

**AIR NEW ZEALAND LIMITED**

**AND**

**QANTAS AIRWAYS LIMITED:**

**APPLICANTS' PRELIMINARY RESPONSE TO THE  
DRAFT DETERMINATIONS:  
COMMERCE COMMISSION'S  
PRELIMINARY ANALYSIS  
AND METHODOLOGY**

**19 JUNE 2003**

**TABLE OF CONTENTS**

**INTRODUCTION** ..... 1

**Draft Determination** ..... 1

**Summary of Applicants’ key concerns with Draft Determination** ..... 1

**BACKGROUND TO THE APPLICATIONS** ..... 7

**Qantas**..... 7

**Air New Zealand**..... 8

**Virgin Blue**..... 10

**MARKET DEFINITION**..... 11

**Commission’s preliminary views**..... 11

**Passenger markets**..... 12

**Freight markets**..... 13

**Wholesale travel distribution** ..... 15

**COUNTERFACTUAL**..... 15

**Commission’s preliminary views**..... 15

**Weight of evidence**..... 16

**Air New Zealand and the Counterfactual** ..... 17

**Virgin Blue and the Counterfactual** ..... 18

**Conclusion** ..... 18

**COMPETITIVE DETRIMENTS**..... 19

**Barriers to entry and expansion** ..... 19

**Fifth-freedom carriers** ..... 24

**NZ – Asia market** ..... 25

**Freight markets**..... 25

**Wholesale Travel Distribution Services market** ..... 26

**COMMISSION’S PRELIMINARY APPROACH TO MODELLING DETRIMENTS**..... 27

**Allocative efficiency** ..... 27

**Productive and dynamic efficiency** ..... 31

**CONCLUSIONS ..... 34**

## INTRODUCTION

### Draft Determination

1. On 10 April 2003 the New Zealand Commerce Commission (the **Commission**) issued a draft determination proposing to deny authorisation to Qantas Airways Limited (**Qantas**) and Air New Zealand Limited (**Air New Zealand**) in respect of the proposed acquisition of 22.5% of Air New Zealand's voting equity by Qantas, and the proposed Strategic Alliance Agreement (**SAA**) (together the **Alliance**) between Qantas and Air New Zealand (the **Draft Determination**).
2. The Applicants acknowledge that the Draft Determination contains the Commission's preliminary analysis and views. However, in reviewing the Draft Determination, the Applicants have identified a number of key areas where, in their view, the Commission's preliminary analysis fails to take relevant evidence into account, or misapplies relevant legal and economic principles. This preliminary response outlines how the Commission's preliminary analysis of each of these key areas would, if not corrected, affect the ultimate determination. The Applicants will file a more detailed submission in response to the Draft Determination with the Commission on 20 June 2003.

### Summary of Applicants' key concerns with Draft Determination

3. In the Applicants' view, there are a number of aspects of the Commission's preliminary approach that have led it to form erroneous preliminary views. The Applicants' key concerns are summarised below.

### Weight of evidence

4. In the Applicants' view, the Commission should pay more regard to the weight of evidence put before it by the Applicants.
5. The Applicants have provided substantial evidence to the Commission detailing the Alliance and its potential impacts. In addition to the Applications for Authorisation filed on 9 December 2002, the Applicants have answered all of the Commission's questions and responded to third parties' submissions in detail. As is inherent in any application for authorisation, as opposed to clearance. The Applicants have not suggested that detriments are not likely to flow from the Alliance. They have set out a balanced and compelling case that the public benefits flowing from the Alliance materially outweigh the detriments.
6. The Applicants' evidence has quantified the public benefits and detriments flowing from the Alliance and has included:
  - rigorous economic modelling of the benefits and detriments of the Alliance;<sup>1</sup>
  - details of internal modelling undertaken by the Applicants of operations under the Alliance;<sup>2</sup>

---

<sup>1</sup> Including a report by NECG provided to the Commission on 9 December 2002, excel workbooks containing relevant data, NECG letter regarding model dated 29 January 2003; NECG presentation to Commission on 21 January 2003; and NECG paper setting out the revised NECG model provided on 5 March 2003.

<sup>2</sup> Including the Qantas Holidays Business Plan provided to the Commission on 6 March 2003, and GRA Reports provided to the Commission by Air New Zealand on 27 March 2003.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

- internal board papers and analyses regarding the Alliance;<sup>3</sup>
  - airline industry case histories;<sup>4</sup> and
  - literature on the nature of competition in the aviation industry, and the systemic changes affecting the industry.<sup>5</sup>
7. The board papers and other internal deliberative material provided to the Commission demonstrate that the assumptions and assessments of the decision makers within Qantas and Air New Zealand were (and remain) consistent with the economic modelling and other evidence provided to the Commission.
  8. The Commission should accord more weight to this evidence. Rather, it has uncritically adopted the assumptions and piecemeal modelling of third parties, or attempted its own modelling, without adequate consideration as to whether these are consistent with the weight of evidence before it.
  9. The Applicants are the only global full service network operators (**FSAs**) in the domestic segments of the Australasian market and therefore, have direct knowledge of the network impacts in these markets. In the absence of more compelling evidence to the contrary, and to date the only submissions have been provided by those without comparable experience of the industry, the Applicants' substantiated and supported views on the dynamics of the global industry and their impact on FSAs should be preferred.

### ***Beyond "structural presumptions"***

10. Of utmost concern to the Applicants is the Commission's unwillingness to "look behind" structural presumptions regarding increased concentration to the evidence regarding the actual conduct and performance of the airline industry.
11. Structural presumptions are an appropriate basis for determining "safe harbours" or "thresholds" that define an arena of competition that is not likely to be significantly affected by a merger or other arrangement. For example, the Commission has appropriately sought to delineate certain "safe harbour" concentration thresholds in its *Practice Note on Business Acquisitions*.<sup>6</sup> However, the Commission itself recognises that these thresholds are a screening device only, and that further detailed analysis and investigation of competition conditions must take place before any conclusion can be drawn regarding a particular transaction.<sup>7</sup>
12. The Applicants believe that the Commission could analyse more rigorously both the airline industry and the Alliance in the light of the extensive evidence that has been made available to it.

---

<sup>3</sup> Including Air New Zealand board papers provided to the Commission on 14 March 2003.

<sup>4</sup> For example, as set out in the Air New Zealand Powerpoint presentation to the Commission, 13 March 2003.

<sup>5</sup> For example, papers by the United States Department of Transport documenting an extensive study into the nature and impact of VBA competition. See NECG Report dated 9 December 2002, page 48.

<sup>6</sup> Commission *Practice Note on Business Acquisitions*, pages 28-29.

<sup>7</sup> Commission *Practice Note on Business Acquisitions*, page 29.

**Structural changes in the aviation industry**

13. In the Applicants' view, the Commission has come to a number of questionable preliminary views regarding the background to the Alliance and the current situation in the international airline industry. These preliminary views regarding the Applicants' likely actions and reactions and the likely Counterfactual, materially affect the basis for authorising the Alliance.
14. The Commission reaches the preliminary view that
- "...the references in the Application to the difficulties being experienced by a number of overseas airlines, and the strong inference that Australasian airlines are similarly threatened, do not appear to be realistic".<sup>8</sup>
15. However, the Applicants, and in particular NECG, provided substantial and largely uncontested evidence that there has been significant structural change (separate to and pre-dating, but reinforced by, cyclical fluctuations and external shocks) in the airline industry as a result of:
- the development and rapid expansion of low cost carriers or value based airlines (**VBAs**), which is evidenced in Australasia by the entry and rapid expansion of Virgin Blue in the Australian domestic segment of the market;<sup>9</sup>
  - globalisation and the rise of airline alliances, which have increased the need for Qantas and Air New Zealand to obtain a global network presence in the face of consumer demand for seamless long-haul travel;<sup>10</sup>
  - the effect of deregulation, which is represented by the advent of the Single Aviation Market in Australasia;<sup>11</sup>
  - a write-down in the value of aviation as a whole, evident in Australasia by the demise of Ansett and the impact of that on Air New Zealand's balance sheet and the impact of the events of September 11, terrorism, and Severe Acute Respiratory Syndrome (**SARS**) on the value of both Qantas and Air New Zealand;<sup>12</sup> and
  - changes in consumer demand such as a reduction in expectations of fare levels caused by the emergence and success of VBAs such as Virgin Blue.<sup>13</sup>
16. The Commission's preliminary view that the Applicants are experiencing only temporary or cyclic pressures is unsustainable in the face of this evidence of extensive structural

---

<sup>8</sup> Draft Determination, paragraph 277.

<sup>9</sup> Applicants' submission dated 9 December 2002, pages 7-8 and 26-29 ; NECG report, pages 9-11 and 48-53.

<sup>10</sup> NECG report, pages 7-9.

<sup>11</sup> Applicants' submission dated 9 December 2002, pages 21-23; NECG report, pages 6-7. SAM is particularly relevant, creating one of the most liberal aviation markets anywhere in the world. In addition, the Applicants compete with subsidised and protected international airlines.

<sup>12</sup> NECG report, page 5.

<sup>13</sup> Applicants' submission dated 9 December 2002, pages 46-48. See also the Updated Executive Summary submitted to the Commission 17 March 2003 and in addition, refer to the DOT Senate Committee report dated 9 January 2003, which Qantas supplied in response to the Commission's questions on 13 March 2003.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

change in the airline industry. These changes are almost universally acknowledged by the industry, the business media and governments. There is no substantiated evidence supporting the Commission's preliminary view.

### ***Most likely Counterfactual***

17. The Commission reaches the preliminary view that the Applicants' Counterfactual is unlikely, and that the more likely Counterfactual will involve a continuation of competition from Qantas on the Tasman and domestic New Zealand routes, with capacity being expanded "in line with market growth".<sup>14</sup> The Applicants' comments concerning the Commission's Counterfactual are dealt with in detail below. However, at this stage, the Applicants note the following.

### *Impact of share gaps on FSAs*

18. The Applicants provided historical material to the Commission that demonstrated that the Applicants' Counterfactual is realistic.<sup>15</sup> The material provided by the Applicants outlined the way in which FSAs compete, and the conditions under which FSAs will supply capacity to grow, win market share and increase network profits.<sup>16</sup> This material highlighted the existence of "share gaps" - higher yields accruing to the FSA with greater frequency on a route (also known as the **S-curve effect**). To this end, the Applicants note that it is accepted within the industry that where two FSAs are competing on a city pair, the FSA with the higher frequency on that city pair will, all else being equal, capture a "disproportionately" larger share of the profits on that city pair.<sup>17</sup>
19. However, frequency and the S-curve effect are not generally issues for VBAs. By offering a simpler product from a lower cost base, VBAs mitigate the existence of the share gap. Virgin Blue's 2003 profit results provide evidence that the existence of share gaps is not an issue for Virgin Blue. Virgin Blue has, on latest estimates, emerged with 33% EBIT share in the Australian domestic market for only 23% market share.<sup>18</sup>

### *Qantas' growth is sustainable*

20. The material provided by the Applicants shows that the proposed Qantas growth on the Tasman is in line with historical market growth. The main Qantas capacity growth under the Counterfactual would be in domestic New Zealand and Asia/Pacific – all of which is economically rational.
21. The authorisation test involves a comparison of the futures "with and without" the Alliance. As noted above, the Applicants are in the best position to know what future outcomes are likely to occur for them. Adopting an incorrect Counterfactual significantly affects the weighing process. In the Applicants' view, the Commission has adopted an incorrect and internally inconsistent Counterfactual.<sup>19</sup> Accordingly, the Commission's

---

<sup>14</sup> Draft Determination, paragraph 300.

<sup>15</sup> NECG response to submissions in relation to NECG's report, March 2003, page 26.

<sup>16</sup> For example, Air New Zealand presentation to the Commission 13 March 2003.

<sup>17</sup> See for example, European Commission, Industry dialogue on air transport competition policy exploratory questionnaire on selected airline alliances and merger competition assessment issues, in particular questions 48-54 available at [http://europa.eu.int/comm/competition/general\\_info/airline/en.pdf](http://europa.eu.int/comm/competition/general_info/airline/en.pdf).

<sup>18</sup> Figures reported in Australian Financial Review, *Virgin gives Qantas the blues*, 17 May 2003.

<sup>19</sup> For example, in his modelling of the Counterfactual, Professor Gillen adopts the Applicants' Counterfactual plus 20% capacity, which is inconsistent with the Commission's preliminary Counterfactual.

## **Applicants' Preliminary Response to Commerce Commission's Draft Determination**

preliminary weighing process has been skewed to the disadvantage of the Applicants, particularly in the quantification of the cost efficiencies that will flow from the Alliance.

### ***Expansion of Virgin Blue***

22. Virgin Blue has stated in its submission to the Commission that it will expand into the Tasman and domestic New Zealand markets regardless of whether the Alliance proceeds.<sup>20</sup> As evidenced by its stated intentions, Virgin Blue does not perceive any barrier to expansion on these routes. Despite Virgin Blue's statements, the Commission has taken a theoretical approach in examining barriers to entry and expansion. In doing so, the Commission has disregarded the best evidence available to it in relation to the likely expansion of Virgin Blue in the relevant markets. As a result of its theoretical approach, the Commission has reached the erroneous preliminary view that Virgin Blue does not represent a significant competitive constraint in the Factual.

### ***FSA / VBA competition***

23. In the Applicants' view, the Commission's preliminary view that Virgin Blue would not materially constrain the conduct of the Applicants is the result of the Commission failing to differentiate between FSAs and VBAs and underestimating the impact of VBA competition. For example, the Commission's preliminary view that any new entrant to main trunk routes in New Zealand (whether FSA or VBA) would need to match the frequency of the incumbent airlines to provide a constraint on the Alliance, does not take into account the differing characteristics of FSAs and VBAs.<sup>21</sup>
24. Empirical studies by the United States Department of Transportation (**U.S. D.O.T**), among others, have shown that even a low level of entry by a VBA such as Virgin Blue does have a significant effect, far greater than its market share may suggest and greater than entry at the same scale by an FSA would have.<sup>22</sup> The conclusions drawn by the U.S. D.O.T are consistent with experience in Europe, Australia and Canada, where the impact of VBAs on competitive conditions has been far greater than implied by their initial market shares.
25. The Commission's unwillingness to fully recognise the impact of VBA competition is but one example of the Commission's reliance on structural presumptions and its unwillingness to look behind them to actual conduct and performance.

### ***Commission's approach to modelling detriments***

26. The Applicants consider that there are serious flaws in the modelling on which the Commission has relied in concluding that the Alliance will impose substantial detriments in the form of losses in allocative, productive and dynamic efficiency.

### ***Allocative efficiency***

27. Nowhere in the Draft Determination does the Commission set out a systematic assessment of NECG's modelling of allocative efficiencies. Although the Commission does raise an number of criticisms of NECG's modelling, careful examination reveals that

---

<sup>20</sup> Virgin Blue's submission to the Commerce Commission, 12 February 2003, paragraph 3.39(c).

<sup>21</sup> Draft Determination, paragraph 375.

<sup>22</sup> United States Department of Transportation, "Enforcement Policy Regarding Unfair Exclusionary Conduct in the Air Transport Industry: Findings and Conclusions on the Economic Policy and Legal Issues, 17 January 2001.



## Applicants' Preliminary Response to Commerce Commission's Draft Determination

these criticisms generally apply with even greater force to the modelling on which the Commission has relied. That examination makes it clear that the estimates upon which the Commission has relied have not been properly audited, are based on flawed assumptions about the world and are derived from a model which embodies a methodology which has little credibility and which, in any event, is improperly implemented.

28. The Applicants also have very serious reservations about the most recently announced changes to the Commission's assessment of allocative efficiency losses. Specifically, the Commission has moved from using its original model – which, in its original form and its first amended form, would have substantially eliminated allocative efficiency loss (i.e. shown a pro-competitive outcome) – to adopt a new scenario, which it has not used until its latest “audited” announcement, which generates an increased allocative efficiency loss. However, careful analysis reveals that that new modelling is itself deeply flawed.
29. The Applicants consider these outcomes require a fundamental change to the Commission's approach.

### *Productive efficiency*

30. The Applicants believe the Commission's estimates of productive efficiency losses are in error. This submission identifies six major errors. These are set out in paragraphs 150 to 158 of this preliminary response. These errors include obvious triple counting. These errors have not been addressed by the Commission in its revised estimate. In fact, in these revisions, the Commission has materially increased the estimated productive efficiency losses, resulting from the use of an arbitrarily higher variable cost estimate (assumed at 0.77 of total revenue rather than 0.65 as in the original estimates). The Applicants believe that the lack of credibility of this estimate is readily shown: it implies that even on the routes most directly affected by the Alliance, the Applicants now lose more from the cost increases the Commission suggests will arise from productive inefficiency than the Applicants consider they can gain in profits from the Alliance. Why the Applicants would be willing to enter into the Alliance when, on the Commission's estimates, it would make them materially worse off, is left unexplained. The inevitable conclusion is that the Commission's approach is fundamentally illogical and incorrect.

### *Dynamic efficiency*

31. The Applicants also consider the Commission's finding that the Alliance would result in substantial dynamic efficiency is incorrect. It is based on an incorrect preliminary conclusion that VBA entry is less likely in the factual than in the counterfactual. Ironically, the Commission's own modelling confirms the Applicants' view that a VBA entrant would be substantially more profitable in the factual than in the counterfactual. In addition, the Commission plainly double counts the efficiency losses it has calculated. The cost difference at issue is already reflected in the Commission's allocative efficiency modelling.

## BACKGROUND TO THE APPLICATIONS

32. In the Applicants' view, the Commission's preliminary views in relation to the likely actions and reactions of Qantas, Air New Zealand and Virgin Blue in the Counterfactual and the Factual are the result of a number of incorrect preliminary views regarding competitive conditions in the Australasian airline industry. In the Applicants' view, this has included an incorrect assessment of the impact of global aviation changes on Australasian airlines.

### Qantas

33. In its discussion of the external environment facing Australasian airlines, the Commission notes that "Qantas is a very profitable airline currently".<sup>23</sup> The Commission reaches the preliminary view, on the basis of this and other factors, that "the Asia Pacific markets appear to have suffered from less severe downturns than those evident in North America and Europe, and to be recovering more quickly".<sup>24</sup>
34. Although Qantas is a profitable airline, its profitability is not a reason to conclude that it – and more so Air New Zealand – is immune from the challenges faced by airlines as a result of fundamental changes in world aviation markets, in particular, deregulation, the impact of VBAs and general economic decline.
35. The Commission itself notes that care should be taken when drawing too much from one year's financial performance.<sup>25</sup> The Applicants agree, and note that in the 1999 financial year, Ansett Australia recorded a 143% increase in pre-tax profit to A\$200.4m. However, in September 2001, Ansett Australia was placed into voluntary liquidation.
36. The Commission also notes the impact that SARS has had on Qantas' capacity.<sup>26</sup>
37. Qantas' current profitability is not an indication that it is not as susceptible to international aviation developments as other airlines (its profits have been materially effected by SARS). Further, even if such a premise was accepted, this cannot provide a basis for concluding that Air New Zealand is immune from the significant downturn in the aviation industry.
38. The Commission, however, wrongly concludes that the effect of these developments means that Qantas is less likely to engage with Air New Zealand in domestic New Zealand. In fact, the contrary is true. The difficulty Qantas is experiencing in its international (particularly Asian) operations, means that it is imperative that it secures its Australasian home base. Since the Single Aviation Market, domestic New Zealand is a component of the Australasian market, which is Qantas' home base. Accordingly, the options open to Qantas to achieve a secure home base are limited to either the Alliance or, in the absence of it, expanding capacity to properly secure the available revenues that contribute positively to its global network operations.

---

<sup>23</sup> Draft Determination paragraph 277.

<sup>24</sup> Draft Determination, paragraph 277.

<sup>25</sup> Draft Determination, paragraph 276.

<sup>26</sup> Draft Determination, paragraph 277.

**Air New Zealand**

39. The Commission reaches the preliminary view that the Counterfactual will involve a gradual recovery in the financial position of Air New Zealand and ongoing financial viability, and that the company's recent financial difficulties seem "almost entirely due to the consequences following the Ansett acquisition".<sup>27</sup> For the reasons set out below, Air New Zealand does not believe that the Commission's preliminary views accurately reflect the position that it finds itself in.

***Current profitability***

40. Air New Zealand's half year profit result of NZ\$94 million (and its forecast full year net profit after tax to June 2003 of NZ\$177 million) does not provide an adequate foundation for concluding that Air New Zealand is recovering and sustainable. NECG has outlined why this result provides little indication of longer term financial performance,<sup>28</sup> and Air New Zealand has informed the Commission why its recent profitability has been the result of positive external factors beyond the control of Air New Zealand.<sup>29</sup>
41. In addition, Air New Zealand has provided the Commission with financial projections prepared for the benefit of Air New Zealand's Board and senior management.<sup>30</sup> These board papers demonstrate that, based on thorough analysis of all evidence available to it, Air New Zealand has come to the conclusion that a long term improvement in its underlying business will not occur simply through strong financial management and a focus on cost reductions and fare initiatives. While these initiatives can and do go some way towards meeting Air New Zealand's immediate cash needs, they cannot provide the extent of improvement needed for Air New Zealand to be able to earn its cost of capital to enable it to finance the cost of replacing its long-haul fleet.

***Impact of Ansett***

42. The failure of Ansett is independent of the long term strategic imperatives facing Air New Zealand. Indeed, the Ansett acquisition demonstrates the importance Air New Zealand places on obtaining a wider Australasian based network.
43. Even if Ansett were considered to be a contributing factor to Air New Zealand's current situation, that does not exempt the Commission from considering the most likely future scenario absent the Alliance. Regardless of Ansett, this scenario involves Air New Zealand having very limited potential to earn its cost of capital or to fund necessary future investments.

***Impact of the Alliance on Air New Zealand's position***

44. The Commission reaches the preliminary view that:

"...capital funding (and the related matter of the company's balance sheet) would be an issue under both counterfactual and factual. However, Air New Zealand's need for funding,

---

<sup>27</sup> Draft Determination, paragraph 278.

<sup>28</sup> NECG response to submissions in relation to NECG's report, March 2003, page 25-26.

<sup>29</sup> Applicants' Response to Commission's question, question 13, and Applicants' Response to Third Party Submissions, section 1.2.

<sup>30</sup> Air New Zealand board presentation provided to the Commission on 14 March 2003.

## **Applicants' Preliminary Response to Commerce Commission's Draft Determination**

and the question mark over the Government's willingness to provide further capital, may suggest the need for an alternative cornerstone shareholder in the counterfactual".<sup>31</sup>

45. The Commission's preliminary view is based on the premise that Qantas might be unwilling to provide the full level of funding required to finance Air New Zealand's ongoing investment requirements.<sup>32</sup>
46. The Applicants note that the Alliance provides Air New Zealand with a NZ\$550m injection over the first three years of the Alliance. Accordingly, Air New Zealand's access to capital funding is significantly enhanced under the Factual as opposed to the Counterfactual.

### ***No modelled scenario covers costs of capital***

47. The Commission notes that Air New Zealand has not claimed a "failing firm" argument in the Applications. The Commission notes that modelling:

"[r]esults also show that no scenario, factual or counterfactual, achieves Air New Zealand's target [ ]% pre-tax return for any year over the period 2003-06. Overall, the Cameron and Company forecasts, coupled with analysis of past results, suggest that Air New Zealand's airline business overall is currently, and will continue to be, a profitable operation in the near term".<sup>33</sup>

48. The Commission itself has emphasized the difference between economic and accounting profitability. Air New Zealand is not now, and absent the Alliance will not be, operating anywhere near economic profitability. In contrast, the Alliance would result in Air New Zealand moving far closer to its weighted average cost of capital, and hence, would result in Air New Zealand having a far greater potential to earn its cost of capital and finance the cost of replacing its long-haul fleet.<sup>34</sup>
49. The Commission appears to discount Air New Zealand's improved capital position under the Alliance on the basis that Air New Zealand's rate of return in the Alliance may not reach its target rate of return.<sup>35</sup> However, the Commission overlooks the fact that the Alliance provides the highest rate of return for Air New Zealand. Accordingly, the Alliance provides the best opportunity for Air New Zealand to fund the cost of replacing its long-haul fleet.

### ***Other alliance partners***

50. The Commission reaches the preliminary view that:

"...there appear to be other possible alliance options available, aside from the one with Qantas, and others could emerge over time for a variety of reasons".<sup>36</sup>

---

<sup>31</sup> Draft Determination, paragraph 283.

<sup>32</sup> Draft Determination, paragraph 282.

<sup>33</sup> Draft Determination, paragraph 283

<sup>34</sup> Air New Zealand board papers provided to the Commission.

<sup>35</sup> Draft Determination, paragraph 285.

<sup>36</sup> Draft Determination, paragraph 299.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

51. In reaching this preliminary view, the Commission has not cited likely alternative future alliance partners and has ignored extensive evidence provided by Air New Zealand that another alliance partner does not exist.<sup>37</sup>

### Virgin Blue

52. The Commission notes that Virgin Blue has stated that it intends to expand into both the Tasman and domestic New Zealand markets. However, the Commission discounts this intention because:
- Virgin Blue says it will be more difficult to expand into these markets in the factual;<sup>38</sup>
  - VBA entrants are disinclined to engage in head-to-head competition with incumbents;<sup>39</sup> and
  - there are few unexploited market opportunities available to Virgin Blue.<sup>40</sup>
53. In the Applicants' view, VBA expansion by Virgin Blue or entry by another VBA is certain. In the factual, the Commission has modelled higher prices and reduced capacity. Accordingly, as noted in the NECG Report, based on the modelling the Factual is a more attractive proposition than the Counterfactual for a VBA.
54. In this respect, the Commission should recognise that Virgin Blue has built a strong financial and operational base in Brisbane and, as explained below, faces no material barriers to expansion from its Australian base on to the Tasman and New Zealand domestic routes. Virgin Blue's strong base and its commitment to acquire 10 new B737 aircraft (with options for a further 40 over the next eight years) gives it the flexibility to make expansion decisions to suit its own commercial timetable when opportunities present themselves. As such, Virgin Blue's ability to supply side substitute on to the Tasman and New Zealand domestic routes quickly and for minimal cost imposes an ever present competitive threat in the Tasman and New Zealand domestic segments of the market.
55. In any event, as a matter of consistency, the Commission cannot model higher prices in the Factual and then ignore the market opportunities that these higher modelled prices create. Conversely, it is not open to the Commission to state that the incumbents may reduce prices in the Factual in order to deter VBA entry or expansion and then claim that a VBA does not constrain the incumbents.
56. Further, the Commission's statement that VBA entrants are disinclined to engage in head-to-head competition with incumbents is inconsistent with Virgin Blue's entry in Australia.<sup>41</sup> Virgin Blue's first route in Australia was Sydney – Brisbane, which at that time was served by Qantas, Ansett and Impulse. Since that time, Virgin Blue has entered a large number of routes, almost all of which were solely served by Qantas and/or Ansett pre-Virgin Blue entry. As a result, Virgin Blue currently operates on 24 of the 30 largest routes in Australia in direct competition with Qantas, a point alluded to by

---

<sup>37</sup> Air New Zealand confidential annexure to the Applicants Response to the Commission's questions.

<sup>38</sup> Draft Determination, paragraph 291.

<sup>39</sup> Draft Determination, paragraph 293.

<sup>40</sup> Draft Determination, paragraphs 416 and 494.

<sup>41</sup> Draft Determination, paragraph 293.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

the Commission at paragraph 288 of the Draft Determination and which is inconsistent with the Commission's statement that VBA entrants are disinclined to engage in head-to-head competition with incumbents.

### MARKET DEFINITION

#### Commission's preliminary views

57. For the purposes of the Draft Determination, the Commission defined 10 relevant markets:
- New Zealand main trunk passenger air services (**New Zealand Main Trunk**);
  - New Zealand provincial passenger air services (**New Zealand Provincial**);
  - New Zealand - Australia passenger air services (**Tasman**);
  - New Zealand – Asia passenger air services (**NZ – Asia**);
  - New Zealand – Pacific Islands passenger air services (**Pacific Islands**);
  - New Zealand – USA passenger air services (**US**);
  - Certain other international passenger air services;
  - Tasman belly-hold freight services market;
  - International belly-hold freight services;
  - Domestic air freight services; and
  - National wholesale travel distribution services market.
58. It is the Applicants' view that, in general, in defining the relevant markets, the Commission has focused too heavily on the product characteristics and passenger reasons for travel, and neglected the scope for supply side substitution. Legal authority, economic theory and regulatory practice all recognise that an appropriate market definition must capture both demand and supply side substitutes. In fact, the Commission's new guidelines now explicitly state that both demand side and supply side factors should be taken into account in defining market boundaries.<sup>42</sup>
59. The Applicants' evidence and submissions prove that commercially, there is an Australasian passenger services market because it is both logical and feasible for carriers operating in one geographic segment of a market to expand to the other segments, and that such expansion is likely. Indeed the Commission notes that:

“...possible entrants would see New Zealand and Australia as one market”<sup>43</sup>

---

<sup>42</sup> “Practice Note: 4 – the Commission's Approach to Adjudicating on Business Acquisitions under the Changed Threshold in Section 47 – a Test of Substantially Lessening Competition”.

<sup>43</sup> Draft Determination. paragraph 374.

## **Applicants' Preliminary Response to Commerce Commission's Draft Determination**

60. Similarly, the Applicants' evidence concerning the changing patterns of passenger demand in response to the product offering and business model of VBAs demonstrates that passengers travelling for business reasons are increasingly availing themselves of the services of VBAs.

### **Passenger markets**

#### ***Customer segmentation***

61. While the Commission did not reach the preliminary view that there are separate markets for business passengers and leisure passengers, the Commission did consider the "differential impacts" of the Alliance on the business and leisure segments of the market.<sup>44</sup>
62. The Applicants agree that there is no basis for defining a separate market for business passengers.<sup>45</sup> However, the evidence provided to the Commission also demonstrates that there is no basis for concluding that a "business segment" of the market will be disproportionately affected by the Alliance, or that it is necessary to maintain two FSAs to service this segment of the market.
63. The Applicants provided evidence to the Commission that VBAs have fundamentally transformed the nature of competition by changing the way business passengers purchase air travel. A key change is that VBAs have replaced traditional pricing models by price discriminating on the basis of date of purchase, rather than by imposing onerous conditions. By offering a combination of lower fares and fewer restrictions, VBAs have greatly expanded the size of the business market available to them. The ability of VBAs to attract business passengers is demonstrated by Virgin Blue, which actively targets business passengers.<sup>46</sup> For example, Virgin Blue spokeswoman, Amanda Bolger, was reported on 13 June 2003 as stating that business travellers now form the largest group of customers of Virgin Blue, ahead of leisure travellers and people visiting friends and family.<sup>47</sup>

### **Geographic scope**

#### ***Australasian Market***

64. As stated above, in the Applicants' view, as a matter of commercial reality, it is important and necessary for an airline to provide services throughout Australia and New Zealand. Indeed, the Commission itself notes:

"...possible entrants would see New Zealand and Australia as one market and would be unlikely to enter New Zealand without first entering Australia and the Tasman".<sup>48</sup>

---

<sup>44</sup> Draft Determination, paragraph 169.

<sup>45</sup> While the Applicants agree with this conclusion, the Commission has erred in its underlying economic analysis. For example, the Commission does not appear to dispute NECG's critical loss analysis (paragraph 150). In not rejecting the critical loss analysis, the Commission should logically conclude that demand side substitution brings all customers into a single product market.

<sup>46</sup> Evidence that Virgin Blue actively targets business passengers was presented in the NECG Report, dated 9 December 2002, pages 49 – 50.

<sup>47</sup> "Cheaper Tickets sideline options", The Australian, 13 June 2003.

<sup>48</sup> Draft Determination, Paragraph 374.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

65. The Commission itself, in its Practice Note, has accepted the fact that it will sometimes be appropriate to define a relatively wide market to take into account supply substitutability.<sup>49</sup> Once supply side considerations are taken into account to define the relevant market as being broader than city-pairs, those same considerations mean that there is no justification for limiting the geographic market to anything narrower than Australasia. Indeed, such a market definition is supported by government policy as represented in the Single Aviation Market. The Applicants acknowledge that the Commission is technically restricted to assessing the impact of competition on "a market in New Zealand". However, in the Applicants' view, the Commission must also recognise the reality of the competitive environment in which the Applicants operate by considering Australasian competition as an 'import' or 'potential competition'.<sup>50</sup>

### *NZ-Asia and Pacific Islands markets*

66. In the Applicants' view, the Commission erred in applying the concept of "substitutability" in reaching the preliminary view that there are separate New Zealand – Asia and Pacific Islands markets, for the reasons set out below.
67. The Commission noted that each destination was of a "different, non-substitutable nature".<sup>51</sup> However, the Applicants note that every holiday destination offers different, non-substitutable qualities. This should not automatically lead to the conclusion that these destinations are located in separate markets. Rather, based on the Commission's own market definition principles, the relevant question is whether there would be sufficient substitution to defeat a price rise for services to any given destination. The Australian full Federal Court dealt with the appropriate test for distinct holiday destinations in *Singapore Airlines Limited v Taprobane Tours*.<sup>52</sup> In that case, the court rejected the allegation that Singapore Airlines had market power in respect of the supply of services between Australia and the Maldives, even though it was the main supplier of such services. The court noted that there were many island holiday destinations that were substitutable for the Australian – Maldives services. The court found that the attempt to promote the Maldives as a "unique" holiday destination was simply an example of product differentiation and, a tool for attaining a competitive advantage in the larger market for "island travel".
68. In addition, the Applicants provided evidence that there are many carriers that could increase or shift capacity between Asia and the Pacific given the appropriate incentive.
69. For these reasons, in the Applicants' view, it is not appropriate for the Commission to consider the competitive effects of the Alliance in the context of distinct NZ - Asia and Pacific Islands markets.

### **Freight markets**

70. The Commission defined distinct markets in respect of belly-hold freight and dedicated freight services on the assumption that demand and supply side substitution between the

---

<sup>49</sup> The Commission notes: "For example although air travel on different city-pair routes may not be substitutes in the eyes of travellers, they may be on the part of suppliers, and so it may be appropriate – and aid the subsequent competition analysis – to classify them in a single product market such as an "air services market". (pages 16 – 17 of the Practice Note).

<sup>50</sup> See, for example, *Fletcher Metals* 6 NZAR 33.

<sup>51</sup> Draft Determination, paragraph 187.

<sup>52</sup> (1991) 104 ALR 633.



## Applicants' Preliminary Response to Commerce Commission's Draft Determination

two types of services is weak.<sup>53</sup> The Commission nominated the following reasons as the basis for this preliminary view:

- freight services offered by dedicated freighters and passenger aircraft are significantly different;
- the marginal cost of operating dedicated freighters is much higher than the marginal cost of carrying belly-hold freight;
- consumers cannot substitute between dedicated freighters and passenger services due to differences in price, route network and flight frequency; and
- dedicated freighters do not attempt to provide a substitute for passenger services, instead they attempt to develop a niche market.

71. The Applicants have provided the Commission with evidence that demonstrates that there will be sufficient demand and supply substitution between belly-hold and dedicated freight services to warrant a market definition that encompasses both services.<sup>54</sup> In this respect, the Applicants note that:

- narrow bodied B737 passenger aircraft are only capable of carrying loose freight (and A320s are only capable of carrying smaller containers);
- larger air passenger aircraft are capable of carrying palletised and containerised freight in addition to loose freight; and
- dedicated freighters can carry all of the above as well as certain types of volumetric freight that air passenger aircraft are not capable of carrying.

72. Accordingly, the Commission has overlooked the fact that dedicated freighters provide a broader set of freight services than air passenger aircraft, i.e. freight services that passenger aircraft are able to provide are a subset of freight services. In doing so, the Commission has:

- not recognised the existing ability of a dedicated freighter to provide the same freight services as those that may be provided by an air passenger aircraft. In the Applicants' view, this is the relevant direction of substitution when taking a purposive approach to market definition because the Alliance involves aggregation in freight provided by air passenger aircraft rather than aggregation in dedicated freighters; and
- overlooked the scope for demand side substitution from air passenger aircraft to dedicated freighter services.

73. In addition, the Commission's focus on the alleged (but not demonstrated) higher cost of dedicated freight and the less frequent service provided by dedicated freight overlooks the key question, which is whether dedicated freight and belly-hold freight services are fungible. Despite dedicated freight and belly-hold freight being fungible services, the Commission has initially defined them in separate markets.

---

<sup>53</sup> Draft Determination, paragraph 201.

<sup>54</sup> See for example, Applicants' answers to Commission's questions 15 and 16.

### **Wholesale travel distribution**

74. The Commission reached the preliminary view that there was a separate national wholesale travel distribution market.<sup>55</sup> This is in contrast to the Commission's conclusion in *Bodas*. The Commission reached its preliminary view on the basis that:

- the travel distribution services market has changed markedly since *Bodas* due to the wide spread use of the internet and telephone call centres. The internet has been adopted by airlines selling directly to the public, and airlines have now become much more active and competitive participants in the market for the retailing of airline tickets; and
- the Alliance would affect the wholesale distribution of travel services to a considerably greater degree than the retail of travel services due to Qantas Holidays' expansion into the New Zealand market.

75. In the Applicants' view, there are no separate functional levels within the travel distribution market. The Applicants believe that defining a separate market for the wholesale distribution of travel services is inconsistent with accepted economic principles for defining functional markets. Rather, the Commission's observation regarding the growth of direct distribution channels is consistent with the Applicants' view that there is considerable scope for consumers to purchase airline tickets, and any additional products or services supplied in a wholesale travel package, from different layers in the distribution chain, and hence, that there is a single functional market from an economic point of view. The Applicants' view is consistent with *Bodas*, ACCC precedent and the comments of Australia's Federal Court in *Singapore Airlines v Taprobane Tours*. In *Singapore Airlines v Taprobane Tours*, the Federal Court stated that:

"At the functional level it would be possible to limit the market to the supply of services by airlines to wholesalers. Such a limitation, however, seems unduly restrictive. The integration of wholesale and retail activities within Singapore Airlines and other agencies suggests that the appropriate functional level comprehends the supply of airline services to wholesalers and packaged tours by wholesalers to consumers. The exercise of market power at either of the two upstream functional levels is closely connected with and capable of affecting competition downstream in the chain identified."<sup>56</sup>

## **COUNTERFACTUAL**

### **Commission's preliminary views**

76. As stated above, the Commission's preliminary analysis rejected the scenario that the Applicants advanced as the most likely Counterfactual to the Alliance, i.e. that there will be a more aggressive level of competition between them resulting in increased capacity being applied to material parts of their Australasian networks.

77. The Commission's preliminary view is that the Counterfactual is likely to have the following characteristics:

- a gradual recovery in the financial position of Air New Zealand and ongoing financial viability;

---

<sup>55</sup> Draft Determination, paragraph 212.

<sup>56</sup> (1991) 104 ALR 633, at paragraph 52.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

- a continuation of the present support by the Government for Air New Zealand, but with a question mark over whether sufficient capital in addition to retained earnings, would, if necessary, be forthcoming to pursue its preferred network strategy;
- in the short-run a continuation of competition from Qantas on the Tasman and domestic New Zealand routes, but with capacity being expanded in line with market growth, not accelerated to produce a "war of attrition";
- Air New Zealand standing alone in the short term, while seeking, and perhaps in the medium term gaining, an alternative alliance with another airline; and
- incremental entry by Virgin Blue being likely on the Tasman, with possible expansion onto the New Zealand main trunk.<sup>57</sup>

78. In the Applicants' view, the Commission's Counterfactual is not the most likely future scenario absent the Alliance for the reasons set out below.

### Weight of evidence

79. In reaching its preliminary view on the Counterfactual, the Commission has preferred the untested views of third parties to the tested statements, views and analysis of the Applicants. Both Air New Zealand and Qantas are large, listed public companies that are required to make continuous disclosure to the market. Each Applicant has publicly indicated throughout the Commission's investigation process what its future actions will be if the Alliance is not authorised.
80. Further, the Commission's Counterfactual is inconsistent with that accepted by the New Zealand Government when it decided to grant Kiwi Shareholder approval for the Alliance. The Cabinet Business Committee accepted advice from an independent external adviser - First NZ Capital - that the Factual and Counterfactual put forward by Air New Zealand and Qantas "provide a reasonable assessment of the competitive environment with and without the Alliance".<sup>58</sup> Thus, even before the Commission had commenced its investigation, the Applicants' Counterfactual had already been rigorously tested by the New Zealand Government and its independent external advisors through the process of obtaining Kiwi Shareholder approval.
81. The Commission has, in its preliminary analysis, summarily rejected the publicly stated intentions and expectations of the Applicants – supported by economic analysis by NECG - and the analysis undertaken by the Government in the absence of other, more compelling evidence to the contrary. It is the Applicants' view that in the absence of such evidence, the Commission's preliminary view is both unsupported and unsupportable on the facts.

### Qantas and the Counterfactual

82. Given the competitive dynamics of network airlines, and considering that:
- Qantas lost its source of feed from domestic New Zealand with the demise of Tasman Pacific (trading as Qantas New Zealand) and so immediately commenced its own operated services in domestic New Zealand; and

---

<sup>57</sup> Draft Determination, paragraph 300.

<sup>58</sup> CBC Minute <http://www.treasury.govt.nz/release/airnz/alliance/cabinet/anz-cbc02-11-8.pdf>

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

- Qantas views New Zealand as an integral part of its home base and believes that securing a strong home base is essential to place Qantas on a more even footing with its main international competitors and to contribute to the sustainability of Qantas as a global full service network operator,

Qantas concluded that in a world without the Alliance, in order to attract high yield customers and obtain a sustainable presence throughout Australasia, Qantas would have to come closer to matching the domestic New Zealand frequency offered by the competing FSA, Air New Zealand.

83. The Applicants note that the Commission is of the preliminary view that such an increase in capacity would lower Qantas' profits.<sup>59</sup> However, the Commission's preliminary view is incorrect because it does not incorporate the implications of a capacity increase in domestic New Zealand for the wider Qantas network. Indeed, there is no reference to the impact of network benefits in the Draft Determination. Qantas is a global full service network operator. As a result, its behaviour in the Counterfactual is rational because increasing capacity in domestic New Zealand will increase Qantas' network profitability. As stated above, Qantas' behaviour is consistent with the way FSAs supply capacity to grow, win market share, and, thus, increase their profits.<sup>60</sup>
84. The rationality and plausibility of Qantas' behaviour in the Counterfactual is further supported by:
- independent economic analysis by NECG who tested the commercial rationale for the Counterfactual and found the predicted behaviour to be economically rational,<sup>61</sup>
  - detailed and comprehensive analysis conducted by the Applicants and documented in a paper entitled "Further Description of the Qantas and Air New Zealand Counterfactual",<sup>62</sup> and
  - Air New Zealand's independent conclusion that Qantas' behaviour in the Counterfactual is economically and commercially rational, and that Qantas is likely to undertake such a strategy.

### Air New Zealand and the Counterfactual

85. Given the nature of airline network competition outlined above, the Applicants have demonstrated that Air New Zealand's rational response - given an increase in Qantas' capacity would be to increase its capacity to maintain its frequency advantage. However, as Air New Zealand has previously stated, it will not be in a position to increase capacity to compete with Qantas' increases in capacity. Air New Zealand's only option is to maintain its status quo, which effectively concedes market share to Qantas. This concession will compromise Air New Zealand's viability. As a result, if the

---

<sup>59</sup> Paragraph 237.

<sup>60</sup> For example, Air New Zealand presentation to the Commission 21 March 2003, Air New Zealand presentation to the Commission 13 March 2003 (copy supplied to the Commission on 19 March 2003).

<sup>61</sup> NECG report, pages 20-23.

<sup>62</sup> Filed with the Commission on 13 March 2003.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

Commission's chosen Counterfactual were the relevant Counterfactual, it would be one in which any competition between Qantas and Air New Zealand was short-lived.<sup>63</sup>

### Virgin Blue and the Counterfactual

86. The Commission concluded that the Counterfactual would include:

"...incremental entry (i.e. 4 aircraft) by Virgin Blue being likely on the Tasman, with possible expansion onto the New Zealand main trunk".<sup>64</sup>

87. The Applicants note that the Commission's view is in contrast to the public statements made by Virgin Blue that it will expand into the markets regardless of whether the Alliance proceeds. For example, Virgin Blue has stated publicly in its submission to the Commission it:

"With or without the Proposed Alliance, Virgin Blue will commence on these [trans-Tasman and domestic New Zealand] routes".<sup>65</sup>

88. Virgin Blue's conviction and imminent entry onto those routes is further supported by the IASC application for capacity to serve New Zealand, which it filed on 16 June 2003.

89. The NECG Report also presented public statements made by Virgin Blue that it was focused on expanding into the Tasman and New Zealand domestic markets in the near future.<sup>66</sup> In light of the public statements made by Virgin Blue, it is not appropriate for the Commission to conclude that the most likely future scenario does not involve significant expansion by Virgin Blue onto the Tasman and domestic New Zealand segments of the market.

90. Even if, as the Commission found, expansion by Virgin Blue into the New Zealand domestic market is "possible", this finding should provide the Commission with sufficient certainty that there is a real risk to Air New Zealand's viability. NZ Express does not immunise Air New Zealand against the effect (or threat) of VBA entry or Virgin Blue expansion due to the lower costs that VBAs enjoy. Air New Zealand's threatened financial future is the motivation for the Alliance.

### Conclusion

91. For the reasons outlined above, the evidence does not support the Commission's preliminary view regarding the Counterfactual. The evidence supports the view that the most likely outcome is that put forward by the Applicants in their submission because:

- both Air New Zealand and Qantas concluded independently that the only Counterfactual to test against the Factual is one in which the Applicants compete with increased capacity on the basis that it involves economically rational behaviour by both parties consistent with the behaviour of other airlines;

---

<sup>63</sup> Indeed, if Qantas believed Air New Zealand would not match capacity increases, that would make its own capacity increases all the more profitable and hence certain. In other words, one cannot believe both (1) that Air New Zealand will accommodate capacity increases by Qantas **and** (2) that Qantas will not have an incentive to increase capacity.

<sup>64</sup> Draft Determination, paragraph 300.

<sup>65</sup> Virgin Blue's submission to the Commerce Commission, 12 February 2003, paragraph 1.4..

<sup>66</sup> NECG Report, dated 9 December 2002, pages 86-88.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

- the Applicants, as the only FSAs operating domestically in the Australasian market, are best placed to ascertain the appropriate Counterfactual;
- the Applicants have provided extensive internal documentation supporting their actions in the Counterfactual;
- the Counterfactual is consistent with information and assessments provided separately by Air New Zealand and Qantas to NECG on a confidential basis;
- NECG have derived and tested the appropriateness of the Counterfactual;
- First NZ Capital and the New Zealand Government concluded that the Applicants' Counterfactual is a reasonable assessment of the competitive environment without the Alliance; and
- the Commission's reasons for rejecting the Applicants' Counterfactual are unsupportable.

### COMPETITIVE DETRIMENTS

92. The Commission has come to a number of questionable preliminary views in its assessment of the anti-competitive effects of the Alliance. These preliminary views have led the Commission to substantially overstate the competitive detriment and to substantially understate the public benefits in the Draft Determination.

#### Barriers to entry and expansion

93. In general, in its preliminary analysis of barriers to entry and expansion in the New Zealand domestic and Tasman segments of the market, the Commission has not gone beyond a theoretical analysis of barriers to entry or expansion to examine what will amount to barriers to entry or expansion in practice. In the present situation, an incumbent with an historically successful performance record (i.e. Virgin Blue) has declared its intention to expand into the relevant sectors of the market. Yet the Commission has not accepted this in formulating its Counterfactual. The Commission has already accepted, in theory, that VBA entry is the most likely type of entry in present industry conditions as the following illustrates:

“All round the world FSAs are retrenching and it appears to be a commonly held view amongst industry participants that if any airline is likely to enter a market, it will be a VBA”.<sup>67</sup>

94. The Applicants agree with the Commission that the most likely entrant is a VBA, and indeed regard entry by Virgin Blue as certain. Accordingly, the correct analysis is to consider what additional or increased costs a VBA – and in particular, Virgin Blue - must bear as a condition of entry or expansion.<sup>68</sup> Further, it is only the asymmetry in costs as between incumbents and entrants that is relevant to an evaluation of barriers to entry and expansion.

---

<sup>67</sup> Draft Determination, paragraph 325.

<sup>68</sup> As noted above, the Applicants believe that the relevant market is an Australasian market. Hence, were Virgin Blue to serve the Tasman and New Zealand domestic markets, this would constitute expansion within a market. The Applicants adopt the Commission's terminology for ease of exposition only.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

95. In respect of passenger markets, in its preliminary analysis, the Commission has identified a number of entry conditions.<sup>69</sup> However, the Applicants note that in this preliminary analysis the Commission has largely focused its attention on "start-up" rather than expanding airlines, and in addition, has not taken account of the different costs that would be incurred by a VBA entrant as opposed to a FSA entrant. As stated above, the Applicants' believe that the analysis of barriers to entry and expansion should be undertaken in relation to the potential participants that the Commission has recognised are most likely to enter (i.e. VBAs).
- Capital requirements are not a barrier to entry for Virgin Blue, which, in addition to strong profit performance in Australia, has strong financial backing from Sir Richard Branson, the wider Virgin group and from Patrick Corporation. In any event, the Commission has overstated the difficulties that any VBA entrant would have in obtaining the necessary capital to enter the markets. Worldwide, investors value VBAs more highly than FSAs. Southwest's current p/e is 70.9 and AirTran's is 38.8.<sup>70</sup> In comparison, Air New Zealand's current p/e is 7.7<sup>71</sup> and Qantas' is 8.7.<sup>72</sup> While Virgin Blue is not publicly listed, its value has been estimated at A\$1.7 billion, approximately 11 times its current earnings.<sup>73</sup>
  - The Commission's preliminary analysis of sunk costs does not apply to Virgin Blue because:
    - Virgin Blue has already undertaken some of the investments necessary to enter the markets, which means that many start up-costs are only marginal,<sup>74</sup> and
    - Virgin Blue has committed to acquiring 10 new B737 aircraft (and has options for a further 40 over the next eight years), which it could deploy on Tasman and domestic New Zealand routes without disturbing its existing capacity.<sup>75</sup>
  - For an established Australian airline such as Virgin Blue, the cost of meeting the regulatory requirements in New Zealand is marginal and cannot be regarded as amounting to a barrier to entry.
  - With respect to the Commission's concerns with access to facilities, the Applicants refer the Commission to the substantial undertakings that have been offered to the ACCC, where the Applicants undertake, for example, to provide new entrants with such facilities as may be reasonably required to commence services on the Tasman and in domestic New Zealand.
  - Access to travel distribution services do not amount to a barrier to entry for Virgin Blue – and indeed for any VBA entrant – because as the Commission rightly points out, VBAs have:

---

<sup>69</sup> Draft Determination, paragraph 331.

<sup>70</sup> [www.nyse.com](http://www.nyse.com)

<sup>71</sup> [www.stockwatch.co.nz](http://www.stockwatch.co.nz)

<sup>72</sup> [www.tradingroom.com.au/apps/qt/quote.ac?code=QAN](http://www.tradingroom.com.au/apps/qt/quote.ac?code=QAN).

<sup>73</sup> <http://www.smh.com.au/text/articles/2002/11/18/1037599365942.htm>

<sup>74</sup> For example, the Commission acknowledges that existing airlines such as Virgin Blue and fifth-freedom carriers would face low barriers in terms of building a brand (paragraph 412).

<sup>75</sup> Virgin Blue submission to ACCC, dated 16 April 2003, page 2.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

"...a high proportion of direct ticket sales (which ensures VBAs are not necessarily reliant on, or captive to, third-party distributors and the associated higher distribution costs)".<sup>76</sup>

Virgin Blue sells approximately 90% of its seats directly through its internet site.<sup>77</sup>

- Access to feeder traffic is not a barrier to entry for Virgin Blue – or indeed any VBA entrant – because:
  - VBAs concentrate on point-to-point routes with little or no interlining or codesharing; and
  - the majority of passengers in domestic New Zealand and Tasman markets are point-to-point travellers.

In this respect, the Applicants also note an inconsistency in the Commission's arguments. In relation to the Counterfactual, the Commission appears to dismiss Qantas' arguments regarding the importance of domestic New Zealand feeder traffic in the context of network benefits. However, in relation to barriers to entry, the Commission highlights the importance of feeder traffic. The Applicants believe that the correct view is that feeder traffic is of significance to FSAs – and, indeed, underpins the network carrier model – but is of limited or no relevance to VBAs.

- Loyalty schemes do not create a barrier to entry for a VBA. International experience indicates that frequent flyer programs do not prevent or limit market entry and expansion by VBAs.<sup>78</sup> In any event, VBAs do not use loyalty schemes that impose a cost on the VBA.

96. In addition, the Commission considered that incumbent response, the requirement for an entrant to match the size and scale of the incumbents and the size of the Tasman and domestic New Zealand markets each constituted a barrier to entry. With respect to the Commission's preliminary views about these three barriers, the Applicant's make the following comments.

### ***Incumbent response***

97. The Commission reached the preliminary view that incumbent response to entry would be a barrier to entry and would be a greater barrier under the Factual than under the Counterfactual on the basis that:

- the Alliance would have enlarged CRS displays, which would increase bookings on the Applicants' flights by travel agents;
- the Alliance would mount a competitive response on the routes entered by the VBA and cross-subsidise any losses suffered from the remainder of its

---

<sup>76</sup> Draft Determination, paragraph 137.

<sup>77</sup> Virgin Blue Submission to Commerce Commission, 12 February 2003, footnote 34.

<sup>78</sup> American Airlines and United Airlines operate comprehensive programs with many members, yet this has not prevented the rapid growth and success of Southwest, JetBlue, and other VBAs. Ansett had a large, innovative and successful frequent flyer program but that had very little impact, if any, on its ability to retain customers in the face of competition from Virgin Blue.



## Applicants' Preliminary Response to Commerce Commission's Draft Determination

operations. Further, the Alliance would be more profitable so the Applicants could devote more profits to subsidising price reductions; and

- NZ Express in domestic New Zealand and Freedom on the Tasman would be used to compete in an anti-competitive fashion against an entrant.

98. The evidence does not support the Commission's preliminary views for the following reasons.
99. First, the incumbents will not be able to respond in a predatory manner in light of both the illegality of such behaviour, and the conditions offered to the Commission, which restricts any increase in capacity on relevant routes if the Alliance is authorised.
100. Secondly, international experience demonstrates that the use of a low-cost subsidiary in response to VBA entry has not been a successful strategy in other markets. For example, Air Canada's introduction of Zip and Tango did not prevent entry and expansion by WestJet nor did it prevent Air Canada, which was Canada's only FSA following its acquisition of Canadian Airlines, from being forced to file for bankruptcy protection. British Airways launched its low cost subsidiary Go in May 1998 to compete with European VBA competition. Despite the deployment of Go, European VBAs continued to flourish and grow at an extraordinary rate. Go was the subject of a management buyout in June 2001 after British Airways decided that Go did not fit its overall full service strategy. In May 2002, EasyJet acquired Go.
101. Thirdly, because Virgin Blue sells approximately 90% of its tickets directly to the public, the impact of the Alliance having an enlarged CRS display is not a material issue for Virgin Blue.<sup>79</sup>
102. Fourthly, the Commission has overestimated the ability of the Applicants to use NZ Express and Freedom as an effective response to VBA entry. Virgin Blue is an experienced, well managed, and well-capitalised airline. Further, the Commission has ignored the Applicants' evidence that NZ Express' cost base remains at least 12.5% higher than a true VBA. This cost differential arises because NZ Express has retained some "frills", such as interlining, connectivity, codesharing, lounges, frequent flyer points and seamless baggage handling. On all international services Air New Zealand remains a full FSA.

### ***Scale and scope of entry***

103. The Commission reached the preliminary view that:

"...any new entrant to the main trunk market, whether FSA or VBA, would need to match the frequency of the incumbent Alliance in order to capture the business market and provide a constraint on the Alliance".<sup>80</sup>

104. It is clear that over time, a VBA would seek to expand its frequencies so as to secure a larger and wider share of the market: indeed, this is the strategy Virgin Blue is pursuing in Australia. However, it is incorrect to conclude that for VBA entry to be effective, such entry needs to occur on the same scale as that offered by the incumbents. Empirical

---

<sup>79</sup> Virgin Blue Submission to the Commission, 12 February 2003, footnote 34

<sup>80</sup> Draft Determination, paragraph 375.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

studies by the U.S. D.O.T,<sup>81</sup> among others, have shown that even a low level of entry by a VBA such as Virgin Blue has a significant effect, far greater than its market share may suggest<sup>82</sup> and greater than entry at the same scale by a FSA would have.<sup>83</sup>

105. In addition, the Commission's Counterfactual implicitly rejects Air New Zealand's arguments - and Qantas' commercial judgment - that in order for Qantas to compete effectively with Air New Zealand, Qantas needs to match its capacity. As a matter of consistency, the Commission cannot state that:
- A. a VBA entrant would need to match the Applicants' capacity to compete effectively; and
  - B. Qantas, a FSA, would not need to match the Applicants' capacity to compete effectively.
106. In the Applicants' view, based on the evidence before the Commission, both propositions A and B should be rejected. That is, as discussed above, Qantas (as an FSA) must match Air New Zealand's capacity in domestic New Zealand in order to provide it with a secure Australasian (Single Aviation Market) home base from which to leverage its global network. Further, a VBA does not have to match the incumbents' capacity in order to compete effectively and provide a competitive constraint.
107. Accordingly, the scale and scope of entry does not amount to a barrier to entry for a VBA entrant, nor does a lower scale of entry imply that entry would not provide effective competitive disciplines.

### **Size of the market**

108. The Commission has reached the preliminary view that the introduction of NZ Express in domestic New Zealand and Freedom on the Tasman has taken up some of the potential for a VBA to stimulate these markets.<sup>84</sup>
109. In relation to Virgin Blue, neither the introduction of NZ Express in domestic New Zealand nor the introduction of Freedom on the Tasman, amounts to a barrier to entry. Virgin Blue's past behaviour shows a willingness to enter mature markets. For example, the first route flown by Virgin Blue in Australia was Sydney - Brisbane. When Virgin Blue entered, the Sydney - Brisbane route was served by Qantas, Ansett, and Impulse. Accordingly, it is disingenuous for Virgin Blue to claim that it would not enter a mature route.
110. Further, the Commission states that an entrant would need a large share of the New Zealand segment of the market to be viable and notes Qantas' statement that it would

---

<sup>81</sup> Applicants' submission dated 9 December 2002, paragraph 6.103: "In noting the sharp decreases in prices that typically resulted from VBA entry, the United States DOT noted that this indicated 'that the type of competition, not the density in the absence of competition, determines fare levels'."

<sup>82</sup> Applicants' submission dated 9 December 2002, page 65. See also Robert J. Windle and Martin E. Dresner, "The Short and Long Run Effects of Entry on U.S. Domestic Air Routes" 1995 *Transportation Journal*, Vol. 35, pp. 14-25.

<sup>83</sup> NECG report, pages 104-105; see also "Actual, Adjacent, and Potential Competition: Estimating the Full Effect of Southwest Airlines"; By **Morrison, Steven A.**; *Journal of Transport Economics and Policy*, May 2001, v. 35, iss. 2, pp. 239-56.

<sup>84</sup> Draft Determination, paragraphs 416 and 494.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

require 40% of the domestic New Zealand market to be profitable.<sup>85</sup> In the Applicants' view, the Commission has overlooked the different cost structures faced by Virgin Blue and the Applicants. Due to its lower cost structure, Virgin Blue would not need the same market share to make its entry profitable. Further, the Commission has discounted the claims of Qantas that it would compete to increase its market share.

111. In any event, the Commission's preliminary view that, in the factual, Virgin Blue would have a low market share on the Tasman and in domestic New Zealand, and may not even enter the Tasman or domestic New Zealand, in the absence of a "hole" in the market, has significant implications for Virgin Blue's position in the Counterfactual. If:

- A. there is not a sufficient "hole" for Virgin Blue to gain any significant share of (or possibly even enter) the trans-Tasman market if the Alliance proceeds; and
- B. there will be less capacity in the Factual than in the Counterfactual,

then Virgin Blue would be less likely to enter the Tasman market under the Counterfactual.

112. More generally, experience has demonstrated that the New Zealand segment of the market has never generated sufficient profits to support two airlines. Accordingly, the Applicants find it difficult to accept that the New Zealand domestic market could support three carriers in the Commission's Counterfactual. As a result, in the Applicants' view either the Commission's view that entry would occur in the Counterfactual is incorrect, or the Commission must come to the view that in the Counterfactual one of the FSAs would exit.

### Fifth-freedom carriers

113. In reaching its preliminary view that there is a substantial lessening of competition in the Tasman market, the Commission concludes that fifth-freedom carriers do not impose a significant constraint on the Applicants.<sup>86</sup>

114. In reaching this preliminary view, the Commission discounted evidence that fifth-freedom carriers represented 15% of capacity on the Tasman and have the ability to expand capacity or enter if conditions in the market are sufficiently attractive. The announced entry by Emirates Airlines and Royal Brunei Airlines is evidence of this capacity. In this respect, the Applicants note that the competitive constraint imposed by a group of competitors with individually low market shares can be strong, as observed by the Court of Appeal in its judgment in *Southern Cross*.<sup>87</sup> Fifth-freedom carriers do not face any material barriers to expansion into the Tasman market and so regardless of the Applicants' market share, the Applicants' ability to impose a supra-competitive price increase will be constrained by the ability of fifth-freedom carriers to mount an effective rivalrous response.

115. In addition, the Commission's concern that fifth-freedom carriers are uncommitted participants is misplaced. The ability of fifth-freedom carriers to 'tag fly' at marginal cost means that the impact of fifth-freedom carriers is disproportionate to their market shares.

---

<sup>85</sup> Draft Determination, paragraph 414.

<sup>86</sup> Draft Determination, paragraph 502.

<sup>87</sup> *Commerce Commission v Southern Cross Medical Care Society CA*, 21 December 2001.

**NZ – Asia market**

116. The Commission reaches the preliminary view that the Applicants would not be constrained by existing or potential competition in this market.<sup>88</sup> The Commission bases this preliminary view on:

- the fact that on some routes in the Factual the Applicants will have a high market share; and
- barriers to entry are the same as on Tasman markets.

117. The Commission's preliminary analysis does not reflect the fact that the Alliance will not result in aggregation of market shares in New Zealand to Asia routes. Accordingly, to reach the preliminary view that there would be less competition in the Factual than the Counterfactual, the Commission must demonstrate that the Alliance would weaken existing competitive constraints or increase entry and expansion barriers. However, the Commission states:

“The Commission is of the view that airlines already operating in the NZ-Asia market are capable of expanding their operations to a sufficient extent to constrain the proposed Alliance, if the proposed Alliance attempted to exercise market power. However, the Asia to New Zealand sector is low yielding and not considered to be a major focus by these airlines. Furthermore, the East Asian market is expanding rapidly and Asian airlines will be focusing on growth in that market rather than the routes to New Zealand. Accordingly, the Commission cannot be satisfied that the proposed Alliance will be constrained by potential competition.”<sup>89</sup>

118. The statement above is inconsistent with a finding that there are significant barriers to expansion in the NZ – Asia market. The Applicants refer again to *Southern Cross* decision and note that the existence of a large market share by itself is not sufficient to support a conclusion that competition will be substantially lessened. Even if it is accepted that other carriers do not currently regard New Zealand as a major focus, this does not justify a conclusion that if the Alliance imposed a supra-competitive price increase, foreign carriers would not respond. Indeed, the Commission concedes that airlines already operating in the NZ-Asia market are capable of expanding their operations to a sufficient extent to constrain the Applicants, if the Applicants attempted to exercise market power.

**Freight markets**

119. The Commission reached the preliminary view that the Alliance would result or would be likely to result in a substantial lessening of competition in the Domestic Air Freight and Tasman, and International belly-hold freight markets.<sup>90</sup>

120. The Applicants note that the Commission's preliminary view is a result of its failure to recognise that dedicated freight operators represent a competitive constraint for belly-hold freight services, for the reasons outlined above. However, in addition to the market definition point, the Applicants note:

---

<sup>88</sup> Draft Determination, paragraph 514.

<sup>89</sup> Draft Determination, paragraph 511.

<sup>90</sup> Draft Determination, paragraphs 556, 566 and 573.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

- In respect of the domestic New Zealand segment, the Commission has ignored the constraint imposed by land-based freight on domestic air freight. The Applicants note that the trucking time from Christchurch to Auckland is 20 hours and that air freight accounts for only a small proportion of total domestic freight. Further, Qantas does not operate in the New Zealand domestic freight segment, as all its belly-hold space is dedicated to passenger baggage, which means the Alliance will not result in any aggregation in this market.
- In respect of the Tasman segment, the Commission has not recognised that the move by Air New Zealand to narrow-bodied aircraft will result in considerably less aggregation of freight capacity than if Air New Zealand were operating wide-bodied aircraft. Further, the Applicants will continue to be constrained by fifth-freedom carriers and the potential expansion by, or further entry of, large multinational dedicated freight carriers, which could be induced to enter the Tasman market if air freight prices were to increase.
- In respect of the international market, the Applicants note that the Alliance will result in minimal aggregation. The Applicants consider that they will continue to be constrained by the large number of incumbent air passenger airlines, incumbent dedicated freighters and potential dedicated freighters. The ability of customers to transport freight on indirect flights lessens the relevance of increased concentration on international services, including between New Zealand and the USA.

### Wholesale Travel Distribution Services market

121. The Commission reached the preliminary view that the Alliance would result or would be likely to result in a substantial lessening of competition in the national wholesale travel distribution services market.<sup>91</sup> The Commission's preliminary view is purported to be based on the following grounds:

- the possibility that in the long term, the Applicants might foreclose customers to independent travel agents by selling their tickets exclusively through their own outlets.
- House of Travel's submission, which stated that the entry of Qantas Holidays (QH) into the New Zealand market will significantly reduce, if not eliminate, competition in the New Zealand market because of the dominant position that Qantas holds in both the airline and wholesale travel distribution markets.
- United Travel's submission, which stated that the Alliance would allow Air New Zealand to exercise dominance in the travel distribution market.
- Gullivers Pacific's submission, which stated that Air New Zealand's current dominant position in the travel distribution market would be strengthened by the Alliance. Further, Gullivers stated that the combination of QH and Air New Zealand Destinations would strengthen their position in the market.

122. The Commission has relied on submissions relating generally to travel distribution services in drawing conclusions relating to its narrow "wholesale" market.

---

<sup>91</sup> Draft Determination, paragraph 593.

## **Applicants' Preliminary Response to Commerce Commission's Draft Determination**

123. In the Applicants' view, the Commission has yet to provide any reason why Air New Zealand or Qantas would have incentives to increase costs or use inefficient forms of distribution downstream with or without the Alliance. The Applicants have no incentive to reduce competition in distribution, unless a reduction in competition could give them monopoly rents upstream. However, despite the Commission's preliminary conclusions that entry barriers would increase with the Alliance, the fact that there are 800 independent retail and inbound travel agencies in New Zealand who are not owned or operated by either Air New Zealand or Qantas demonstrates that barriers to entry in the travel distribution market are low.<sup>92</sup> Even if they were not, as noted above, entrants would have other distribution channels on which they could rely.
124. In addition, the Commission and third party submitters have overlooked the distinction between inbound and outbound markets. QH has minimal outbound product offering in the New Zealand market and, in the factual, QH's initiatives focus on the New Zealand inbound tourist market).<sup>93</sup> To this end, the Applicants note that the inbound tourist market is global and fiercely competitive as between international destinations and providers.
125. The Commission accepted concerns from industry participants that travel agent remuneration would be adversely affected. However, in doing so, the Commission ignored evidence provided by the Applicants' that Qantas has no plans to change the current levels of remuneration under the Factual or the Counterfactual. In any event, the concerns of travel agents should be addressed in the context of the worldwide structural changes occurring in the travel distribution industry caused by increasing internet bookings and the direct selling characteristics of VBA airlines, which the Commission accepts as the most likely entrant.

### **COMMISSION'S PRELIMINARY APPROACH TO MODELLING DETRIMENTS**

126. The Commission reaches the preliminary view that the Alliance will impose substantial detriments in the form of losses in allocative, productive and dynamic efficiency. In the Applicants' view, and in the view of the Applicants' expert economists, the Commission's preliminary findings are incorrect. This section sets out the main reasons for the Applicants' views.

#### **Allocative efficiency**

127. The Applicants submitted modelling work undertaken by NECG that quantified the allocative efficiency losses associated with the Alliance. NECG and the Applicants noted that the estimates generated by the modelling were conservative for several reasons. In particular:
- The estimates reflected modelling of average fares, however, it seemed likely that fares to the most price sensitive travellers would increase by substantially less than the average fare. As a result, the reduction in demand, and consequent loss in consumer and producer surplus, would be less than that built into the Applicants' estimates.
  - The estimates assumed that the competitive interaction between the Applicants' parties and a VBA that expanded on to the routes most directly affected by the Alliance would reflect a Cournot pattern. In fact, international evidence, including

---

<sup>92</sup> Gullivers Pacific Submission, paragraph 6.10.

<sup>93</sup> See for example, the Qantas Holidays Business Plan and TFI Report, February 2003.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

that of Qantas' own experience in Australia following the entry of Impulse and Virgin Blue, suggests that VBAs impose a much greater competitive discipline than a Cournot-type model would imply. As a result, the modelling overstates the increases in average fares resulting from the Alliance, hence again, overstating the consumer surplus loss.

- Additionally, NECG's estimates were conservative in their treatment of New Zealand in that transfers of producer surplus from New Zealand to Australia were treated as entirely a cost to the New Zealand economy. In fact, given that the transfers arise from the purchase by Qantas of an equity stake in Air New Zealand, the only component of those transfers that is a net cost to the New Zealand economy is the amount of the transfer that is a payment in excess of the capital charge on the equity provided (the remainder being simply a payment for a productive input, namely the equity injection).
128. The Commission has not accepted the estimates provided by NECG. Nowhere in the Draft Determination does the Commission set out a systematic assessment of the NECG model. That said, the Commission does raise a number of criticisms. Those criticisms generally apply with even greater force to the modelling on which the Commission chooses to rely.
129. That modelling is based on work carried out for the Commission by Professor David Gillen (the **Gillen Model**). The result of that modelling is an estimate of allocative efficiency losses that is substantially greater than the estimates advanced by the Applicants.
130. The Applicants have devoted substantial time and effort to understanding the modelling on which the Commission has relied. Two factors have severely hindered this process.
131. First, there is virtually no relation between the modelling as it is described in the Draft Determination and the supplementary material provided by Professor Gillen (titled "Modelling for Qantas-Air New Zealand Alliance" and dated 4 April 2003) and what is actually done in the Gillen Model. To cite but one example out of many, the Commission claims (at footnote 72 on page 159) that the Gillen Model implies revenue maximisation "subject to a minimum profit constraint". However, despite the Commission's assertion, there is no such "minimum profit constraint" in the Gillen model. Overall, the Draft Determination describes a model that is highly complex and thereby, reflective of the complexity of the competitive situation; but what is actually implemented is a relatively simple, formulaic approach based on many restrictive and unexplained assumptions.
132. Second, while the model that Gillen has implemented is relatively simple, the actual calculations are at best opaque and at worst simply confused. NECG, on behalf of the Applicants, reviewed the modelling and identified a substantial number of calculation errors – for example, though the model description claimed that a particular scenario was being modelled, in fact the inputs used had been taken from a completely different scenario. These computational errors were set out to the Commission and Professor Gillen, and resulted in the Applicants' being sent (on 3 June 2003) a revised set of estimates. However, examination showed that these estimates still contained substantial computational errors. A further set of estimates was then received on 11 June 2003. While Professor Gillen says that these estimates have been "double, triple checked"<sup>94</sup>, many of the prior errors have not been corrected and new errors have been introduced.

---

<sup>94</sup> See p. 1 of Gillen's further revised document dated 5 June 2003.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

133. The result is that the Commission has relied on estimates that it cannot have properly audited. Such an audit would have revealed that the estimates are based on flawed assumptions about the world and are derived from a model that embodies a methodology that has little credibility and which, in any event, is improperly implemented.
134. Turning to the assumptions on which the estimates of allocative efficiency are based, these are, in many cases, simply implausible. Additionally, some of these assumptions are directly inconsistent with other elements in the Commission's preliminary analysis. Four such assumptions can serve to exemplify the flaws at issue.
135. First, the estimates of allocative efficiency are based on the assumption that the Applicants maximise revenues (i.e. the dollar value of sales) in the Counterfactual, without regard for cost coverage; but then become profit-maximisers once the Alliance proceeds. No explanation is given for this substantial change in behaviour, which is in any event directly inconsistent with what the Commission assumes in its preliminary analysis of productive and dynamic efficiency (where the Applicants are viewed as being less profit conscious in the Factual than in the Counterfactual, and hence, more willing in the former than in the latter to tolerate excess costs). In any event, the Applicants note that the revenue maximisation assumption is unsustainable in other than the short term, i.e. an airline that revenue maximisers will soon go broke because its marginal costs would not cover its marginal revenue. Accordingly, as a basis of assessing a medium term economic position, revenue maximisation is an inappropriate assumption.
136. Second, the estimates of allocative efficiency are based on the assumption that a VBA would enter the Tasman in the Counterfactual but not in the factual. This assumption is made despite the fact that the Commission's own modelling estimates that a VBA entrant would be three times more profitable under the Factual than under the Counterfactual.
137. Third, the estimates of allocative efficiency are based on the assumption that Air New Zealand does not materially contract its services in the Counterfactual. This is despite the fact that under the Commission's modelling, Air New Zealand's margin over costs is halved in the Counterfactual as compared to the status quo – with that reduction occurring from a level at which Air New Zealand already incurs substantial economic losses. Quite how, or why, Air New Zealand would continue to operate in such circumstances is left completely unexplained.
138. Fourth, it is assumed that in the factual, the Applicants would fly their planes half empty. The assumed load factors are lower than those the Applicants experience on any route they fly at the moment. These load factors imply that the many hundreds of millions of dollars the Applicants have invested in yield management systems serve little purpose. Even if it were the case that loads would be as low as the Commission claims (which the Applicants dispute), the Applicants would surely not keep the capacity they used to serve these routes unchanged. Rather, as they have done on other routes where demand has proved low relative to capacity, the Applicants would reduce capacity, thereby saving costs.
139. In addition to relying on these implausible assumptions, the estimates the Commission has adopted are derived from a model that lacks credibility from a methodological perspective. This model, which reflects the so-called conjectural variations approach to modelling competition, has two serious flaws. The first is that it requires the competing firms to make assumptions about each others' behaviour that are not consistent and would not persist over time. The second is that there are serious, likely intractable, difficulties in empirically estimating models of this kind.



## Applicants' Preliminary Response to Commerce Commission's Draft Determination

140. In the specific case of the Gillen Model, no attempt is made to address these flaws. Rather, these flaws are dealt with by introducing further, arbitrary, assumptions. For example, about the manner in which FSAs compete with each other relative to the manner in which they compete with VBAs and vice versa. As with the assumptions noted above, many of these assumptions are simply inconsistent with what is known about the world. For example, despite extensive empirical evidence to the contrary, the model assumes that VBAs impose less of a competitive constraint on FSAs than FSAs do on each other.
141. Finally, even if a model broadly of the kind the Commission relies on could be accepted, the Commission's model has been so poorly implemented as to not be useable. Three sets of difficulties are involved.
142. First, there are some elementary technical constraints that the Gillen Model does not respect. For example, in a properly specified model of a non-collusive equilibrium, each firm's marginal revenue should be equated to its marginal cost. If a firm's marginal revenue does not equal its marginal cost, that firm would have the incentive to either increase or decrease output in order to increase profits. However, in the Gillen Model, in equilibrium, marginal revenues and marginal costs are not equated.
143. Second, as noted above, key parameters are simply assumed without any attempt being made to test (even if only qualitatively) the plausibility of the values being used.
144. Third, major errors are repeatedly made in the actual calculations. Incorrect values have been inserted into the calculations as references that seem intended to point to one cell or set of cells but in fact, point to other cells. Even more importantly, the errors have not been eliminated in the successive versions of the results that have been issued. Rather, as old errors are corrected, new errors have been introduced.
145. Given the sheer magnitude of the errors, it is unsurprising that the model generates results that are incorrect on their face. This applies both at the more technical level of model detail and as far as the overall estimates are concerned.
146. Thus, in respect of the model detail, the model generates values for some variables that are outside the theoretically conceivable range. For example, the estimate of the conjectural variation parameter for the VBA is greater than the number that can characterise a model of this kind. It was this kind of result that led Haugh and Hazledine, in their earlier work on which Professor Gillen has relied,<sup>95</sup> to stress that their results were 'really very suspicious' and that the estimated 'competitive conjectures are actually seriously wrong. 'Unfortunately, no such 'health warnings' have been attached to Professor Gillen's analysis.
147. Of even greater concern are the manifest errors involved in the overall estimates. Nowhere are these errors more striking than in the latest version of the Gillen Model, and notably in the results of the aggregate model – which is the model the Commission relied on in the Draft Determination.
- While this model previously generated an estimate of a substantial allocative efficiency loss associated with the Alliance, it now generates an allocative efficiency gain. Thus, at the aggregate level, the allocative efficiency detriment

---

<sup>95</sup> Haugh D and Hazledine T, 1999, "Oligopoly Behaviour in the Trans-Tasman Air Travel Market: The Case of Kiwi International", New Zealand Economic Papers 33 (1), 1-25

## **Applicants' Preliminary Response to Commerce Commission's Draft Determination**

from the Alliance has plainly diminished – to the point where there is no longer a social loss.

- However, the disaggregated model, which the Commission had not relied on so far, now generates an increased allocative efficiency loss relative to previous versions. Indeed, by changing the scenarios used to evaluate the loss, the estimated price increase has been doubled from its initial level.

148. The Applicants have serious reservations about the manner in which the Commission has handled these changes. Specifically, without in any way stating that this is what it was doing, the Commission has shifted from using the aggregate model – which would have shown a substantially eliminated allocative efficiency loss – to using the disaggregated model, which it had not used until now but which generates an increased allocative efficiency loss. That said, the fact that the estimates vary in this way highlights the deeply flawed nature of the modelling, and requires the Commission to abandon an effort that has been poorly designed and even more poorly implemented.

### **Productive and dynamic efficiency**

149. The Commission also reaches the preliminary view that the Alliance will cause substantial welfare losses as a result of reductions in productive and dynamic efficiency. The Applicants believe that the Commission's preliminary findings in these respects are also incorrect, for reasons that are summarised below.

#### ***Productive efficiency***

150. The Commission's concern appears to be that were the Alliance to proceed, a degree of 'slackness' (often referred to as X-inefficiency) would set in to the way the Applicants operated, slackness which might manifest itself in ways that include:

- less pressure on input suppliers, including providers of managerial services, to provide as great a contribution as they could;
- the provision of higher payments to input suppliers; and
- resulting reductions in the Alliance's usage of these inputs, and hence, some foregone output.

151. The Applicants believe this concern to be misplaced and the Commission's resulting preliminary estimates of productive efficiency losses to be seriously erroneous, for six reasons.

152. First, the Commission's concerns are based on the assumption that the Alliance would result in a situation in which the Applicants' operations were largely, if not entirely, free from competitive pressures. In fact, the Applicants believe that in the markets most directly affected by the Alliance, they will face continued and indeed intensified competitive pressures, most notably from VBA and fifth-freedom competitors. Additionally, they will face strong competition, as they now do, in the other areas of their operations, including domestic Australia and their respective long haul networks. As these highly competitive markets account for the bulk of the Applicants' combined activity, it is implausible that the Applicants would tolerate the development of inefficiencies that would inevitably and seriously jeopardise their overall viability.

## Applicants' Preliminary Response to Commerce Commission's Draft Determination

153. Second, even if the Alliance did reduce the competitive pressures that the Applicants face, the Commission errs in implying that economic analysis suggests any simple or relevant relation between this diminished competition and productive efficiency.
154. Thus, the main link identified in the economic analysis between competitive pressures and productive efficiency involves the ability of investors to monitor the comparative performance of firms and, on that basis, reward firms that are efficiently managed while penalising those that are not. To the extent to which competitive markets provide investors with a greater range of 'comparator' firms, productive efficiency will be greater in those markets than in markets that are more concentrated.
155. However, the Alliance will not result in any reduction in the capacity or incentive for this type of benchmarking to occur. To begin with, the pool of firms the Applicants benchmark themselves against will not be significantly affected – a pool that includes substantial players such as Singapore Airlines, Cathay Pacific, American Airlines, Emirates Airlines and Southwest. Additionally, the Alliance provides the Applicants with a greatly enhanced ability to benchmark their operations against each other and thus, to identify opportunities to improve productivity. Lastly, the mechanisms contained in the SAA by which the rights to serve routes are awarded under the Alliance create powerful pressures for each of Air New Zealand and Qantas to secure whatever scope there is for further efficiencies to be obtained.
156. Third, to the extent to which the Commission bases its preliminary findings on economic research with respect to aviation, it has done so inappropriately. Thus, the Commission relies mainly on work by Oum and others, and on an OECD study by Gonenc and Nicolletti. Oum et al's study is now dated and, in any event, does not distinguish between the effects of market structure and those of regulation. As for the Gonenc and Nicolletti study, which does provide a more rigorous framework for analysis, it recognises that as well as the effects of changes in market structure, changes in scale and traffic density must be taken into account in assessing the determinants of productive efficiency. When this is done, the model Gonenc and Nicolletti develop cannot properly be used to claim that the Alliance would reduce productive efficiency.
157. Additionally, the Commission has ignored the substantial body of economic work that shows that aviation alliances tend to increase efficiency. This work, which includes studies by Oum, highlights the scope alliances create to secure economies of scale, scope and density and to improve the quality of service customers obtain.
158. Fourth, the Applicants submit that their own experience is directly inconsistent with the Commission's preliminary findings. To begin with, although Qantas experienced a significant increase in its market share as a result of the collapse of Ansett, its productivity increased materially, rather than declined. Additionally, far from become 'slacker' in its efforts to reduce costs, Qantas has retained, and indeed intensified, its drive to secure efficiencies. Finally, Qantas' experience with its Joint Services Agreement with British Airways confirms the many ways in which aviation alliances can bring about substantial efficiency improvements.
159. Fifth, the preliminary approach the Commission has adopted to quantifying the productive efficiency detriments is incorrect in that it involves triple counting. In effect, the Commission counts the same foregone cost savings three times – directly in the calculation of productive efficiency detriments with respect to existing demand, then again in the calculation of dynamic efficiency losses, and finally in the calculation of the allocative efficiency detriment. The Commission then adds each of these detriments up, ignoring the fact that they overlap.

## **Applicants' Preliminary Response to Commerce Commission's Draft Determination**

160. Sixth, unsurprisingly, the resulting preliminary estimate is implausible on its face. In effect, the estimates imply that the Applicants would allow cost excesses to absorb all of the producer surplus gain from the Alliance. Indeed, given the losses such cost excesses would inevitably cause on other parts of the Applicants' operations (as too high wages and too generous conditions spilled over, as they would, into Qantas' route structure as a whole), the result would be that the Applicants would be substantially worse off with the Alliance than without it.
161. These difficulties, including the triple counting, have not been addressed by the Commission in its revised estimates. In fact, in these revisions, the Commission has materially increased the estimated productive efficiency losses largely because an arbitrarily higher variable cost estimate has been assumed (0.77 of total revenue rather than 0.65 as in the original estimates). The Applicants believe that this estimate lacks credibility: for whereas the original estimate did not fully absorb the profits the Applicants could expect from the Alliance, the revised estimate implies that even on the routes most directly affected by the Alliance, the Applicants now lose more from cost increases than NECG suggested they could ever gain in profits from it. Quite why the Applicants would be willing to enter into the Alliance, given that it will make them materially worse off, is left completely unexplained.

### ***Dynamic efficiency***

162. Finally, the Commission says that the Alliance would result in substantial dynamic efficiency losses. The Commission's preliminary finding is based on the belief that VBA entry is less likely in the Factual than in the Counterfactual. Given this, the Commission asserts that the Alliance will lead to the cost savings associated with VBA entry being foregone.
163. The Applicants do not accept that VBA entry is less likely in the Factual than in the Counterfactual – and indeed, the Commission's own modelling suggests a VBA entrant would be substantially more profitable in the former than in the latter. As a result, the Applicants believe the Commission is incorrect in advancing the view that differences in the likelihood of entry provide a basis for attributing a dynamic efficiency loss to the Alliance.
164. Additionally, the Applicants note that the Commission's quantification of this loss involves major errors.
165. To begin with, the Commission considers the entire difference in cost between the VBA and the incumbents as a saving to society. This ignores the fact that in the Commission's own modelling, the VBA provides an inferior service relative to that supplied by the incumbents. Any cost differentials therefore need to be discounted for the substantial difference in service that the Commission's description of its demand modelling entails.
166. Second, the Commission completely ignores the fact that the VBA it models is highly likely, if not certain, to be non-New Zealand owned. As a result, the Commission does not properly calculate the detriment to New Zealand associated with the transfer of profits to foreign shareholders.
167. Finally, the Commission double counts the efficiency loss it claims to have identified. In effect, the cost difference at issue is already reflected in the allocative efficiency modelling.

## **Applicants' Preliminary Response to Commerce Commission's Draft Determination**

168. Although the Commission has not revised the aggregate amount of these estimated losses in its latest revisions, it has changed their composition. These changes are difficult to interpret, as they involve using parameters (notably for the elasticity of demand) that differ from those used in the modelling of allocative efficiency detriments and strictly speaking, imply a breach of technical conditions that a demand equation must meet. These changes, therefore, merely make it all the more important that the Commission does not continue to persist with estimates that do not stand up to scrutiny.

### **CONCLUSIONS**

169. While the Applicants acknowledge that the Draft Determination contains only the Commission's preliminary analysis and preliminary views, the Applicants have a number of serious concerns with the Commission's preliminary approach. These concerns are compounded by the way in which changes have recently been made to the Commission's approach to modelling, which remains deeply flawed. In the Applicants' view, if the issues raised in this paper were not to be rectified in the Commission's final determination, the Commission's weighing process would be inappropriately skewed to the detriment of the Applicants.
170. The Applicants submit that the Commission should give adequate consideration to the weight of evidence before it and be slow to reject the tested analysis and statements of two large listed companies in favour of the untested and equally partial views of third parties.