

# Structural change in the global aviation industry

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## The Issue

- 2.1 In its Draft Determination the Commission reached a 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>1</sup>
- 2.2 This chapter describes the present crisis in the global airline industry and demonstrates why it is **not** short term in nature. It also shows why it is not reasonable to assume that either Australia or New Zealand is protected from the crisis. The purpose is to ensure that the Commission has the necessary information on the changed structure of the industry, and the resulting changes in its conduct and performance. Without this information about the behaviour of suppliers and customers in the airline industry, there is a risk that the Commission will misapply competition law and policy, including by applying “old learning” that was relevant before the underlying structure, conduct and performance of the industry changed.
- 2.3 The Applicants have already provided the Commission with substantial and largely uncontested evidence that there has been significant structural change in the airline industry, separate to but reinforced by cyclical fluctuations and external shocks.<sup>2</sup> Its impact has been largely accepted by the Commission in the Draft Determination. This paper provides further detail and context, and cross-references a large number of analytical articles and papers written by experienced and qualified industry experts and commentators. The detail provided and conclusions reached in the chapter are not merely the views of the Applicants, fashioned to support their applications – they are the well understood and well accepted views of the aviation industry and its wider industry associates and commentators.
- 2.4 There have been profound structural changes in the airline industry, manifested in:

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<sup>1</sup> Commission Draft Determination, paragraph 277.

<sup>2</sup> See Applicants’ submission *Review of the draft determinations: Commerce Commission’s preliminary analysis and methodology*.

- the emergence and success of a new business model for airlines, namely low cost carriers or value based airlines (VBAs)<sup>3</sup>; and
- changes in patterns of passenger demand and attitudes to acceptable fare levels<sup>4</sup>.

2.5 The factors contributing to these changes include<sup>5</sup>:

- deregulation;
- globalisation;
- changes in technology, including aircraft and communications technology; and
- exposure of inefficiencies in the old full service network carrier or “full service airline” (FSA) business model.

2.6 These changes predate the more recent external shocks, such as the terrorist attacks of 11 September 2001 and the resulting increase in security costs, the wars in Afghanistan and Iraq, and the SARS outbreak. However, the impact of these shocks has exposed and exacerbated the effects of the structural changes.

2.7 Australia and New Zealand are insulated neither from the structural changes nor from the impacts of the recent external shocks.

2.8 Failure to recognise these changes and impacts has material consequences for market definition, for the identification of the correct counterfactual and its implications, for the assessment of the likelihood of entry by new carriers and, in particular, expansion by Virgin Blue, and for the measurement of the benefits and detriments flowing from the Alliance.

2.9 This chapter will go on to describe:

- the structure of the industry under the “old” FSA model and resulting competitive conduct and performance;
- the forces that led to the emergence and success of the “new” VBA model, and its impact on the conduct and performance of the industry;
- the appearance of the new model in Australasia;
- the recent external shocks, and their impact in Australasia; and
- the likely future for both models.

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<sup>3</sup> Commission Draft Determination, paragraph 137.

<sup>4</sup> Commission Draft Determination, paragraph 142.

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## The old airline model

- 2.10 Advances in aviation technology, in particular the introduction and subsequent increasing efficiency of the jet engine, allowed airlines to cut real unit costs dramatically in the 1950s and 1960s and extend the range of routes that could be served. New, larger models of aircraft were introduced, often in reaction to competition from other airlines, at a rapid pace.<sup>6</sup> The modern FSA emerged out of this period of technological change.
- 2.11 The archetypal airline was (and arguably still is) an FSA<sup>7</sup>. Its competitive focus was on network and product quality.<sup>8</sup> The emphasis was on providing services to as many cities as possible and providing high levels of frequency and interconnectivity. This required investment in aircraft of different sizes and ranges, IT systems and other facilities and infrastructure to support complex itineraries within and between airlines. FSAs also provided amenities such as inflight catering and entertainment, extra leg room, and lounges and loyalty programs, with the extent of the service provided being differentiated by class of travel.
- 2.12 An important feature of this airline model is the extensive use of price discrimination, relying on a combination of restrictive conditions on tickets and time of purchase, limiting the flexibility of passengers' travel arrangements. This allows airlines to cover fixed costs by tapping the higher willingness to pay of some passenger segments as compared to others. Price discrimination is implemented by means of complex revenue management systems, which themselves require substantial investment in IT systems not only for yield management but also for ticketing and revenue reconciliation.<sup>9</sup>
- 2.13 Reflecting the importance FSAs place on connectivity, other important features which have come to characterise many FSAs have been some degree of reliance on a "hub and spoke" network structure, and the use of alliances (ranging from simple code shares

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<sup>5</sup> Some of these factors have been recognised by the Commission; see draft determination, paragraph 135.

<sup>6</sup> Rigas Doganis (2002), *Flying off course: The economics of international airlines*, page 13.

<sup>7</sup> Examples of FSAs are: Singapore Airlines, British Airways, United Airlines, American Airlines, Qantas and Air New Zealand.

<sup>8</sup> See *Airline Strategy*, Air NZ powerpoint presentation to the Commission 13 March 2003, slide 11.

<sup>9</sup> See Michael E. Levine, *Pricing Discrimination without market power*, Harvard Law School Discussion Paper No. 276 2/2000 for an outline of the theory and practice of price discrimination by FSAs (available at [http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/276.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/276.pdf)), and McKinsey Quarterly, *Europe's best airline network managers may have won an unassailable lead*, 1997 Number 3, for a description of IT systems employed by network carriers.

- to global marketing alliances) to extend network reach, enhance service quality and reduce some elements of cost.<sup>10</sup>
- 2.14 The FSA model entails high costs, many of them fixed, and relies on economies of network size and traffic density to bring unit costs down. High fixed costs and the resulting need for complex pricing, plus the highly income elastic nature of demand for air travel, have made airline profits highly cyclical. As well, the profitability of FSAs has been exposed to frequent cost shocks (such as those arising from changes in fuel prices and in exchange rates). In earlier times, governments attempted to provide some degree of stability by nationalising air carriers and protecting them with a regulatory regime based on public convenience and necessity. In recent decades, most governments have chosen to privatise and deregulate aviation.
- 2.15 Initially, airline competition was largely confined to competition between FSAs. These carriers have been shown to be capable of being relatively intense competitors, with periodic and severe price and capacity wars in areas where FSA networks overlap. As a result, many FSAs have failed to earn their cost of capital over the longer term. This has progressively weakened their capital base, and made a number of them highly vulnerable to bankruptcy. Reflecting this underlying weakening in the industry's capital adequacy, large (and in some cases even moderate) shocks have forced numerous airlines either into liquidation or into severe contraction.
- 2.16 One result of this process is that even when FSAs have had the market virtually to themselves, few city pairs have durably "supported" more than two carriers, each strong at one end of the route. Rather, economics of scale and density – including the tendency for the airline with the greater city presence at one end of a route to get higher yields and profits, essentially through its ability to attract a disproportionate share of business travel – has forced FSAs that lacked durable strength out of most routes.
- 2.17 The FSA product is remarkable, providing high interconnectivity within and between airlines for relatively low transaction costs for the passenger. This is a high value outcome for the passenger with a complex itinerary or requiring flexibility in his or her travel arrangements. However, the same airline and systems also service passengers with simple point to point itineraries.
- 2.18 While this model provides a remarkable product, that segment of passengers who have simple point to point itineraries (requiring little or no connectivity) and who place a lower value on extra amenities have been "lumped together" with those who have complex

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<sup>10</sup> The emergence of global alliances in the airline industry, and the nature of hub and spoke competition, is outlined in detail in the background note to the OECD roundtable on airline mergers and alliances (2001), available at

itineraries and who place a higher value on amenities. To the extent that this segment of the market could be served more efficiently on a stand-alone basis, the traditional FSA model has therefore involved diseconomies of scope, which might not be offset by greater economies of traffic density or network size. The competitive risks this entails have obviously been all the greater when inappropriate pricing has forced the point to point customers to pay higher fares than they could have secured from a stand-alone service.

- 2.19 As Michael Tretheway, a Canadian economist specialising in the aviation industry, notes, “network carrier provision of high connectivity services to **all** passengers is sub-optimal” [emphasis added]<sup>11</sup>. It is this sub-optimal element that has created substantial space for the entry by point-to-point suppliers described below.

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## Changes in the markets

- 2.20 Demand for air travel grew rapidly in the last decades of the twentieth century, at a rate faster than the growth in the general economy. Aviation markets increased in size dramatically, both in aggregate and individually.<sup>12</sup> In the 1950s and 1960s, when aviation was a relatively new industry, the world’s air traffic grew at about 14-15 per cent each year. In the 1970s, annual growth was close to 10 per cent, in the 1980s close to 6 per cent, and in the 1990s around 5 per cent. Most long term forecasts for the first decade of the new millennium are also just above or below 5 percent. In absolute terms, because of the much higher passenger base, a 5 per cent increase at the current time represents a much greater rise in demand than 10 per cent annual growth thirty years ago.<sup>13</sup>
- 2.21 At the same time, deregulation, which had started in the late 1970s, and privatisation, which started in the 1980s, accelerated and became more widespread, increasing competition between incumbent airlines and removing regulatory impediments to entry. The United States adopted an “open skies” policy in 1992, based on the negotiation of liberal Air Services Agreements with other countries. While still negotiated under the bilateral framework established by the Chicago Convention, these agreements generally incorporated:
- open entry on all routes between the bilateral partners;

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<http://www.oecd.org/pdf/M00007000/M00007731.pdf>.

<sup>11</sup> Dr Michael W. Tretheway, *Why the Network Airline Model is Broken*, paper presented to Hamburg Aviation Conference, February 2003, page 2.

<sup>12</sup> Commission Draft Determination, paragraph 135.

<sup>13</sup> See Rigas Doganis (2002), *Flying off course: The economics of international airlines*, page 4.

- unrestricted rights to operate between any international gateways in the United States and participating countries, including intermediate and beyond points;
- unrestricted capacity, frequency and aircraft on all routes; and
- flexibility in setting fares within certain guidelines.<sup>14</sup>

2.22 In the 1990s, as businesses continued to expand internationally and large multinationals grew through mergers and acquisitions, there was an increasing expectation that major service providers would be able to do business with them on a global scale. Airlines were no exception.

2.23 Initially, this was considered a nearly impossible task for most of the world's major airlines. The high cost of operating an airline prevented the vast majority of independent operators from expanding on a global scale. The national regulatory requirements in bilateral Air Services Agreements dealing with national ownership and control of designated carriers, and limitations on the traffic rights of foreign airlines, also limited the ability to expand networks.

2.24 In order to meet the growing pressure to deliver a global solution, airlines began forming alliance networks based on the recognition that no single airline could address all of its customers' needs in the areas of service or network coverage. The expansion in the number of airline alliances and cooperation between individual airlines or groups of airlines was explained by Joos Stragier<sup>15</sup> in a paper presented at the 13th Annual Conference of the European Air Law Association as follows:

“Air carriers in Europe also recognise that they will need to expand beyond their national home markets, through mergers and acquisitions, in order to build up larger networks and gain economies of scale. However, the current system of bilateral agreements for international air services with its nationality restrictions and designation rules and general restrictions as far as foreign ownership of airlines is concerned are clear handicaps for this natural process to take place. In this context airline alliances have come up as a partial and provisional answer to the need for restructuring and consolidation.”<sup>16</sup>

2.25 As noted by Mr Stragier, global airline alliances such as the Star Alliance and **oneworld** are only a partial and provisional answer to the need for restructuring and consolidation

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<sup>14</sup> See *International Air Services (Report No 2)*, Productivity Commission inquiry report, Chapter 4. This is available on the internet at <http://www.pc.gov.au/inquiry/airserv/finalreport/index.html>

<sup>15</sup> Head of Transport Unit, DG Competition, EC Commission.

<sup>16</sup> Paper presented by Joos Stragier at the 13th Annual Conference of the European Air Law Association, Zurich, Friday 9 November 2001.

in the airline industry. However, they do not address supply side issues, including the need for FSAs to consolidate to reduce costs.

2.26 There were also significant changes in aviation technology during the 1990s. The flying range of medium sized aircraft was increased, allowing more direct non-stop flights on “thinner”, long haul flights that could not support large traditional long-haul aircraft. Small, efficient and light jet engines were developed that could power small passenger airline services that had previously been dependent on turbo-propeller engines.<sup>17</sup>

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## The new airline model

2.27 Growth of demand and deregulation facilitated the emergence of a new airline business model, the low cost carrier or value based airline, providing simple point to point itineraries.<sup>18</sup> Whereas FSAs’ competitive focus is on network and product quality, low cost carriers’ focus is almost entirely on cost.<sup>19</sup> The growth of VBAs has changed the nature of airline competition.

2.28 Although low cost carriers come in many different shapes and sizes, features common to the business model of many VBAs<sup>20</sup> include:

- simple point to point services with no or limited interconnectivity on short haul routes;
- fewer inflight and on ground amenities, leading to lower costs (especially as a result of having more seats on the aircraft);
- single class operations with greater seat density and lower costs per seat;
- uniform fleet, leading to lower operating and maintenance costs;
- in the US and Europe, use of secondary, less congested and cheaper, airports;
- lower labour costs;
- high aircraft utilisation;
- lower cost distribution channels, especially the Internet; and

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<sup>17</sup> For example, the Canadair 50 seater services Regional Jet (launched in 1992), and the Embraer ERJ 145 (launched in 1997) offered faster and more comfortable jet travel on thinner short haul routes previously the preserve of turbo-prop aircraft. See Rigas Doganis (2002), *Flying off course: The economics of international airlines*, page 11.

<sup>18</sup> Commission Draft Determination, paragraph 140.

<sup>19</sup> See *Airline Strategy*, Air NZ powerpoint presentation to the Commission 13 March 2003, slide 11.

<sup>20</sup> Examples of VBAs are: Southwest, Ryanair, easyjet, WestJet and Virgin Blue. See Commission Draft Determination paragraph 137.

- a different, and simpler, form of price discrimination based on time of purchase.
- 2.29 The initial VBAs (with the exception of Southwest) had not yet perfected this model. Poorly capitalised VBAs were not able to sustain their operations in the face of capacity expansion by FSAs. In recent times, however, VBAs are better capitalised, and smarter about their market entry. For example, when WestJet entered the Canadian domestic market in 1996, it owned rather than leased its aircraft (reducing cash outflow in the initial market building period), and was capitalised with a significant amount of cash, allowing it to withstand capacity expansion or other actions by incumbent carriers.
- 2.30 The most remarkable aspect of the performance of the new model in recent years, both before and during the recent shocks, has been the ability of the VBAs to win significant market share from even the most efficient of FSAs, and to outperform FSAs on the key financial measures of profitability and market capitalisation. VBAs have achieved the highest market capitalisation of any passenger air carriers in the United States (Southwest), Canada (WestJet) and the European Union (Ryanair).<sup>21</sup> Very high market capitalisation relative to the value of their physical assets is indicative of expectations of, and an ability to finance, substantial further growth in net revenues and market shares. In turn, the leading VBAs typically have financial structures which are far stronger and more resilient to shocks than those of even their most efficient FSA competitors.
- 2.31 The financial strength of VBAs is manifested in the number of aircraft which they have on order. At a time when many FSAs are in or threatened with bankruptcy, VBAs collectively have more than a thousand aircraft on order.<sup>22</sup>
- 2.32 History shows that, while VBA entry stimulates demand and more passengers travel, fares also decrease across the board, resulting in total market revenue generally remaining relatively static.
- 2.33 VBAs' market share gains do not come only from the leisure segment. Business travellers are able to take advantage of the simpler approach to price discrimination used by VBAs, and so the FSAs' higher yielding business traveller segment also suffers. Increasingly, VBA product offerings are designed to and do service an important part of the business traveller segment.<sup>23</sup> As a result, VBAs thrive and FSAs suffer. Faced with a

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<sup>21</sup> Dr Michael W. Tretheway, *Why the Network Airline Model is Broken*, page 3.

<sup>22</sup> The annual reports of VBAs reveal that they have the following numbers of aircraft under firm order or on option: Southwest: 430 JetBlue: 290, EasyJet: 240; Ryanair: 150; WestJet: 90; Virgin Blue: 50.

<sup>23</sup> For example, on 15 May 2003 Virgin Blue announced that it would commence a new Adelaide-Canberra service. Sir Richard Branson stated that this new service was "timed to serve with the business market". He also stated that Virgin Blue's new terminals "are attracting business travellers and this will continue to grow market share and yields". Virgin Blue confirmed recently that business travellers now form the largest group of



loss of market share to VBAs, FSAs find it difficult not to move backward up the unit cost curve (which slopes downward because of economies of traffic density), while the VBAs move to lower and lower unit cost levels by exploiting traffic density economies. With a loss of collective market share to VBAs, the FSAs may need to consolidate in order to maintain their unit costs at existing levels. This will become especially important as the VBAs move from fleets of 40 or fewer aircraft to fleets as large as or larger than the FSAs.

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## The new model in Australia and New Zealand

- 2.34 Under the Single Aviation Market, Australia and New Zealand form one of the most deregulated markets in the world.<sup>24</sup> Both Australia and New Zealand have also removed restrictions on foreign ownership of domestic airlines. The removal of domestic entry barriers (other than those based on safety) and important economic features have made Australian and New Zealand routes as contestable as any domestic market in the world. Under the Single Aviation Market, Qantas and Virgin Blue can compete with Air New Zealand in New Zealand on an equal footing. Air New Zealand exercised the opportunity to compete in the Australian domestic market through its ownership of Ansett, but was not successful.
- 2.35 On the Tasman routes, Australia and New Zealand permit open access for all qualified Australian and New Zealand airlines. Both governments have also provided opportunity for further competition by granting fifth freedom rights to a vast number of third country airlines. In recent years, rights for third party carriers have expanded substantially, reflecting the liberal attitudes of both the New Zealand and Australian governments to third country carriers' access to the Tasman and other international routes. The announcement by Emirates on 9 June 2003 that it would introduce, over the next few months, 21 weekly services in each direction between Sydney/Melbourne/Brisbane and

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customers of Virgin Blue, ahead of leisure travellers and people travelling to visit friends and family. See *Cheaper tickets sideline options*, the Australian newspaper, 13 June 2003.

<sup>24</sup> See *International Air Services Policy Statement* by The Hon John Anderson MP, Deputy Prime Minister and Minister for Transport and Regional Services (June 2000) (located at <http://www.dotars.gov.au/avnapt/ipb/intairservices.htm#2.2>) for an outline of the reforms introduced in Australia to:

- liberalise international air services arrangements;
- liberalise ownership of Australian airlines;
- allocate capacity under Australian air services arrangements; and
- liberalise international aviation multilaterally

Auckland<sup>25</sup> illustrates the competitive effect of the liberal air services regulatory regimes in New Zealand and Australia.

- 2.36 In operational terms, new entrant airlines in Australia and New Zealand need to target only a handful of city pairs to get access to the bulk of the available traffic.<sup>26</sup> Furthermore, a large proportion of available traffic on these city pairs is point to point and not reliant on feed or connectivity.<sup>27</sup>
- 2.37 Moreover, there are few if any “secondary airports”, so that the impact of VBA entry is felt directly and immediately in incumbent FSAs’ home sector markets.
- 2.38 VBAs are not as interested in connectivity and feeder traffic if this incurs significant cost. They therefore choose routes without fear of detriment to the broader network – which is a problem FSAs competing with other FSAs in long haul markets cannot ignore, even on the short haul sectors.
- 2.39 The VBA model has therefore had a dramatic impact in Australia, with the launching in 2000 of Impulse Airlines and of Virgin Blue. After a relatively brief period of intense competition and the failure of Impulse Airlines and Ansett Australia, Virgin Blue has, on latest estimates, emerged with 33% EBIT share in the Australian domestic market for only 23% market share.<sup>28</sup>
- 2.40 Virgin Blue also has highly publicised plans for:
- fleet expansion<sup>29</sup>;
  - a share market IPO<sup>30</sup>; and
  - network expansion to the Tasman, New Zealand domestic and other international markets.<sup>31</sup> Most recently, on 12 June 2003, Virgin Blue applied to the Australian International Air Services Commission for capacity to New Zealand, Fiji and Vanuatu, effective October 2003.

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<sup>25</sup> Emirates will commence with 14 Tasman weekly services each way in August 2003, increasing to 21 from 26 October 2003. These services will be extensions of Emirates Dubai – Australia flights.

<sup>26</sup> The Commission acknowledges that the main New Zealand “trunk” routes account for 80% of all flying in New Zealand. See draft determination, paragraph 174.

<sup>27</sup> See Applicants’ submission regarding *VBA entry*.

<sup>28</sup> Figures reported in Australian Financial Review, *Virgin gives Qantas the blues*, 17 May 2003. Note that the 23% market share was Virgin Blue’s average market share over the year in question.

<sup>29</sup> For example, Virgin Blue media release, *Virgin Blue’s going Boeing: \$5.4 billion for up to 50 new aircraft*, 16 January 2003.

<sup>30</sup> Confirmed by Sir Richard Branson at Adelaide press conference, 15 May 2003.

<sup>31</sup> Confirmed by Sir Richard Branson at Adelaide press conference, 15 May 2003.

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## Recent shocks

- 2.41 In 1998 global aviation had its best year ever, with global profits of US\$3.1 billion. Qantas and Air New Zealand also recorded strong profits around this time. Qantas recorded a net profit of A\$442.9 million in 1998/1999, and Air New Zealand a net profit of NZ\$214.4 million.
- 2.42 However, even before the terrorist attacks of 11 September, 2001 in the US, there were warning signs for many carriers. Business travel in key long haul markets, across the Atlantic and the Pacific, and between Europe and East Asia, started to fall off during 2001.<sup>32</sup> The decline in the profitability of the United States aviation industry for the year ended 30 June 2001 was the largest year-over-year decline ever up to that point in time.<sup>33</sup> The decline accompanied aggressive price cuts as airlines tried to stimulate demand.<sup>34</sup>
- 2.43 Then, in rapid succession, the airline industry was faced with the terrorist attacks of 11 September 2001, increased security measures, the wars in Afghanistan and Iraq, and the outbreak of the SARS virus. Each of these events affected airlines, primarily as a result of dramatic and sudden reductions in passenger demand. Ansett Australia entered into administration in September 2001, and ceased its (by then substantially reduced) flying in March 2002. In October 2001, Swissair and Sabena Airlines filed for bankruptcy in Europe. The characteristics of these failed airlines included:
- small home markets relative to the markets around them;
  - poor balance sheet gearing; and
  - in some cases, the entry of a VBA competitor.
- 2.44 It is not simply the smaller FSAs which have suffered. In the United States, U.S. Airways and the world's second largest airline, United Airlines, filed for protection under Chapter 11 of the U.S. Bankruptcy Code in August and December 2002. Air Canada filed for bankruptcy in April 2003.
- 2.45 Other FSAs continue to adjust to these shocks. For example, American Airlines announced 7,000 job cuts in April 2003, and reached deals with unions to cut the wages of thousands of workers by 15 to 20 percent in an attempt to restructure without formally

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<sup>32</sup> Rigas Doganis (2002), *Flying off course: The economics of international airlines*, page 19.

<sup>33</sup> Statement of Jeffrey Shane, Associate Deputy Secretary U.S. Department of Transportation, to the January 2003 U.S. Senate committee hearing on the financial condition of the airline industry. This statement is available at <http://www.senate.gov/~commerce/hearings/witnesslist.cfm?id=715> ).

<sup>34</sup> McKinsey Quarterly, *Rethinking the aviation industry*, 2002 Number 2, page 2.

seeking bankruptcy protection from the courts. It is hoped that these measures will save the airline around US\$1.8 billion. British Airways has recently cut 3,000 jobs. Continental Airlines has cut 5,500 jobs since September 2001, including 25 per cent of its top management.<sup>35</sup>

2.46 U.S. carriers lost more than US\$10 billion in 2002, up from US\$8 billion the previous year. Worldwide, losses were more than US\$50 billion.<sup>36</sup> Fundamentally, the world's major airlines have failed to find a business model that provides them with sustainable margins in a competitive environment- with shocks and downturns changing what are already too low accounting profits into a sea of red ink.

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## Impacts in Australia and New Zealand

2.47 The Australian and New Zealand aviation market is a microcosm of the global aviation industry. Existing FSAs in this market:

- have a high cost structure, and a limited ability to change this;
- are faced with a new VBA entrant with the ability to secure significant market share and to expand this share significantly;
- are faced with competition from other FSAs which benefit from regulated markets or government subsidised capital;
- should be consolidating to reduce their cost base in order to maintain economies of traffic density and compete effectively with VBAs.

2.48 Air New Zealand is in a similar situation to many of the failed airlines mentioned above, in that:

- it operates in a small domestic market;
- its profitability is related to short haul services which are most vulnerable to VBA entry;
- its domestic network is threatened with envelopment by the network of another FSA;
- it has a weaker balance sheet than its major FSA competitors; and

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<sup>35</sup> CBC news online, *World airline woes: Carriers hit financial turbulence*, 2 April 2003, available at <http://www.cbc.ca/news/aircanada/airlinewoes.html>.

- it is attempting to reduce costs, but does not have the “Chapter 11” style methods of reconstruction available to it to match the cost of new entrants.
- 2.49 The recent shocks continue to have an impact on the operations of Qantas and Air New Zealand. On 28 March 2003, Qantas announced significant reductions in its planned international flying as a result of the war in Iraq and the effects of SARS.<sup>37</sup> On 7 May 2003, Qantas announced to the Australian Stock Exchange that it had downgraded its 2002/2003 profit forecast as a result of the continued impact of the SARS virus across all sections of the aviation and tourism.<sup>38</sup>
- 2.50 On 20 March 2003, Air New Zealand announced to the New Zealand Stock Exchange that SARS and the impending war in Iraq had resulted in a substantial softening in forward bookings on its international flights.<sup>39</sup> On 15 May 2003, Air New Zealand announced to the Stock Exchange that it would reduce its international capacity by 8% of its total available international capacity from May to September 2003, following a long term analysis of the continued general downturn in demand for travel on some international routes, including those Asian countries affected by SARS.<sup>40</sup>

## The future of the old model

- 2.51 The airline industry will not see the demise of FSAs. These carriers provide a valuable product for which there is ongoing demand, but they now must share the market with the low cost carriers and necessarily survive on lower market shares and lower revenues.
- 2.52 FSAs will continue to compete vigorously with each other on long haul routes. Neither Qantas nor Air New Zealand operate out of a “fortress hub” such as is seen in North America, Europe and Asia and are therefore weaker, in network terms, than many of their FSA competitors. That said, it is apparent that Qantas is by far the stronger of the two carriers, given its scale, the size and more rapid growth of its home market and its capacity largely to envelope Air New Zealand’s network.

<sup>36</sup> See Tim Hansson, Jurgen Ringbeck and Markus Franke, *A new business model for the airline industry*, Strategy and Business Magazine, Summer 2003, page 80.

<sup>37</sup> Qantas press release at <http://www.qantas.com.au/regions/dyn/au/publicaffairs/details?ArticleID=2003/mar03/2895>.

<sup>38</sup> Qantas press release at <http://www.qantas.com.au/regions/dyn/au/publicaffairs/details?ArticleID=2003/may03/Q2915>.

<sup>39</sup> Air New Zealand statement to New Zealand Stock Exchange at [http://www.airnz.co.nz/resources/air\\_nz\\_forward\\_bkgs.pdf](http://www.airnz.co.nz/resources/air_nz_forward_bkgs.pdf).

<sup>40</sup> Air New Zealand statement to New Zealand stock exchange at [http://www.airnz.co.nz/resources/intl\\_capacity\\_reduct\\_15may03.pdf](http://www.airnz.co.nz/resources/intl_capacity_reduct_15may03.pdf).

- 2.53 An FSA may exercise a significant competitive constraint on other FSAs by virtue of operating as a “fifth freedom” carrier and having the ability to withdraw and deploy capacity in a flexible manner.
- 2.54 In many situations there will not be a regulatory “level playing field”. While Australia and New Zealand operate in one of the most deregulated aviation environments in the world, many FSAs have the benefit of profits from regulated markets and capital on which a return is not required.
- 2.55 What is required to ensure survival is one or both of further deregulation of bilateral and national ownership rules to allow true mergers, and consolidation and the demise of a number of the FSAs.<sup>41</sup>
- 2.56 The Commission appears to believe that Air NZ can reinvent itself as a low cost carrier. Here it need only be noted that no airline anywhere has yet succeeded in doing this and that this is unlikely to happen in a market characterised by overlapping expansion by a larger and financially stronger FSA, entry or expansion by a successful VBA, and external shocks of the magnitude of those encountered recently. Ansett Australia failed under the impact of the first two; Air NZ faces all three.

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<sup>41</sup> Dr Michael W. Tretheway, *Why the Network Airline Model is Broken*, page 9.

## Global airline industry timeline 1995-2003

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1995	<b>November:</b> EasyJet airlines commences operations in Europe
1996	
1997	
1998	Global industry profits peak at US\$3.1 billion
1999	
2000	<b>July:</b> Vanguard Airlines file for bankruptcy in the U.S.
2001	<b>September 11</b> terrorist attacks <b>October:</b> Swissair and Sabena file for bankruptcy in Europe War in Afghanistan commences Global airline industry records a US\$18 billion loss (IATA)
2002	<b>August:</b> US Airways files for protection under Chapter 11 of the U.S. Bankruptcy Code <b>December:</b> United Airlines files for protection under Chapter 11 of the U.S. Bankruptcy Code Global airline industry records a \$US 13 billion loss (IATA)
2003	<b>February:</b> SARS outbreak <b>March:</b> War in Iraq commences <b>April:</b> Air Canada files for bankruptcy protection

## Australia and New Zealand airline industry timeline 1995-2003

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1995	<p>Ansett International commences trans-Tasman services</p> <p><b>October:</b> Freedom Air commences services</p> <p>ACCC authorises Qantas/BA Joint Services Agreement</p>
1996	<p>Australia – New Zealand Single Aviation Market Arrangements entered into</p> <p><b>September:</b> Kiwi international enters into liquidation</p> <p><b>October:</b> Air NZ acquires 50% stake in Ansett</p>
1997	<p>Ansett International discontinues trans Tasman services</p> <p>Origin Pacific commences operations in domestic New Zealand</p>
1998	<p>Global aviation had its best year ever. Qantas recorded a net profit of A\$442.0 million in 1998/1999; and Air New Zealand a net profit of NZ\$214.4 million.</p>
1999	<p>Air NZ and Ansett join the Star Alliance</p> <p>Qantas becomes a founding member of the oneworld alliance</p>
2000	<p><b>March:</b> Air NZ acquires remaining 50% interest in Ansett from News Limited</p> <p>The Australian Government amends foreign investment guidelines to allow foreign airlines to acquire all the equity in an Australian domestic airline, or start a new domestic airline</p> <p><b>August:</b> Virgin Blue commences domestic Australian operations</p> <p>Ansett NZ sold to Tasman Pacific, operates in domestic NZ under a Qantas NZ franchise</p> <p>ACCC authorises Qantas/BA Restated Joint Services Agreement</p>
2001	<p><b>March:</b> Ansett acquires Hazleton Airlines</p> <p><b>April:</b> Tasman Pacific ceases operating</p> <p><b>May:</b> Qantas acquires Impulse Airlines</p> <p><b>September 14:</b> Ansett voluntary administrators cease operations</p> <p><b>October:</b> NZ Govt agrees to recapitalisation program for Air NZ</p>
2002	<p><b>March:</b> Ansett ceases operating</p>



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June 19, 2003

The Chairman  
**Commerce Commission**  
PO Box 2351  
Wellington, New Zealand

Dear Sir:

**Re: Air New Zealand & Qantas - Applications for Authorisation**

I am Dr. Michael W. Tretheway. I hold a Ph.D. in economics from the University of Wisconsin, where my thesis was a productivity and cost study of the U.S. Airline Industry. From 1983-1996 I was Associate Professor of Transportation and Logistics in the Faculty of Commerce of the University of British Columbia. I continue to hold the title of Adjunct Professor with UBC. In 1994 I was a visiting fellow at the Australian Bureau of Transport and Communications Economics. Since 1997, I have been Vice President and Chief Economist with InterVISTAS Consulting Inc., an employee owned transportation economics consulting practice of 40 individuals.

I have written several books on transportation economics, including *Airline Economics*, published by the UBC Centre for Transportation Studies. I am currently completing a book to be published by Ashgate Publishing on *Airport Economics*. I have written roughly 40 scholarly papers on transportation economics subjects in journals such as the *Rand Journal of Economics*, the *Journal of Air Transport Management*, *Annals of Air and Space Law*, the *Journal of Transportation Economics and Policy*, and others. I have written on matters of airline cost and industry structure, entry barriers into the airline industry, empirical studies of industry efficiency, industry institutions (such as IATA, ICAO, international air services agreements), and various management practices (such as airline seat management).

I was Director of Research for the Canadian Ministerial Task Force on International Air Policy, and authored the five volume report produced by the Task Force. I have been a consultant and expert witness on aviation matters for the Canadian Bureau of Competition Policy, including two proceedings before the Competition Tribunal on Computer Reservation Systems, a major proceeding on the issue of avoidable costs as the first phase of an application by the Commissioner of Competition Policy alleging predatory pricing by a major air carrier, and on several airline mergers.

I have appeared before the predecessor of ACCC as an expert witness on behalf of Qantas and British Airways in their application to undertake a joint services agreement, and before the NZCC on behalf of Qantas in the matter of the acquisition of Ansett Australia by Air New Zealand. I also note that I submitted an expert witness statement to the ACCC on behalf of IATA in the matter of their application to continue the IATA travel agency program in Australia.

I have been asked by counsel for Air New Zealand and Qantas to review Chapter 2, titled "Structural change in the global aviation industry", in their submission to the Commission dated 20 June 2003.

I have read Chapter 2 of the submission dated 20 June 2003 and I confirm that I concur with the information and the opinions contained in the chapter. I agree that the global aviation industry is undergoing significant structural change, and that Air New Zealand and Qantas are not protected from these changes.

Yours faithfully

A handwritten signature in dark ink, appearing to read "M. Tretheway", with a long horizontal flourish extending to the right.

Michael Tretheway  
Vice President & Chief Economist

Encl.