zealand") each an "Applicant" and (together, the "Applicants"):

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

2.2 The application filed jointly at the Commission on 9 December 2002 by Qantas and Air New Zealand (the "Alliance Application") to enter into a Strategic Alliance Agreement (the "Alliance Proposal").

3 The Equity Application and the Alliance Application are together referred to as the "Applications". In addition, unless otherwise defined, capitalised terms have the meaning in the submissions given to them in the Draft Determination.

Parties making these submissions

4 These submissions are made by the following people and organisations:

4.1 Gullivers Pacific Group;

4.2 Infratil Limited;

4.3 Major Accommodation Providers;

4.4 Kerry Prendergast, Mayor of Wellington;

4.5 Talley Fisheries; and

4.6 Wellington International Airport Limited.

5 These submissions on the Draft Determination are made further to a submission made by the same group on 18 February 2003 in respect of the Applications.

Overall Comments

6 Overall, we agree with much of the analysis set out in the Draft Determination. In particular, we endorse the Commission's findings that:

6.1 The preferred counterfactual is one involving gradual recovery by Air New Zealand in the face of competition, something less than the "war of attrition" proposed by the Applicants;

6.2 The relevant markets are "route specific";

6.3 The detriments associated with the Equity Proposal and the Alliance Proposal are greater than those asserted by the Applicants;

6.4 The benefits associated with the Equity Proposal and the Alliance Proposal are less than those asserted by the Applicants.

7 However, there are certain areas in which it is considered that further comment would assist the Commission, namely:

7.1 The Commission's analysis of each of the Applications being collapsed into one;

7.2 The Commission's handling of the procedure under which the Applications have been considered;

7.3 The impact of the various changes in circumstances that have occurred since the Applications were made and, in particular:

(a) The commercial success of Air New Zealand's "Express" initiative;

(b) The aviation industry "decline" and the impact of the SARS epidemic;

(c) United Airlines' exit from the New Zealand market; and

(d) Emirates' proposed entry on trans Tasman routes.

7.4 The regard which should be had by the Commission to any conditions which may be proposed by the Applicants;

7.5 The role of Government in the Commission's process;

7.6 Tourism benefits being overstated by the Applicants;

7.7 The possible impact of Air New Zealand's withdrawal from the Star Alliance; and

7.8 The fact that Qantas and British Airways are "associated persons" for the purposes of the Equity Proposal.

8 We deal with each of these matters in turn below.

The Commission's analytical framework

9 Our submission of 18 February 2003 expressed the firm view that the Applicants' approach under the Applications was fundamentally flawed in that it failed to appropriately attribute benefit and detriment as between the Alliance Proposal and the Equity Proposal. Paragraphs 4 to 15 of our submissions on the Applications sought at length to draw the Commission's attention to the incompatibility of the Applicants' "pooled" approach with the scheme of the Commerce Act. We refer the Commission again to those submissions. In summary, the submissions pointed out that:

9.1 The relevant provisions of the Commerce Act for the Alliance Application made under section 58 and the Equity Application made under section 66 each give rise to significantly different legal processes and, in particular:

(a) *different legal tests* – for the Alliance Application the Commission must be satisfied that the benefit associated with the Alliance Proposal would "outweigh the lessening in competition" (section 61(6)), whereas for the Equity Application the Commission must be satisfied that the Equity Proposal would result in "such a benefit that it should be permitted" (section 67(3)(b));

(b) *different ways in which those legal tests can be satisfied* – while a variety of "behavioural" conditions may be attached to an authorisation granted in respect of the Alliance Application (section 61(2)), only "structural" divestment undertakings may be accepted in the context of the Equity Application (section 69A(1)); and

(c) *different options for the Commission in terms of ongoing supervision of the matters which are subject to the Applications* – an authorisation granted in respect of the Alliance Application may be revisited by the Commission if there is a "material change of circumstances" (section 65(1)(b)). The Commission has no such jurisdiction

in respect of an authorisation granted in relation to the Equity Application; and

9.2 The "pooling" of benefits and detriments inappropriately obscures the distinct substantive issues relevant to each of the Equity Application and the Alliance Application. This compromises the ability of interested parties to comment sensibly on each Application.

10 Those submissions are now of particular importance given the Commission's failure:

10.1 to require that Qantas, in the case of the Equity Application, and both Qantas and Air New Zealand, in the case of the Alliance Application, present each Application in a form allowing the Commission and interested parties to undertake a reasoned critique of each Application; and

10.2 itself to deal appropriately with the Applications as separate legal processes requiring separate and reasoned analyses under the relevant statutory provisions.

11 The approach taken by the Commission seems to have allowed convenience to supersede the statutory requirements of the Commerce Act. By taking such an approach, the Commission is, in our submission, making an error of law giving rise to appeal rights in the High Court for any party able to assert such rights. The novel "pooling" approach taken in the Draft Determination has serious implications for both these Applications and future applications made under the Commerce Act. In particular, the Applicants' approach, endorsed in the Draft Determination:

11.1 fails to identify the genesis of the benefits and detriments as between each of the Equity Proposal and the Alliance Proposal; and

11.2 encourages the parties to any future problematic merger to attempt to "cure" fundamental structural problems by entering into a "side agreement" to circumvent Parliament's express prohibition on "behavioural" undertakings as set out in section 69A(2).

12 We attach as an Appendix to this submission an analysis, which attempts to apportion the Commission's figures appropriately to the respective Application to which the particular figures should relate. Unsurprisingly, both Applications fail the statutory test. In the absence of any guidance from the Applicants, or the Commission, in this regard, such apportionment is a difficult exercise. But, we submit, it must be done. Unless and until the Commission itself adheres to the statutory decision making framework, which prescribes separate process and legal tests in respect of transactions

offending against difficult parts of the Commerce Act, there can be no meaningful engagement on these issues by interested persons.

Procedural matters

13 In previous correspondence with the Commission we have expressed concerns regarding the process it has adopted for consideration of the Applications. In particular, we are of the view that the Commission failed to comply with its statutory duty under section 62(3) of the Commerce Act to fix a date from which all relevant timetabling matters can be arranged. In this regard, the Commission claimed (in a letter from Ken Stephen dated 12 May 2003) that "the Commission clearly has discretion to set the timetable in the way it has". We have stated very clearly that we take a contrary view. Further, the Commission itself subsequently recognised the validity of our argument a mere 4 days later by taking care to fix such a date under section 62(3) with respect to the current Pohokura joint gas marketing authorisation application (paragraph 33 of the Commission's draft determination dated 16 May 2003 refers).

14 The practical effect of the Commission's failure to comply with that statutory duty has been to delay the "holding" of the conference for some three months. As we have noted, the Commission's final determinations are now not due until 30 September 2003 – meaning a delay of ten months from the date the Applications were filed.

15 In our submission, such delay serves to defeat the purpose of the Commerce Act. In particular, the delay effectively provides an unacceptably long "amnesty" period during which Qantas and Air New Zealand are able to operate a "benign" duopoly (where neither airline competes to the full extent possible) on the basis that the Alliance may at some stage in the future be approved. The interests of consumers are not protected by these delays. The delay only assists the Applicants and provides them the opportunity to explore other strategic avenues while the "de facto" alliance effectively neutralises competition on certain routes.

16 Yet, while consumers are the ones to feel the effects of the delays caused by the Commission's creative timetabling measures, we note that the Commission entered into no consultation as to the extensions granted in respect of the Applications. In that regard, the process has been not only manifestly wrong at law, but also demonstrably unfair to interested parties other than the Applicants.

17 This situation further demonstrates the harm done by the Commission in agreeing to consider both Applications as a "package deal". The Commission has allowed itself to adopt the more open-ended timetabling process under section 58, for both the section 58 and the section 67 Applications. In short, the Commission is giving itself the "best of both

worlds" and the significance of this approach in terms of precedent-value will not be lost on others seeking authorisation for problematic mergers. Again, it would appear that convenience has superseded the scheme of the Commerce Act to the detriment of consumers. This may be an example of a situation where the new purpose statement in section 1A (inserted in 2001) takes on special relevance.

Impact of the changes in circumstances

18 Of course, the Applicants have made much of the need for combined strength in Air New Zealand and Qantas to generate the capacity to withstand "shocks" in the volatile aviation industry. Given the significant lapse of time that has accrued since the Applications were first made, certain events have occurred that should be examined to test the impact on the Applicants and the aviation industry overall. Our review of these events, which we set out in paragraphs 19 to 34 below, suggests that Air New Zealand is in the process of demonstrating that, contrary to the theme running through the Applications, "size is not everything" in the markets in which it operates.

Air New Zealand's "Express" initiative

19 The far-reaching steps Air New Zealand took in executing its recovery from near-disaster in 2001 included the restructuring of its domestic services with the introduction of "Express" class, which combined a lower range of fares with the retention of some of the features of a full-service carrier. It was an inventive move that recognised the signs worldwide that price was becoming a major determinant of travel decisions, and also astute in anticipating competition from both Qantas, which had already begun to operate domestically, and Virgin Blue, which had announced its intention to do so.

20 Air New Zealand's operational statistics over the seven months from the introduction of "Express" class in November 2002 demonstrate a significant improvement in the airline's performance. Passenger traffic carried, as indicated by revenue passengers per kilometre (RPKs), increased by an average of 13% per month over the corresponding month in the previous year, or 22.1% when the comparison excludes the domestic services of Freedom Air, which ceased in September 2002. Monthly load factors over the seven-month period averaged 75.6%, an average monthly increase of 8.5% compared with the previous year, and reached a seasonal peak of 80.7% in January 2003.

21 Meantime, Qantas has maintained a limited full-service schedule on the trunk route Auckland-Wellington, which it operates at a substantial loss reputed to be of a multi-million dollar scale. In meeting the pressure of competition from an expanding Virgin Blue in its own domestic market and, in the wake of the Iraq war, terrorism and the SARS crisis, apparently

incurring losses on its international routes, Qantas seems preoccupied with the demands of restructuring to lower its costs. Its failure to compete effectively with Air New Zealand on New Zealand domestic routes may also result from adherence to a "truce" while the Applications are before the regulatory authorities in both countries. However, in consequence, Air New Zealand's grip on the domestic market has become stronger and will be all the more difficult to challenge should the Applications finally be declined.

The aviation industry's "decline" and the impact of SARS

22 At the recent annual general meeting of the International Air Transport Association (IATA), the Director General, Giovanni Bisignani, commented that "crisis is the only way to describe the state of our industry today". The successive impact of September 11, a world economic slowdown, Iraq and SARS had been "devastating", with IATA airlines losing a total of US$25 billion in 2001 and 2002. Airlines in the Asia/Pacific region did better, he said, because some of the structural problems were hidden by spectacular growth, but SARS was badly hurting the region. However, at least over the past eighteen months, Air New Zealand has been an exception to the situation Mr Bisignani describes. It has carried out considerable restructuring, reducing costs, streamlining its booking and pricing systems, refocusing Freedom and introducing "Express" class.

23 Air New Zealand has also been less affected by SARS than other airlines in Asia/Pacific, including Qantas. On 15 May, when announcing capacity reductions on its four Asian routes through to September, it advised that across the entire international network and, except for June (11%), the monthly reduction was 6-7%. This compares with reductions in excess of 20% by a wide range of other airlines, again including Qantas.

24 In consequence, Air New Zealand is in relatively good financial order. At its annual general meeting in November 2002, it forecast a profit of $200 million before unusuals and tax. The forecast was raised a month later to $230 million, only to be reversed back to $200 million in April 2003 following the SARS outbreak. When announcing its capacity reductions, Air New Zealand said it would continue to monitor events and booking profiles and would advise the market if this resulted in a significant change. With less than two weeks before the close of the current financial year, and no further revision announced, it would seem safe to assume that the company expects to achieve a profit before unusuals and tax of $200 million.

25 Air New Zealand's achievement may be illustrated by comparison with the relative decline in Qantas' fortunes over the same period. So far this year, Qantas has announced two downward revisions in its forecast profit for the year to June. In early May, some Australian analysts predicted that the airline would suffer a loss in the second half year, resulting in a decline in

net profit from A$428 million in 2001-2002 to A$390 million this year. A contributory factor is the cost of redundancy with the laying off of some 4,000 employees.

26 The difference in performance between the two airlines also reflects a widening of the gap between the two countries in terms of international visitor arrivals. In March, total arrivals in New Zealand dropped by 4.3% compared with March 2002, whereas the fall in Australia for the same month was 10.7%. In April, arrivals in New Zealand bounced back to an increase of 4.5% over the previous year, whereas in Australia, the seasonally adjusted estimate for April was 15% lower than trend calculations, and the lowest for five years (Australian Bureau of Statistics, Press Release, 20 May 2003).

27 It may be inferred from these comparative data that Air New Zealand has recovered well from the Ansett debacle in 2001 and, in relative terms, has also weathered the continuing aviation crisis better than Qantas and, indeed, probably better than most full-service or network airlines. This suggests that a combination of factors:

27.1 the increased efficiency of Air New Zealand;

27.2 the nature of the markets it serves – including the orientation of its network that avoids the Middle East; and

27.3 the perception of New Zealand as a safe destination by Northern Hemisphere travellers who constitute most of its major inbound markets;

adequately compensates for the lack of size that an alliance with Qantas would provide.

28 Given the likelihood that the profit forecast of $200 million for 2002-2003 will hold, Air NZ will complete the year in a much improved financial position, including a further fall in the gearing level of the company. In presenting the half-year results in February, Air New Zealand's chairman, John Palmer, advised that Air New Zealand's then current gearing level was 69.6% - this constitutes a marked improvement from the position following the collapse of Ansett where the gearing level reached 93%. He also confirmed that it was still the company's intention to further strengthen the balance sheet by conducting a rights issue that had been planned for the current quarter. It was then hoped the issue would be completed in the first half of this year. However, as the end of the financial year approaches, there has been no move on a rights issue nor any further announcement. While a rights issue may still ensue at some stage, there is

clearly no urgency. It may also be noted that as at 30 June 2002 (the last balance date for both airlines):

28.1 Shareholders' equity funded 28.7% of Qantas' A$14,801 million of total assets; and

28.2 Shareholders' equity funded 22.6% of Air New Zealand's NZ$3,896 million of total assets.

Qantas today has a sharemarket capitalisation of approximately A$5,070 million, which is A$515 million less than its market value when the proposed alliance with Air New Zealand was announced. Air New Zealand's market capitalisation at NZ$2,228 million is about the same as it was when the proposed alliance was announced.

29 It may be reasonably inferred from these financial particulars and the strong operational performance of the airline that the availability of capital does not present a substantial problem for Air New Zealand, and that this is not therefore a valid reason for authorising the Equity Proposal.

30 This is not necessarily suggesting that Air New Zealand would not benefit from a strategic alliance with another strong airline – one that did not have the highly anti-competitive impact of both the Alliance Proposal and the Equity Proposal. Given the dynamic, changing nature of the aviation industry, further opportunities could arise in the medium term for an alliance that is beneficial to Air New Zealand and New Zealanders alike.

United Airlines' exit from the New Zealand market

31 With the withdrawal of United Airlines from the Los Angeles – Auckland route, both Air New Zealand and Qantas announced increases in their flights by three per week, but with the onset of SARS these were subsequently abandoned – until June in the case of Air New Zealand. Meanwhile, however, Air New Zealand has maintained its twice daily service between Auckland and Los Angeles (compared with Qantas' single daily service). Although it was announced as early as January, the withdrawal of United Airlines at the end of March appears to have had no immediate effect on the number of visitor arrivals from the United States. In April, the number rose by 9.7% over the same month in 2002, the biggest such rise this year. Thus, despite the ongoing aviation crisis and the withdrawal of United Airlines, Americans have clearly not been deterred from visiting this country and the route is in a healthy state for Air New Zealand.

32 This was borne out when, in mid-May, Air New Zealand noted that bookings on both the Los Angeles sector and the on-going daily service between Los Angeles and London remained strong. While British visitors come by various routes, it is nevertheless relevant to note that in April arrivals from

the United Kingdom rose by a remarkable 47.3% over that month in 2002. As noted in our initial submission (paragraph 78), Los Angeles acts as a hub for Air New Zealand in respect of both its own services to London and code-sharing on the services of other airlines – United, Lufthansa, Air Canada and Mexicana Airlines, all of which reciprocally code-share on Air New Zealand's services to Auckland. Similar arrangements may also be made with US Airways, which will soon be joining the Star Alliance. Qantas' code-sharing links at Los Angeles are with American Airlines and British Airways only. Given both the greater frequency of Air New Zealand's services to Los Angeles and the extent of its code-share connections there, it is likely that the airline's market share on the Los Angeles route will increase.

Emirates proposed entry on trans-Tasman routes

33 Emirates Airline, based in Dubai, United Arab Emirates, has announced that it proposes to commence a daily return service to Auckland from both Sydney and Melbourne in August, and from Brisbane in October. This would increase trans-Tasman services by fourteen per week initially, and later by 21, potentially increasing the trans-Tasman market share of airlines other than Air New Zealand and Qantas from the current 15% to between 20% and 25%. However, three points should be noted:

33.1 this increased portion of the market would be fragmented between seven airlines, all of which would be operating under 5th freedom rights rather than dedicated trans-Tasman services. Their traffic would therefore include a significant number of through passengers, thereby reducing the number of seats available for those travelling only between New Zealand and Australia;

33.2 with the Emirates' services split between three Australian cities, a single daily flight from each will diminish their competitive impact; and

33.3 in the absence of flights to Wellington or Christchurch, neither will benefit from increased competition.

34 There must also be an element of doubt concerning the permanence of Emirates' trans-Tasman services. At least four airlines – United, British Airways, Air China and China Airlines (Taipei) – have extended their Australia services across the Tasman during the last decade and have subsequently found the sector uneconomic and have withdrawn. Those 5th freedom carriers that have remained on the sector frequently resort to heavily discounted pricing in order to fill seats. Emirates has gained an enviable reputation but, operating only to Auckland, will be competing as much with the other 5th freedom carriers as with Air New Zealand and Qantas. The services it has proposed do not provide a valid basis for regarding the airline as an effective competitor to each of the Applicants.

Difficulties associated with undertakings and conditions

35 As noted in paragraph 9.1 above, the Applicants' approach of "pooling" the Alliance Proposal and the Equity Proposal raises particular difficulties in relation to conditions which the Commission may impose, and the undertakings which the Commission may accept. Very briefly, the Act provides that:

35.1 authorisation for the Alliance Proposal may be granted subject to such conditions not inconsistent with the Act … as the Commission thinks fit: section 61(2); and

35.2 in granting authorisation for the Equity Proposal the Commission may accept a written undertaking given by the applicant to dispose of the assets or shares specified in the undertaking: section 69A(1).

36 Importantly, process as well as subject matter distinguishes a condition from an undertaking.

37 An undertaking is a promise proffered by the applicant as part of the application (or application as amended). The Commission has consistently taken the view that, as such, it is the responsibility of the applicant to define the parameters of the undertaking. In particular, the Commission itself will not engage in a dialogue with the applicant as to how much divestiture may be enough to tip the balance for it to grant authorisation for the proposed acquisition.

38 Enforcing an undertaking is a straight forward matter for the Commission – either the applicant will have divested the relevant assets or shares within the prescribed time, or it will not have. Failure to divest in accordance with an undertaking can result in the Court making a divestiture order pursuant to section 85(1)(d). More seriously, it will have the automatic effect of removing the protection of the authorisation as the relevant acquisition will have not been implemented "in accordance with" the authorisation. Such removal of course leaves the acquisition exposed to action not just by the Commission but also by third parties.

39 In contrast, conditions are proposed – and imposed – by the Commission itself, not the applicant. Further, if conditions are contemplated, they should be proposed by the Commission in sufficient time to enable not only the applicant but also other interested parties to make submissions as to their likely efficacy at the conference which the Commission must hold.

40 The Commission in *NZ Kiwifruit Exporters Association*, Decision 221 previously has opined on when it should impose conditions, acknowledging that the discretion given to the Commission appears to be wide. Crucially, the Commission goes on to state that:

Their enforceability is also important particularly if used to 'tip the balance' in favour of authorisation.

41 Enforceability is important because the consequences of failure to comply with a condition are not so immediate or severe as failure to comply with an undertaking. Section 65(1)(c) provides that the Commission may at any time revoke or amend an authorisation of a restrictive trade practice if satisfied that a condition upon which the authorisation has been granted has not been complied with. Before it does so, however, the Commission must comply with the procedural requirements of section 65(2).

42 The difference is stark. Put simply, breach of an undertaking of itself vitiates the authorisation (or clearance) of an acquisition and exposes the parties, inter alia, to divestiture. Non-compliance with a condition can trigger revocation of the authorisation of a restrictive trade practice – but only after the Commission has given notice and the parties have been given a reasonable opportunity to make submissions, or, presumably to remedy the non-compliance.

43 All this suggests that the Commission must attach considerably less weight to a condition than to an undertaking.

44 Further, the practice and procedure in relation to undertakings and conditions under the Australian Trade Practices Act 1974, and their enforceability, is very different than under the Commerce Act. Thus, the fact that the ACCC may accept a form of undertaking or condition, and attach weight to it, is not relevant to the New Zealand Commission's consideration of the same undertaking or condition.

45 So, to unravel the imbroglio which the Applicants have created:

45.1 any undertaking can relate only to the Equity Proposal;

45.2 any undertaking can only be to divest specified assets or shares within a specified time;

45.3 any undertaking must be defined by the Applicants themselves in respect of the Equity Proposal and cannot be "negotiated" with the Commission;

45.4 any condition can relate only to the Alliance Proposal;

45.5 the Commission has a wide discretion to impose conditions, but their enforceability is an important consideration;

45.6 any condition must be imposed by the Commission itself – having proper regard to procedural fairness to other interested parties – not simply offered by the Applicants;

45.7 conditions are less readily enforceable than undertakings and therefore less effective in mitigating competition effects;

45.8 the fact that the ACCC may accept a particular undertaking or condition and attach weight to it, is irrelevant in the New Zealand context.

46 Paragraph 844 of the draft determination states that:

> *The Applicants have indicated they would be prepared to enter into a number of conditions … None of the suggested conditions amount to structural undertakings.*

47 Accordingly, the Commission notes (at paragraph 845) that it "has not given substantive consideration to undertakings to divest assets or shares." However, it gives us an opportunity (at paragraph 851 to 893) to consider the "Outline Conditions" which the Applicants have "supplied". At paragraph 893 the Commission notes that:

- *enforcement of conditions can be difficult and of necessity will only occur after a breach;*
- *they require frequent monitoring; and*
- *by their nature, they are inflexible and unresponsive to market changes.*

48 We agree. But, point out that all these factors in fact go to enforceability. That must be the primary criterion. If detailed behavioural conditions are required to mitigate the competition effects of the Alliance Proposal on an on-going basis, this should only be done by way of a regime that ensures adequate participation by all interested parties and is properly resourced. That requires specific legislation – such as the Dairy Industry Restructuring Act. It is not the function – or within the powers – of the Commission to de facto legislate by imposing extensive conditions that it cannot be sure of enforcing - whatever the Australian practice may be.

The role of Government in the Commission's process

49 Given the various statements made in the media both in New Zealand and in Australia by the Minister of Finance, we have been concerned throughout this process that the Commission may be influenced by Government policy in producing a final determination on the Applications. In that regard, the

Commerce Act prescribes (in section 26) the avenue by which Government policy can be communicated to the Commission. The legal position regarding the persuasiveness of that policy as communicated is clear – the Commission must "have regard" to the statement, but it is not determinative. In particular, section 26 of the Commerce Act states that:

> *The Commission shall have regard to the economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister*.

50 By facsimile dated 24 April 2003, we asked Hon Lianne Dalziel, the Minister of Commerce, to confirm that neither the Ministry of Economic Development nor the Minister herself has any material relating to a possible statement of economic policy pursuant to section 26 of the Commerce Act with regard to the Applications. In response, the Minister of Commerce confirmed that neither she nor the Ministry had any such material and noted further that:

> *… the Government's position has always been that competition concerns will be dealt with the two national competition authorities, being The New Zealand Commerce Commission and The Australian Competition and Consumer Commission …*

51 The fact that the Government has not issued and, according to our communications with the Ministry of Commerce do not intend at any stage to issue, a Government policy statement under section 26 of the Commerce Act in respect of the Applications, suggests that, despite statements in the press by Dr Michael Cullen to the contrary, the Government is indifferent as to whether the Alliance Proposal and the Equity Proposal should proceed. In this regard, we note that the Commission must ignore any "informal" statements of Government policy issued via the media or otherwise.

52 This apparent indifference in respect of the Applications contrasts markedly with the position taken by the Government with respect to the current Pohokura joint gas marketing authorisation application currently being considered by the Commission. In that proceeding, the Government, facing an electricity crisis and an imminent exhaustion of gas supply out of Maui, has issued two relevant policy statements under section 26 of the Commerce Act, namely:

52.1 A statement of Government policy dated 25 March 2003 entitled "Development of New Zealand's Gas Industry"; and

52.2 A statement of Government policy dated 22 April 2003 entitled "Government Policy Statement on the Importance of the Pohokura Gas Field for Energy Security".

Calculation of benefits associated with tourism

53 We believe the Commission is correct to discount the estimate of tourism benefits submitted by the Applicants. On the basis of information submitted to the Commission, we believe that the Alliance would likely have a net negative impact on tourism to New Zealand. That is, the tourism effect of the Alliance should more properly be regarded as a detriment than a benefit for the following reasons:

53.1 The Applicants have not established why Qantas Holidays would have an incentive to develop products that bring benefits to New Zealand. No business case has been made to support the $14 million per annum spending by Qantas Holidays as anticipated in the NECG report. (Undertakings given to the ACCC commit the airlines to spending only an additional A$5.4 million).

53.2 The Applicants have suggested to the Commission that Qantas has not to date allowed Qantas Holidays to develop markets on behalf of Air New Zealand where such activities would result in a profit for Qantas Holidays. No evidence or argument has been produced which supports the contention that Qantas Holidays would now divert its efforts away from increasing its 100% owned parent company's revenue.

53.3 No evidence has been produced to support the claimed 50,000 increase in tourist numbers. Tourism Futures International call it a Qantas Holiday's estimate (p4); NECG referred to the estimate as a Qantas Holiday's instruction (p139); while the Commission in the Draft Determination (at paragraph 750) notes that Qantas Holidays' "Marketing and Sales Plan" attributed the detailed projects to "QF/Air NZ, QH management information". It would seem that the estimate has been made up.

53.4 Rather than an increase in tourism, there is good reason for the Commission to conclude that the Alliance would result in a decrease in tourism, including:

(a) The negative effects on tourism arising from increased fares and reduced capacity;

(b) The negative impact of a withdrawal by Air New Zealand from the Star Alliance. The Commission should place considerable weight on the Ministry of Tourism's view that feed from both the Star Alliance and Oneworld is one reason why New Zealand tourism growth has exceeded growth in the Australian market. Air New Zealand's membership of the Star Alliance provides access to network feed from 15 other

airlines, which would likely be lost to the New Zealand tourist industry. We elaborate on the significance of Air New Zealand's exit from the Star Alliance at paragraphs 56 to 63 below;

(c) As other submissions have made clear, previous attempts at dual destination marketing by Australia and New Zealand have not been successful. The Applicants have provided no reasoning why this time the results would be different; and

(d) NECG's contention that a single voice would be more effective in promoting tourism is contrary to accepted principles of competition economics. Economists would usually expect duopoly advertisers to differentiate and to expand into parts of the market where they can exploit a particular advantage, and so increase the overall size of the market. NECG provide no analysis to support their contention that a single voice would appeal to more people.

54 Finally, we agree with the Commission that the appropriate way to measure any tourism benefit (or detriment) is in terms of its net contribution to public benefit. The application by NECG of gross expenditure numbers cannot be supported.

55 For these reasons, we conclude that the Commission's estimate of a "lower bound" of a net negative contribution of $-2.6 million, is probably closer to the mid point than a lower bound.

The impact of Air New Zealand's withdrawal from the Star Alliance

56 Although not yet publicly announced, it is virtually inevitable that if the Applications are authorised, Air New Zealand would withdraw from the Star Alliance and be absorbed into Oneworld. The Applicants have signed a confidential agreement that sets out the process for dealing with this issue and released documents indicate that a decision would be reached before each of the Alliance Proposal and the Equity Proposal is finally approved by Air New Zealand's shareholders. Air New Zealand's move to the Oneworld alliance would have important and adverse consequences for both the airline and its passengers, and hence to the New Zealand tourism industry also.

57 New Zealand has benefited greatly from the provision of extensive and competitive international services by both Air New Zealand and Qantas. The effect has been almost as if New Zealand had two competing international airlines, a situation considerably enhanced by the fact that each belongs to different and competing global airline alliances. Between them, the two alliances were calculated last year to have 40 - 44% of

global market share – Star Alliance with 22 - 25% and Oneworld 18 - 19%. The Star Alliance share will almost certainly continue to rise with the future inclusion of LOT Polish Airlines and US Airways. Star Alliance says that, with the inclusion of US Airways, it will provide access to 771 airports (increased from 700) in 133 countries (increased from 128).

58 A November 2002 report in Travel Business Analyst (www.travelbusinessanalyst.com) magazine shows market share of international RPKs by airline alliances to be:

Alliance	**2002**	**1998**	**1993**
Star	24.8%	23.2%	23.9%
Oneworld	18.6%	20.2%	20.6%

59 Commenting on this "very advantageous position" of Star Alliance, the Ministry of Tourism advised its Minister in a memorandum dated 11 December 2002 that Air New Zealand's membership of Star Alliance resulted in a number of significant benefits, some of which the Commerce Commission noted at page 198 of its draft determination. In particular, the Ministry also noted that if Air New Zealand were to join Oneworld, the Star Alliance contribution to bringing passengers to New Zealand would be significantly reduced in the country's top five tourism markets (Australia, the United Kingdom, the USA, Japan and Korea), with consequent implications for code-share services, marketing and frequent flyer access.

60 We agree with the Commission's view (at paragraph 776) that "the loss of the Star Alliance has the potential to diminish virtually every projected tourism benefit of the proposed Alliance", and that "were Air NZ to join Oneworld, the benefits to New Zealand could be expected to be much smaller than the loss of Star Alliance benefits, since Qantas already brings a certain amount of Oneworld traffic to New Zealand".

61 The Commission went on to note (at paragraph 777) that "if other Star Alliance partners were able and willing to provide sufficient capacity to New Zealand, losses attributable to Air NZ leaving the Star Alliance might be minimal." However, it added that it had been "unable to identify any Star Alliance members planning to enter New Zealand markets". In any case, there is no likelihood that any other international airline, whether or not a member of Star Alliance, could replicate the range of international services operated by Air New Zealand in accordance with the bilateral air services agreements negotiated by the New Zealand Government, nor therefore the range of connections Air New Zealand has arranged with its Star Alliance

partners. Historically, Air New Zealand has carried, on average, around 45% of the country's total inbound traffic.

62 With regard to Air New Zealand's membership of Star Alliance, it is also noteworthy that, despite the ongoing regulatory procedures in which the Applicants are currently engaged and which, if resulting in approval of the Alliance Proposal and the Equity Proposal, would almost certainly lead to Air New Zealand's departure from the Star Alliance, Air New Zealand has continued to negotiate new code-sharing arrangements with its Star Alliance partners. In addition to those mentioned in our earlier submission (paragraph 78), Air New Zealand announced further extensions of its code-sharing with Air Canada as recently as 21 May, surely evidence of recognition by Air New Zealand of the value of its Star Alliance membership.

63 The adverse consequences of Air New Zealand's departure from the Star Alliance provide important additional reasons for each Application to be declined.

Association with British Airways

64 In paragraph 23 of the Draft Determination the Commission endeavours to avoid the issue of Qantas' association with British Airways by declining to rule on whether those two airlines are "associated" for the purposes of section 47 on the grounds that "there is unlikely to be any competition impact from the Association in this particular instance".

65 That glib dismissal of the two airlines' association is unsatisfactory. The Commission in its draft *Merger and Acquisition Guidelines 2003* states at para 2.3:

> *In assessing any acquisition it is necessary to consider the nature of the person making the acquisition. The Commission is required to identify the person including any interconnected or associated persons… Identifying the person has a number of consequences. In particular, interconnected or associated persons can be held to have contravened section 47 if the acquisition is likely or would be likely to substantially lessen competition in any market. As such any person interconnected or associated with the entity making the acquisition could become liable to enforce the connection, including penalties, injunctions and divestment orders.*

66 As to whether Qantas and British Airways in fact are "associated", the *Guidelines* are equally clear. Relevant factors to which the Commission will have regard are:

- *the nature and extent of ownership links between the companies;*

- *the presence of overlapping directors;*
- *the rights of one company to appoint directors to another; and*
- *the nature of other shareholder agreements and linked between the companies concerned.*

67 With particular regard to ownership links the *Guidelines* state:

> *Shareholding is an important consideration in determining whether or not there is the ability to exert a substantial degree of influence. There are different considerations for public and private companies. In the case of a public company, the Commission will look closely at shareholdings of 15% or more. In some circumstances it may be appropriate to look at a lower level of shareholding.*

68 Given the nature of the other links between Qantas and British Airways – in particular the alliance arrangement very recently authorised by the ACCC in respect of Australian markets – it would be doing extreme violence to the Commission's own interpretation of the associated persons concept for the Commission not to find that Qantas and British Airways are indeed associated persons within the meaning of section 47.

69 Given, too, that Qantas is proposing to implement a business acquisition over which the Commission has jurisdiction, and thus enforcement obligations, it must not avoid making that finding. Indeed, it must be assumed that the commercial decisions Qantas has made to enter into the Equity Proposal (and Alliance Proposal) with Air New Zealand, have the blessing of its largest shareholder.

70 As to the likely competition impact of the association, this must be properly assessed for the Commission's analysis of at least the Equity Proposal. For example, to what extent could British Airways be a potential competitor in the relevant international markets identified by the Commission but for its association with Qantas?

71 Further, the fact that Qantas and British Airways are both members of Oneworld must reinforce the likelihood that Air NZ will be required to leave the Star Alliance.

APPENDIX 1

Attribution of benefits and detriments between transactions

1 In its draft determination, the Commerce Commission took the view that it is appropriate to analyse the combined impact of the two Applications. As such, the Commission has "pooled" the competitive effects, public benefits and detriments of the transactions underlying both Applications.

2 This "pooling" makes it difficult for interested parties to comment on the merits of each Application. This annex attempts an allocation of the benefits and detriments estimated by the Commission in its Draft Determinations, using where possible the arguments advanced by the Commission.

3 The Commission's preliminary estimate is that benefits from the proposed Applications' arise from:

- Cost savings of $32.4 million. These savings are attributable to the Alliance Application.

- Tourism benefits of between -$2.6 million to $13.5 million. There is no obligation within the Alliance Application for Qantas to undertake expenditure on tourism. The upper bound estimate of tourism benefits assume that Qantas Holidays succeeds in its stated ambitions and achieves its targets and that Qantas "might continue to deny itself profits in the counterfactual by not selling packages that include Air NZ products" (page 197). Hence, the tourism benefits seem to be attributable to the Equity Application.

- Scheduling benefits of $0.36 million. These benefits are attributable to the Alliance Application.

4 The Commission's preliminary estimate is that detriments from the proposed Applications' arise from:

- Allocative inefficiency and transfers of $132 million. These detriments are attributable to the Alliance application.

- Productive inefficiency of between $20 million and $150 million. These detriments are attributable to the Alliance application.

- Dynamic inefficiency of between $50 and $150 million. Both the Equity Application and the Alliance Application contribute to dynamic inefficiencies.

5 Taking the Commerce Commission's preliminary estimates of benefits and detriments and attributing them to the Equity Application and the Alliance Application respectively would produce the following summary:

Commerce Commission's estimates allocated between Alliance Application and Equity Application (NZ$ million)[1]

		Alliance Application	Equity Application
Benefits	Cost savings	$35.7	
	Scheduling	$0.36	
	Tourism		-$2.6 to $13.5
	Total Benefits	*$36.06*	*-$2.6 m to $13.5*
Detriments	Allocative inefficiency	-$170	
	Productive inefficiency	-$25 to -$180	
	Dynamic inefficiency[2]	-$25 to -$75	-$25 to -$75
	Total Detriments	*-$195 to -$350*	*-$50 to -$150*
Net Benefits		**-$183.94 to -$388.94**	**-$11.5 to -$77.6**

6 Attributing the benefits and detriments estimated by Commerce Commission to the Alliance Application and the Equity Application separately, indicates net public detriments resulting from each Application.

1 Estimates obtained from Commerce Commission (2003), "Commerce Commission Changes to Draft Determinations Resulting from Modelling Calculation Audit", 11 June.

2 The dynamic inefficiencies estimated by the Commerce Commission (i.e. $50 million to $150 million) are allocated equally between the Equity Application and the Alliance Application.