CHAIR: Good afternoon, we will reconvene the Conference at this time, and I will remind people that we were next to hear from Mr Geoff Dixon of Qantas Airways and I've noticed there's been a change at the front table, so if I can ask you once more to introduce everyone, please.

MR PETERSON: Madam Chair, if I could just introduce myself again; it's Andrew Peterson from Minter Ellison in Auckland acting for Qantas. On my right is Paul Edwards, Executive General Manager of Strategy and Network for Qantas, and on his right is Brett Johnson, the General Counsel of Qantas.

MS REBSTOCK: Thank you for that. Mr Dixon, I will hand you the floor now, please, if you'd like to present to the Commission.

MR DIXON: Thank you, Madam Chair and Commissioners. As you are aware, we have a major board meeting and our annual results announcement this week in Australia, and this commitment prevents me from appearing before you in person, so I apologise for that. But I nevertheless welcome this opportunity to follow Ralph in offering some introductory remarks in support of the application by Qantas and Air New Zealand, and it's an application that I believe, and this company believes, is vital to the future of both airlines. When I am finished, I'll obviously be pleased to answer questions and, obviously, as we go along.

What I would like to do in the time available is to restate the factors that led Qantas to pursue an alliance with Air New Zealand in the first place and outline why it remains of such importance to us.

The one I want to make -- and no-one can escape this fact -- is that the airline industry globally is in crisis. This situation results from a combination of factors and is structurally induced as well as cyclical. It is endemic and applies as much to our part of the world as anywhere else.

In reality, the industry has been in poor shape for more than a decade. People could see a crisis developing, but not everyone saw what was needed to correct the situation. Qantas was among those who saw the problems, and we acted, but too many other airlines continue to struggle with insufficient returns and too much capacity on far too many routes.

Throughout this period rising external costs, changes in consumer preferences, and the growth of low cost carriers placed enormous pressures on the full service airlines. Deregulation and market access liberalisation continue to pace, creating further incentives for airlines to add capacity and to open up routes. Australia and New Zealand were at the forefront of these processes.

Now, while none of this is secret, it is important to recognise the problems confronting the industry were and remain long-term, as I said, structural. They demand long-term solutions and cannot be addressed with a few cosmetic changes.

I'd just like to quote someone, the former Director-General of IATA who gave emphasis to this challenge in April 2001 when he said -- and I will quote:

"In our globalising world economy the limits to size, the achievement of critical mass in marketing, service provisions, cost control, aircraft and other equipment ordering are being rewritten. The drive to further cost reduction suggests that our industry should become much more consolidated."

I continue the quote:

"For many of the world's airlines with a small domestic market base, and unable to achieve critical mass through bilateral treaty limitation and foreign ownership rules their long-term chance of survival in today's global market is likely to become increasingly diminished".

I think it's important to note that the Director-General's assessment of what was going on was delivered before the September 11th terrorist attacks in the United States. Since then we've also seen the economic downturn in the US, the war in Iraq, and the SARS pandemic; events that further aggravated the industry's very poor situation and its outlook.

In normal circumstances the industry might be expected to bounce back quickly from these sorts of events, but this assumes a satisfactory starting point free of structural impediments. Neither Qantas nor Air New Zealand is in that position. A local aviation industry has been impacted far more heavily than anyone could have anticipated by the underlying challenges and pressures for change. This resulted in the collapse of Ansett as we discussed in Australia and the need for the New Zealand Government to come to the aid of Air New Zealand.

Globally the industry has responded to the latest crisis by shedding over 400,000 jobs. Full service airlines have cancelled or deferred aircraft orders and new investment has been quite dramatically curtailed; and really, it does not matter where you look for examples.

In the US, Europe, Latin America, Asia or even closer to home, the situation is the same, and we believe that the lesson we need to take from all this is that, with razor thin margins, the razor thin margins that exist in this industry, external factors can push otherwise healthy airlines into loss-making situations very very quickly. Even profitable, efficient and well established airlines have been forced to slash capacity, earnings forecasts, wages and salaries, and other costs.

While the effects of the recent shocks are beginning to move into the background as carriers rebuild capacity and their short-term financial results improve, the pressure on yields will be felt for some time and there remains a need to address the underlying structural challenges facing this industry.

And, I believe the governments generally have been slow to recognise what is going on and, when they have, many have just reached for their cheque books. Too many airlines which should have exited or consolidated remain protected species. There's no cleansing in this industry at all.

Competition on other Government policies have clashed with sound industry policy with the result that over-supply of airline services has been allowed to continue. Indeed it has been encouraged. This is not sustainable and airline consolidation has to occur.

Although a few established carriers have been allowed to fail, the response of many Governments have been to provide financial assistance to their airlines either overtly or covertly. While sometimes the reason for this can be found in the need to maintain basic and essential domestic services, as was the case in New Zealand, just as often Government support has done nothing other than prop up ailing airlines for nationalistic reasons.

Hand-in-hand with this is the fact that many flag carriers were already owned by their Governments, being used as instruments of national policy and not subject to the same commercial disciplines and return on investment requirements as Qantas or Air New Zealand.

This is a damaging market distortion, pure and simple. It tilts the playing field and makes the task for airlines seeking efficiencies all the harder. It strengthens the case for consolidation. And now compounding these problems are the pressures placed on the traditional business model of airlines like Qantas and Air New Zealand by the growth of low cost carriers. I should say straight away that there is nothing unfair about this per se, but we must be allowed to respond in a rational, economic manner.

Having operated with mixed success over many years, the low cost, no frills airline model really began to take hold in the mid 1990s. It has totally changed the nature of airline competition. With their cost advantages these airlines do not simply operate on the low end of the existing cost curve, but have moved the cost curve for the whole industry. As a result full service networked airlines like Qantas and Air New Zealand have to position themselves on that new curve or face being uncompetitive and ultimately unsustainable.

Now, this does not oblige us to match low cost carriers in everything they do, or become low service airlines in our own right. This is not our intention, and to seek to do so would clearly be a mistake for both Qantas and, we believe, also for Air New Zealand. Equally, I do not think that this is what consumers, particularly long haul international passengers who are used to the benefits of the interline system, alliance membership and seamless travel, either want or expect.

Applicants

For Qantas the correct response is about reducing costs and generating network efficiencies, and this lies behind the alliance we envisage with Air New Zealand. Qantas is also concentrating on the need to take the complexity about what we do without losing the essential attributes of and the benefits from being a competitively focussed, network based airline.

Some of the response is within our own province to achieve. We are focusing on this and have a range of strategies in place to take $1 billion of costs out of the business over the next two years.

Earlier in my remarks I quite deliberately labelled the rise of low cost carriers as a structural issue. As we look around the world, we see many examples of full service airlines spawning off low cost models. They are not some sort of temporary phenomenon and will require a long-term competitive response from airlines like Qantas. It is now clear that at least one low cost carrier with an already proven business record -- that is Virgin Blue -- will extend its operation s to Tasman and domestic New Zealand routes with or without this proposed alliance. And, it is also unquestionable that, without legacy cost of Qantas and Air New Zealand, and with the ability to cherry pick profitable routes, Virgin Blue will grow the market as they have done in Australia.

Now, the logical place to start addressing the challenges which confront Qantas and Air New Zealand is in our home market of Australia and New Zealand which successive Governments have encouraged us to think of as one and which are the most open in the world for foreign service providers. Unless we strengthen our businesses at home, we have no hope of remaining globally competitive.

Both airlines require a stable but growing home base. This is critical for any airline, but it is especially important for two network carriers geographically situated, as we both are far, from our international opportunities. We cannot afford to be picked off in our home market; that, apart from being important in its own right, feeds our international operations. A strong local industry is, of course we believe, also vital for aviation dependent industries, tourism being the most common of these.

Should the alliance not be authorised, Qantas will have no other choice than to continue growing its home market. This growth will be required to provide a sustainable base in the level of services desired by our customers, and Qantas is well positioned to facilitate this expansion. In May 2001 we established our domestic New Zealand subsidiary JetConnect. The JetConnect fleet has now grown to seven, 737 aircraft. Next month JetConnect will commence Trans-Tasman flights from its new base in Wellington, from which we have just recruited 80 staff.

In explaining the Qantas/Air New Zealand alliance we have confronted almost every day the argument that we, the airlines, are only out to help ourselves. The argument universally goes that we can see that the two airlines will benefit but what about the travelling public?

Now, my unashamed response to this is that, within reasonable limits what is good for the airlines will benefit consumers. We just cannot separate the two. The broad benefits of our proposal have been well documented. Certainly we anticipate producer synergies and cost advantages, but we also anticipate firstly increased visitor numbers to both countries by tens of thousands each year, through stronger promotions and more attractive holiday packages. There is no gainsaying the fact that local airlines dedicate more of their resources to promoting and developing home markets than any others; that is a worldwide phenomenon.

Secondly, improved aircraft utilisation for both airlines allowing the development of new direct Trans-Tasman routes that neither airline can offer independently.

Another one is improved schedule co-ordination and convenience, both across the Tasman and within Australia and within New Zealand. Increased freight capacity to the benefit of exporters and importers, and benefits to airline staff throughout protection and promotion of skilled employment, including underpinning of investment in engineering and maintenance facilities. Without the allowance, obviously, these benefits will not flow.

There are differences among economists I know as to the magnitude of the net benefits. While the Commission is obliged to quantify the outcomes, modelling of the sort required is highly dependent on the assumption s that underlie it. It is important that these assumptions reflect a clear appreciation of market circumstances and normal commercial behaviour of airlines in relation to the allocation of capacity, pricing, yield management and so on. There will be more discussion of these issues, I believe, over the next few days.

Now, I have no doubt that the alliance will achieve significant and broadly based benefits and that these will carry through into the economies of both Australia and New Zealand. And, we are smart enough to know, however, that all this will count for naught if consumers come to face higher prices and lower service standards or reduced frequency without opportunity for redress.

It is impossible, in my mind, to conceive of a situation in practise where the combined pricing decisions of Virgin Blue and Fifth Freedom carriers, Emirates being one, will fail to act as a material constraint on the pricing of the alliance. Domestic routes in both countries will be under significant price pressure from Virgin Blue's presence irrespective of alliance activity.

The partnership between Qantas and Air New Zealand will create an airline group with the economic and financial scale to compete in world markets while maintaining two separate, independently managed and locally based airlines with distinctive and popular brands.

Working together, Qantas and Air New Zealand will be able to realise synergies, identify the basis for more efficient and sustainable growth and maximise cost and other advantages associated with operations at their respective hubs. The cultural fit is pretty good. Air New Zealand is a high class airline with a network and commercial outlook which dovetails perfectly with our own.

The alliance will not diminish the unique character of either airline, or lead to the dominance of one over the other. Qantas will continue to grow its operations and the alliance will create valuable new flying opportunities for Air New Zealand.

Finally, as the Commission will be aware, Qantas and Air New Zealand have proposed a set of conditions under which authorisation is sought. These are designed to facilitate substantive new entry on Tasman and domestic New Zealand routes and to materially reduce any competitive detriment arising from the alliance. They will also ensure the delivery of significant public benefits that flow from the alliance.

In refining these conditions the alliance partners have been conscious of the need to make a serious effort to address the concerns of the critics of this proposal. And, we believe we have done that without stifling our own ability to provide consumers with the service and prices they seek, and that the markets in question will remain not only very attractive to new entrants but also highly competitive. Thank you very much, Madam Chair.

CHAIR: Thank you, Mr Dixon. We'll take some questions now on your presentation.

MR CURTIN: Mr Dixon, I was just reading in the Sydney Morning Herald this morning, a piece you may have seen, that was partly speculation about your annual result, and partly some thoughts about what might happen if there was an Open Skies Agreement between Australia and Singapore. Do you regard that as realistic and, if it did happen, how would it impact on your strategies in Australia and New Zealand?

MR DIXON: The story that we were going to open a hub in Singapore?

MR CURTIN: Yes, that and --

MR DIXON: It's untrue. The report is untrue.

MR CURTIN: Did you expect an Open Skies Agreement between Australia and Singapore?

MR DIXON: We expect a very liberal agreement between Australia and Singapore; it's one of the most liberal now, and we believe that it probably will be liberalised more, but on our view it won't be liberalised until both countries will get benefits from it, and at the moment there are benefits that Qantas can't achieve from liberalisation because of agreements that have not been reached with other governments.

MR CURTIN: Apart from setting up a hub which, as you mentioned, is not on your plans, would you expect an Open Market Agreement if there is further liberalisation to have any impact on your strategy in this part of the world?

MR DIXON: Not a strategy as far as our alliance with Air New Zealand; obviously any arrangement that creates more competitive conditions calls for a response from us. But it would be impossible for me to give you an example of an action we would take if in 2 or 3 years there was a more liberal arrangement between Singapore and us -- the Singapore Government and the Australian Government; how that would impact on a relationship we would have with Air New Zealand, I mean I just can't see ahead that far.

But I don't think it would affect -- the whole idea of the arrangement we'd like to have with Air New Zealand is that we are, as I said in my presentation, far away from the rest of the world, the industry will consolidate, we need to have critical mass, and I believe both of us working together can give us a much better opportunity to survive and to grow against airlines that, as I said, once again do not have the same financial disciplines we do.

Malaysian Airlines is an arm of Government policy, I believe Emirates is the same, I believe Garuda is the same, I believe Thai is the same. They cannot, in a very simple equation go broke, we can. But we're not going to.

MR CURTIN: Thank you.

MS BATES QC: Mr Dixon, in your presentation you characterised airlines as being a species protected by Government. I realise you're not talking about all airlines, but that was a general comment you made.

MR DIXON: Sorry?

MS BATES QC: You made the comment that you saw airlines as being a species protected by Government.

MR DIXON: Yes, I did.

MS BATES QC: And then you said something I'd just like you to elaborate on a little, and that is that -- and I might not quote you directly, because I was trying to get down what you said -- but you said something along the lines that competition policy clashes with sound industry policy.

MR DIXON: Yep.

MS BATES QC: Could you just please explain a little bit more, what do you mean by that?

MR DIXON: Well, the competition policy in the airline industry, as I said, is distorted by the fact that many of the airlines are owned by governments; so, they do not have the same disciplines as the rest of us, but also in the current environment many of them, even after 9/11 probably would have gone out of business. They have not gone out of business. In America there's been literally billions of US dollars put in to keep the airlines going; some are in Chapter 11, many of those airlines or several notable ones, are using this Government support to be able to lower fares and to create market share against airlines such as ourselves who do not have that ability.

MS BATES QC: I see; I'm quite glad you've clarified that. What I see you now saying is that both factors are working together; you didn't see them as independent factors. I mean, absent the Government subsidy, do you see competition

policy as being contrary to sound industry practice?
MR DIXON: I see that the competition policy, even allowing -- not allowing for Government subsidies, but as being against sound industry practice. I believe that airlines that are only there for, maybe for tourism benefits, that's the only reason, not to have the same disciplines for market, affect the overall competitive environment.
MS BATES QC: So you think the normal competition rules don't apply to airlines?
MR DIXON: Never. They haven't -- I mean, they don't apply right now. Most of the airlines are being propped up. So, that's not a normal competitive environment.
MS BATES QC: No, I see that. So you are saying that the two factors of Government subsidy and competition policy are working together to create what you see as an undesirable situation?
MR DIXON: A very undesirable situation.
MS BATES QC: Just ignore Government subsidisation for a minute.
MR DIXON: Very hard to.
MS BATES QC: Do your best.
MR DIXON: I will. I'll try; it's very hard for me.
MS BATES QC: Okay, and I don't know if you were listening to Commissioner Rebstock when she put this scenario to Mr Norris, but he said, well, this market in the Tasman and the New Zealand domestic is just unable to support two full serviced airlines and one VBA; that the best it could do was to support one full service airline and one VBA.

Do you agree with that?
MR DIXON: Yes, I do.
MS BATES QC: Well, then she said, well, I just want to know your view on this; she said why not let the two full service

airlines fight it out and the most efficient one wins, and then you've got the desirable situation, why should you need to go to approving this sort of arrangement?

MR DIXON: Well, if that's what the view of people is, that the best way to do this is to have a scorched earth policy, put people out of work and just make it red ink everywhere; I suppose that's one way to go. But why wouldn't you say, here are two airlines that are very important to both countries, the economies of both countries, they get together; I believe then it makes it much easier for Virgin Blue at any rate, or whatever it might be, to come into the market. Three of us fighting it out, some people are going to get very very badly hurt. If that's the law of the jungle, okay, but I don't believe that's a very smart way to go. I believe consolidation when you've two such important companies as Qantas and Air New Zealand, and provided that we do it properly and we're seen to do it properly is a much better outcome.

MS BATES QC: If I could boil it down this way; you say it's better use of resources to have the companies go together?

MR DIXON: I believe it's a much better use of resources, but I think it's a much better outcome in the future as well. It will provide a basis for Qantas and Air New Zealand and I don't see this just as something to do with the Tasman; it is to do with the greater opportunities for both Qantas and Air New Zealand, and for the economies of both those countries internationally well away from this part of the market. And I have no doubt by the way once again that Virgin will do a lot better coming into this market if Qantas and Air New Zealand can work together than they will with all of us going at each other.

MS BATES QC: I don't want to be repetitive, but the ACCC in its draft determination was of the opposite view; it thought that the alliance would be a much more effective competitor against Virgin Blue than Qantas and Air New Zealand standing alone, because they could co-ordinate their resources. If you say that the alliance would provide less -- would make it easier for Virgin, could you just explain why you think that's the case?

MR DIXON: Because they'll have one major competitor instead of two major competitors going at them, and that will be the way. Air New Zealand must, must try and protect its market. We must try and protect our market. I think it's an overall better use of resources. We're not going to concentrate -- if we can get together and have an alliance, we're not going do that and concentrate all those resources and the benefits just on the Tasman and in New Zealand, we're going to go -- and I think there was a question earlier -- we're going to grow, we want Air New Zealand to grow, we want to grow ourselves into overseas markets and other places.

This is not just about this part of the world. The alliance, I believe, facilitates Virgin's entry into this market. It will be much harder for them to come in if both of us are there. But, they will come in, they've said that.

Just on the ACCC, and I don't want to be disrespectful, but they've been known to get it wrong as well, and there's many many things that the ACCC have said that Qantas does not necessarily agree with, and we've been proven right.

MS BATES QC: But that was -- I mean, it is at least feasible that two entities co-ordinating might be more effective as a competitor than two entities not co-ordinating?

MR DIXON: We could be more effective as a competitor, but that doesn't mean that they'll be less effective as a competitor because there is one airline or alliance working together. It doesn't necessarily follow that. They'll be able to put their aircraft when they want.

When you look at our proposal, we're saying we're not going to put all our aircraft at one given time and try and down Virgin. What we're going to try and to is have a spread of capacity and spread of services, and it will be a better outcome for both countries, and I do believe, and I believe it will be a better outcome for Virgin, I believe they know that too. I believe that they overstated their hand a little bit in the first place when they complained and wanted Freedom and that. I think they saw the fact that things may not have been going that way and they are very keen to come into this market.

MS BATES QC: Can I just ask a bit about Qantas and its profitability in various types of business. Whereas Air New Zealand seems to be more profitable on the -- in its domestic business and less so in its international business, is that the same for Qantas?

MR DIXON: No, I am constrained a little bit of course because we have our results coming out on Thursday, but on a historic and very recent basis, we have a pretty even spread of profitability and losses. We make money domestically, we make money internationally, we make money with our subsidiary businesses. We don't get the returns out of any of our business which we'd like; we do better than most airlines, but we certainly do not get what we'd like out of the overall investment. As Ralph said, it's the same with Air New Zealand, but no, we have a pretty widespread and profitable operation.

MS BATES QC: And how profitable is the Tasman route for you?
MR DIXON: At the moment it's profitable.
MS BATES QC: How profitable?
MR DIXON: I'd prefer, once again, because we have our results coming out, I can't give you those exact figures because that changes; I mean, it was a loss maker a couple of years ago; it's been profitable in the last 12 months.
MS BATES QC: Thank you. [**Pause**]. What about the -- and I know you've got difficulties because of your results coming out -- but in a general way would you characterise your business in New Zealand as being profitable?
MR DIXON: No, certainly not. If you count the Tasman -- sorry, if you count the totality of the business and our international operation -- are you talking about domestic, or the total Qantas business in New Zealand?
MS BATES QC: Domestic.
MR DIXON: Domestic? No, we're not making money domestically in New Zealand, but we do not make money in New Zealand when you take in our operations internationally into the Australia and to the US.
MS BATES QC: Would it be fair to say that you might see the proposal as fixing your problems in the New Zealand domestic market, and perhaps Air New Zealand's on the international -- in its international business?
MR DIXON: No, you can make an assumption of that, but that's not the case. We will grow our market in New Zealand, we will have to do that to give us more critical mass. But look, obviously a proposal like this is put together for a variety of reasons, many of them, and an alliance like this will -- we don't want -- I think the question has been asked whether we're better off to wait until Air New Zealand fell

over.

We don't want to diminish Air New Zealand as an alliance partner; we want it growing strongly in New Zealand. And I believe putting both these carriers together and giving us critical mass against the Government owned carriers and the bigger airlines around the world will give us that. But certainly obviously there are elements that this will benefit Qantas and will benefit Air New Zealand, but I think that goes without saying.

I think it's very important to remember, no airline doesn't -- all airlines have loss-making operations, it's a network business, it's a business where you use some parts of your business to feed into your others, and Qantas has always been like that, but we do have loss-making operations and we keep those loss-making operations because they're very important for our network offering.

I mean, I've often discussed with people the idea about, why do you fly here, why do you fly there; you lose money. On a network basis we don't lose money; on a particular route we may well lose money.

MS BATES QC: I can understand that, that's why you've persisted with Qantas and New Zealand although it's been loss-making.

MR DIXON: Not only Qantas and New Zealand, Qantas has many operations around the world -- well, a substantial number of operation s that don't make money but they're part of our network, part of our service offering; we carry about 28 million passengers, they want to go to places and we want to fly them there, we can't always make money, and roofs go up and down, sometimes you make money, sometimes you don't. We made money on the Tasman this year; the previous year or the year before that we didn't make money.

MS BATES QC: But you'd put your interest in New Zealand domestic in that category; that you're prepared to wear the loss because of other benefits?

MR DIXON: We're prepared to stay there, yes.

MS BATES QC: I just am a little puzzled --

MR DIXON: I don't like wearing losses anywhere.

MS BATES QC: No-one does. I'm just a little puzzled; you've been prepared to do this, and one can see why, but now the argument put forward is that you would start competing vigorously with Air New Zealand if this proposal doesn't go ahead. Why would you suddenly start doing that if you've been prepared --

MR DIXON: Because they will start to compete vigorously with us, and they are competing vigorously, and we're just growing. We've only been there as a domestic airline after the failure of Ansett New Zealand and the failure of the franchise operation that we were involved in; that was someone else's operation. We've only been there two years or just on two years; we've been growing that market, we've set up a company called JetConnect which I think was mentioned before which will give us an opportunity on a different cost base and we will continue to grow that market. We need that to feed into our network. Our market, our capacity share, there is around about 25%; we intend to grow that. That's the nature of this business.

MS BATES QC: Thank you.

CHAIR: Just a few further questions. I wonder, Mr Dixon, if you could tell me how you would currently characterise the competition between Qantas and Air New Zealand on the domestic New Zealand routes?

MR DIXON: Vigorous. We are at a substantial disadvantage for a couple of reasons. One is, obviously, we don't have the Air New Zealand brand, we also do not have the critical mass which is a very very important factor, and we cannot provide the spread of services that Air New Zealand provides, and that is the important element in any airline's offering, but it's robust -- certainly robust enough for us not to be making any money, and I expect it will continue to be.

CHAIR: So you're at a disadvantage, but if this proposal doesn't proceed, it's Qantas' view, I assume as well as the applicant's, that you will win the war of attrition?

MR DIXON: Well, one of the things I don't want to get into, Madam Chair, that anything that would be seen as a threat by Qantas on what it will do or won't do, but yes, the airline industry in many areas is a war of attrition. We will lose less money by growing our business.

CHAIR: But do you think that the competition will evolve in such a way that Air New Zealand would go out of business and you would be left to compete against Virgin Blue despite the fact that you see yourself as clearly being at a disadvantage at this stage in the way that you've suggested?

MR DIXON: Well, we're at a disadvantage because we're growing our business. We've got a certain number of aircraft and a certain amount of capital. We are -- we have just started to get our cost base correct in New Zealand, and because the New Zealand and the Australian markets are now regarded as one and we regard them as one, it is no different to us flying there as we fly in Queensland or something like that; we will grow that market and obviously in growing that market we will take market share of Air New Zealand, and Virgin Blue if they're there.

I think, as Ralph said in his evidence, the market has never been able to sustain two carriers to make money; it can't sustain three. So you ask the question, why we're there, we're there as part of our network offering. We have an important set of routes that go the United States over there, we have a huge Tasman market and this would be the one that while we can improve our profitability or our lack of -- improve on our losses by growing the business; that's the way we'd do it.

But I come back to the thing; what we're saying is, I don't believe that what we're suggesting between ourselves and Air New Zealand is anti-competitive. I think it will create in New Zealand and in and out of New Zealand a more sustainable industry. I think the most important thing in the airline industry worldwide at the moment is sustainability, not just open slather on fares and that -- and also I don't believe consumers only benefit -- only benefit from low fares; they benefit from service, they benefit from network, they benefit from a lot of other, safety, you name it, and an alliance between us and Air New Zealand will give that sustainability. All-out going at each other's throat on the Tasman domestic New Zealand, the value based airlines will not do that.

CHAIR: I just wanted to follow-up a comment you made about -- and correct me if I get this wrong -- but you seem to be suggesting that the proposal doesn't result in a substantial lessening of competition, you said you didn't think --

MR DIXON: Sorry, what did I say?

CHAIR: You seemed to suggest that you did not think the proposal arrangement and acquisition of equity in Air New Zealand did not result in a substantial lessening of competition. You said it was not anti-competitive, and I just want to be clear that's your view.

MR DIXON: Obviously, if we do, there's going to be some competitive issues, but it will also make us much more competitive in other markets around the world, and with a value based airline I still believe there will be very very strong competition both in domestic New Zealand and on the Tasman. It's not just a value based airline, it's Freedom carriers, so while it will certainly be less competition between Air New Zealand and ourselves, and no-one can deny that, that would be flying in the face of reality. What I do believe is, it will not overly affect the level of competition in the industry per se.

CHAIR: So, in the market in New Zealand or Australia there's not a substantial lessening of competition in your view?

MR DIXON: I believe that on the basis of everything we've heard, and I think you have heard yourself that Virgin Blue will come in; that the fact that Emirates have come on now and double daily on the Tasman; but no, I believe the competition will still be there. Obviously, there won't be the level of competition between us and Air New Zealand, accept that, that's part and parcel of what we're asking for, but not everything's perfect, there will be a lot of competition. I suppose it's up to you to decide how much competition you want. But, I also go back to what I've said before; sustainability, sustainability is just as important as all-out competition.

CHAIR: Can I just come back to the comments that you made about your involvement in the New Zealand market being for about the last two years and the way you described your entry post the failure of Ansett New Zealand.

It sounds like you were a reluctant player in this market and that you're here because those that were providing the connect to you no longer are, is that fare to say? That's how you view your involvement in the New Zealand market; that the value for you comes from the connecting traffic.

MR DIXON: Yeah, I'd prefer not to have to agree with you, yes, but that's true, I do. There's no way that airlines like starting up operations in markets that have been traditionally very very hard to make money per se, and you'd like to make money on every route. But, as I said, we regard this as such an important market in the Tasman, our service to the United States, that it's important that we have a presence in New Zealand.

And you know, we didn't come -- start flying in New Zealand because we thought this was going to be another great opportunity in the world; we decided to fly there because it's important for the customer proposition that Qantas needs to give.

CHAIR: You've indicated to us that you're in a number of markets where you're losing money and you do it for the connect and for the network effects. I wonder if you take the same approach in all of those markets, that if you're losing money and facing increased competition from VBAs and others, that you'd take quite an aggressive stance in all of those markets to basically out compete your other full service airline competitors?

MR DIXON: Our track record suggests that that's the way we go about our business, yes. We're not a great airline for pulling out of markets. We believe that once again the network offering, and you make money in different ways.

I mean our frequent flyer programme is hugely important to us, we need to be able to provide opportunities for our frequent flyers. We have a substantial number of associated businesses that benefit from our activities, including Qantas Holidays who are mentioned here of course, Qantas flight catering.

But that's the nature of the business and it's the nature of how we've run our business, and I suppose you can only just look at our success relative to other airlines to say whether it's the best way to run a business or not. But the history of airlines is that if you're going to survive, you have to stay and compete. Ones who stay and compete sometimes don't survive, I accept that, but that's where your brand, your product, your reputation and other things come into play.

CHAIR: I guess there's some opportunity cost where you decide to put up a bigger fight rather than less. How do you weigh up the potential returns from taking Air New Zealand on in its home base compared to overcompetitive threats you face and competitive opportunities?

How important is it to you, compared to those other threats and opportunities that you face? Even in the paper's right today you're expected to see your revenue fall by $80 million which suggests that your situation has deteriorated in other markets, and I just wonder, how do you weigh up your need to protect your position here compared to elsewhere?

MR DIXON: Well, I'm not sure about that particular paper, what the paper issue was, but like every airline, I can't comment on what --

MS REBSTOCK: No, sorry, I'm not asking you to comment --

MR DIXON: What I'm saying is in the last six months there's not an airline in the world, except for some of the value based carriers who don't fly internationally and fly point-to-point domestically, who have not been affected by the constant shocks in our industry; so, I don't think anybody would be surprised if Qantas hasn't done quite as well in the last six months.

CHAIR: That's not really my question; I'm sorry for confusing it by mentioning possible difficulties in the last few months.

My point of raising the difficulties is, it seems to me that Qantas faces a number of strategic threats and opportunities. The situation in the New Zealand market is but one, and what I'm asking you is, how do you weigh up the opportunity cost of using whatever resource you have here compared to elsewhere?

MR DIXON: Well, I think Ralph mentioned in his presentation, and I think I have mentioned it as well, that the New Zealand and Australian markets to Qantas and I believe to Air New Zealand are one. The governments have made them such, and I don't regard us being in New Zealand any different to being in Queensland or Western Australia and Victoria. It's an important part of our home market. I don't know of any airline in the world -- any airline in the world that has a future, certainly a sustainable future unless they have a strong presence in their home market.

So, number 1 for us is to ensure that we are strong at home, and while I understand the sensitivities of New Zealand and Australians, we regard New Zealand as a home market, as New Zealand regards Australia as a home market. So, we would be making sure that our resources are and our energies are put in first to shore up our home market so that we do have the strength to try and compete.

As I repeat once again, you know, 10,000 kilometres, 15,000 kilometres away from airlines who do not have the same financial disciplines as us, so shoring up the home market, working together, trying to consolidate here to us with Air New Zealand is much more important than us taking on British Airways or United or something.

CHAIR: Let's take about Virgin Blue in Australian markets. How do you weigh up the opportunity costs of taking on Air New Zealand in its home base, and arguably it's a closer home base here than the domestic market to Air New Zealand than to Qantas, as opposed to consolidating your position in Australia vis-a-vis any threats from Virgin Blue in Australia? How do you weigh up the relative opportunity costs there?

MR DIXON: Well, let's go back for a moment. I think we consolidated our position, not by our own design when Impulse -- who I might add was a lower cost operator than Virgin -- collapsed first and then Ansett, so you end up with a market of around about, well, two airlines, Virgin had about 10% of the market; we had I think around about 60%.

We've now been competing for that market that appeared as a result of Ansett's collapse and as a result of Impulse's collapse. We do have around about 71% of that market; they have 29%. We're competing quite vigorously with them, we have a view on how much we should keep of that market which is internal to Qantas at the moment, and I regard that as the important factor. I regard it as probably one of the most important strategic elements Qantas has got, that is to fight Virgin to make sure we maintain a significant market share in Australia, and we will do that.

So that's one of the fights we have, one of the positions in New Zealand. We have a situation in parts of Asia, Japan; we've got to compete differently there, so they're all different ways of going about our business.

CHAIR: I just want to ask you one last question, it relates to a study by Professor Forsyth on productivity trends in the Australian domestic airline business over the period before and after deregulation, and it concluded that privatisation and the removal of cost plus regulation has meant that the airlines have the maximum incentive to minimise cost and no constraints on doing so.

However, in spite of this they seem to be falling well short of achieving the productivity levels which are feasible. The lack of competition has meant that the airlines have not been forced to minimise costs, and they go on to talk about the labour market -- low labour market productivity.

So, I just -- I know that more recently -- this was in the context of the behaviour between Qantas and Ansett, but I'd just like you to comment on why was it in a period when there was -- seemed to be maximum incentive to minimise costs that didn't happen between --

MR DIXON: What period are you talking about?

MS REBSTOCK: I believe this referred to the period when Qantas and Ansett were the major competitors.

MR DIXON: Certainly, that's not the case since Ansett collapsed, and even well before Ansett collapsed, Qantas has done since privatisation, I'd say, a very very good job in cutting its costs and getting itself efficient; it's one of the more efficient full service airlines around, but we need a lot more work.

Before then many historical reasons. Regulation; you've got to have two airlines in Australia, it was regulated that way; Qantas was a Government owned carrier, took over Australian Airlines which was a Government owned carrier. We've got 14 unions, Ansett had 8; they're the two companies that have more unions -- fully unionised than any other companies in Australia, and that's why there has been and is a constraint on costs, it's a highly unionised work force. Anybody who says that we haven't got any constraint on costs must feel we can just rock up and say to the unions, it's all over, let's have a new cost base, it doesn't happen that way.

Airlines traditionally, whether this is right or wrong, but I think it's got a lot to do with our ownership, because mainly we're -- almost all of them are owned by governments, have passed on the costs -- well, first of all to the consumer initially and that they always gave in over many many years to the unions, particularly unions that could put them on the ground. It's a very very costly thing to have airlines sitting on the ground.

And that's a historical perspective. I think you can only look at airlines now from around about the last 7 or 8 years, or when they started to get privatised, like Air New Zealand was, like Qantas has been. Since then it's a whole new way of doing business, and I think we've done it quite well, and I think other airlines are starting to do it quite well. I go back to the distortion I say, it's not the same as in countries where airlines are still owned by the governments.

CHAIR: Can I just ask you; I mean I understand your point that you've been making gains, but even in the face of VBA entry in Australia, you find yourself in a situation today where I understand that you're looking to reduce your costs by another $1 billion Australian, and that does not sound to me like a company that has minimised its costs at every point along the way. And I just would like your comment on that.

MR DIXON: You may well say that. I do believe the airline industry on a daily basis continues and must continue to reinvent itself. We have changed so often, so often over the years to cut our costs. But what we're after is a different margin, and that we're -- our margins come from how much we can charge for a fare, and how much our cost base is.

As the value based airline company and the fares go down, the yields, it's incumbent on us, incumbent on us, to go after lower costs. That means cutting some of the product offering which we were giving say 3 or 4 years ago because you were getting paid for it, you're no longer getting paid for it so you cut your product offering.

So, what I'm saying is it doesn't mean that certain airlines, be it Qantas or someone, hasn't had a very good handle on costs. What it means is that the situation changes so much, that you must change the way you do business each time. I think it was quite acceptable, say 5 years ago, if Qantas was offering a very very high standard of service as far as food and that, I think we still do that, but we have to do it differently.

We're finding that there's a lot of practices in airline, on other airlines as well that need to be changed. So it's just a continual arm wrestle on getting your costs down and getting efficiencies into your business. I make no apologies to that. There's no way you can transform a company like Qantas 83 years old, 73 of those years -- 74 of those years in Government ownership, overnight.

CHAIR: Thank you Mr Dixon.

MR PJN TAYLOR: I've just got one question around Qantas Holidays, Mr Dixon. The factual posits the position where Qantas Holidays will have an incentive to actively market increased packages into New Zealand, as compared to the counterfactual.

MR DIXON: Sorry, sometimes it's difficult to hear. Sorry, what was the question?

MR PJN TAYLOR: The factual posits the position where Qantas Holidays will be actively marketing New Zealand packages, as compared to the counterfactual where it doesn't have the incentive, and I was wondering how that squares with the general proposition that Qantas sees New Zealand as part of its home market, and there's a bit of a contradiction in there is there not?

MR DIXON: Not really, not really. We do regard New Zealand as part of our home market, particularly in the last few years as we've started the domestic operations. But we also are very very mindful that Air New Zealand is a major major competitor, particularly in this part of the world. So there is no incentive necessarily for us to go very very heavily with a company as good and as big as Qantas Holidays on behalf of Air New Zealand.

Certainly Qantas Holidays will start to work very strongly, more strongly with Qantas if we do not get the alliance up. But that will be working probably on the basis of us not necessarily growing the business but taking business off Air New Zealand, and that's quite a difference to us saying we're going to be in alliance with Air New Zealand, we will unleash a whole apparatus of Qantas Holidays to improve Air New Zealand's position within that market as well as our own.

I mean -- and the same goes a little bit in another way to the engineering. We are committed to give Air New Zealand at the moment our overflow engineering work as, I'd say, first among equals. In other words we have two or three other very reputable suppliers, but provided Air New Zealand can make certain -- you know, come up with the goods they'll get the business. There is no real incentive for us to do that if Air New Zealand is going to be a major competitor of ours.

MR PJN TAYLOR: Thanks.

CHAIR: I'll just check, Mr Dixon, if the staff or external advisors have any questions.

MR STEPHEN: Ken Stephen, Mr Dixon. Would you characterise Air New Zealand as a Government owned airline?

MR DIXON: Do I characterise it as a Government owned airline?

MR STEVENSON: Yes.

MR DIXON: Yes, it is a Government owned airline, of course I do, but I don't believe it acts in the way of a Government owned airline, and it hasn't been Government owned for very long. I do believe that, although it goes against some of the beliefs I have, that it could not have been allowed to fail in the circumstances it found itself in, but I regard it as a Government owned airline, yes, because it is a Government owned, but it doesn't act like one.

MR STEPHEN: And so looking forward, would you say that Air New Zealand could be even more sure than Qantas that it won't go bust?

MR DIXON: Qantas won't go bust, no suggestion of Qantas going bust. I think we've done enough work. Well that depends on how much, and under a scenario, how much trouble Air New Zealand got into and how much the Government of New Zealand would be prepared to continue to invest.

The Government may well then decide to sell Air New Zealand to someone else, that's not what we're setting out to do. We're saying all that should be alleviated by the fact that we have an alliance, where Qantas will put some equity into -- capital in Air New Zealand and work closer together to make sure that both brands have the critical mass to survive. But, yeah, it's a Government owned airline.

MR STEPHEN: Thank you, can I just check, do you think there is a potential perhaps in the future for there to be other folk who might be interested in buying Air New Zealand stock?

MR DIXON: I don't think I can comment on that, I really don't know. I mean I know we're interested in buying it, but -- that's the 22%, but I really can't comment on that. I wouldn't have any idea. It depends on how the industry goes and what have you, but I think Ralph made the point that there wasn't a lot of people out there.

MR STEPHEN: Thank you.

MS REBSTOCK: Thank you for that Mr Dixon, and I didn't thank Mr Norris, but we'll extend that thank you to him as well for the presentations and willingness to take questions.

I might ask the Applicants now if we are moving on to the airline model presentation, is that correct?

MR PETERSON: Yes.

CHAIR: We'll just have a changeover. Thanks again Mr Dixon.

MR DIXON: Thank you.

CHAIR: I'm not planning for a break to be taken, we'll just take 2 minutes to change who's at table for the next presentation please. [**Pause**]. Okay, I would like to resume this session. Before we proceed there is one matter that I would like to deal with.

Following the receipt of submissions on the Draft Determination, and in particular on the use of economic models to assist the competition analysis, the Commission sought the assistance of Professor Zhang of the University of British Columbia. And this assistance was to help the Commission in its own review of submissions post the Draft Determination.

We received Professor Zhang's review this morning. So, that the Applicants and other interested parties have an opportunity to view Professor Zhang's comments. The Commission will make it available to those experts and advisors who have signed confidentiality undertakings. And I would ask that those people who have signed undertakings and wish to receive a copy to please contact Janet Whiteside at the next break.

The Commission will be asking questions on the NECG model and related matters. These questions may in part pick up on some of Professor Zhang's comments. I think there have been a number of parties who have requested this information and we do want to ask questions relating to this material, so if you wish to have a copy of it, please notify our staff. Okay, I will now hand back to the Applicants.

MR PETERSON: Madam Chair, if I could just tidy up a housekeeping issue from our perspective. I think immediately before the lunch break you alluded to the review by Professor Willig of the NECG model. The position broadly, as I can best describe it, is that Professor Willig has looked -- he has the model, and he has looked at the assumptions in the model and the nature of the model.

He is presently en route to New Zealand, only scheduled to arrive mid-morning tomorrow. Nothing has been produced in terms of our -- for us to hand up to you, it is our proposal that he would talk to the issues and be available for questioning by you during the course of the various economic sessions.

CHAIR: I may come back to you on that after the next break. What I would like to know from the Applicants is whether your response to the Commission in a letter of the 6th of August about whether Professor Willig had reviewed the NECG model, I would like to know from the Applicants if that statement was correct, or whether what was told to us earlier is the correct position, or if I've misunderstood that there might be some difference between the two.

MR PETERSON: Like most things in the process, it's been evolving, as at the time that that material was presented to you Professor Willig had not reviewed the model, he has subsequently reviewed it.

CHAIR: And given our interest in whether he had you didn't think we would be interested in knowing that the instruction had changed. I think we'll come back to this after the next break if I can. Okay, let's turn to the next presentation then. And I will ask you to introduce your speaker please.

MR PETERSON: It's my pleasure, Madam Chairman, to introduce to you Dr Mike Tretheway. Dr Tretheway is the Vice-president and Chief Economist at InterVISTAS Consulting at Vancouver. Dr Tretheway is one of the world's leading economists in the aviation industry. He will be talking on two broad areas which he will comment on in more detail in a minute. Essentially it's the emergence, growth and impact of low cost carriers and, secondly, some comments on the Commission's factual and counterfactual analysis. If I could hand-over now to Dr Tretheway.

DR TRETHEWAY: Good afternoon. In my statement I have been asked by counsel for the Applicants to comment on a series of questions regarding developments in the airline industry. These questions can be grouped into two main areas.

First, comments on the emergence, growth and impact of low cost carriers; and second, comments on the New Zealand Commerce Commission's assumptions regarding the factual and counterfactual.

Let me turn to the first topic I have been asked to address; emergence, growth and impact of low cost carriers. In these proceedings the practice has been to revert to carriers such as Virgin Blue, Southwest, and RyanAir as value based airlines or VBAs. I strongly prefer to refer to these carriers as low cost carriers or LCCs.

The reason is that full service network carriers provide additional services to passengers. These additional services are highly valued by some of their customers. Virgin Blue and similar carriers on the other hand provide simpler services but with a lower cost.

I should note that I use the term "cost" in the precise manner of the economist; the costs incurred by the air carrier to provide the service. It is not the same as price, which is the fare that's paid by the passenger. It's the low production cost nature of the carrier such as Virgin Blue which distinguishes them from the full service airlines, as I will refer to them as low cost carriers or

LCCs in my presentation.

The low cost carrier business model is one which has been adopted throughout much of the world. The model was originally developed by Southwest Airlines in the United States. Southwest is now over 30 years old. In the past 5 to 10 years many successful low cost carriers have emerged. In the United States, for example, we have had the emergence of JetBlue, AirTran and Frontier. In Canada we have WestJet. In Europe we have carriers such as RyanAair and easyJet. Brazil now has Gol. Australia, of course, has Virgin Blue and even in Asia and Malaysia we have seen a 737 operator emerge, Air Asia.

As I will describe in my comments, the development of today's low cost carriers have irrevocably changed the airline industry. They have substantially and permanently undermined the revenue base of the full service network carriers and are now the force that drives and disciplines market behaviour.

This diagram describes the growth of the low cost carriers and how dramatic it has been. In this first diagram I start showing the growth of Southwest Airlines, even though this air carrier is 30 years old and fully mature; in the 1990s it grew at an average annual rate of almost 15%. In contrast the major carriers that are members of the US Air Transport Association, excluding Southwest, these carriers are largely full service airlines, grew at less than a quarter Southwest rate at only 3.5% per annum.

As you can see in the diagram, Southwest grew from an index of unity in 1990 to roughly 4.5 at the -- just after the decade in the year 2001. At the same time the other major carriers grew from an index of unity to only 1.5.

This diagram shows another low cost carrier, RyanAir, which is based in Europe. Here we see that low cost carrier RyanAir from the mid 1990s to 2002 grew at almost 40% per annum versus 3.5% per annum for the Association of European Airlines members; again their members are largely full service airlines. I also find it interesting that the 3.5% growth rate of the FSAs in Europe is very similar to the 3.5% growth rate although, for a slightly longer period of time, in the United States.

RyanAir, I might add, continues to grow at these enormous growth rates in the range of 40%. Southwest is over 30 years old. There were many attempts to duplicate its highly successful business model in the United States in the 1980s and indeed in some other countries as well, but these were largely unsuccessful. It was not until the early-to-mid 1990s that successful recommendation of the low cost carrier business model was achieved. There are a number of reasons why the more recent low cost carriers have achieved success, while earlier start-ups were not successful.

Of critical importance was deregulation, which did not occur in Europe, Australia, New Zealand, etc, until the 1990s. Many early attempts at low cost carrier operations were frustrated by airport capacity problems. Start-up carriers in a number of locations found that they could not get access to take-off and landing slots, or the terminal facilities. This entry barrier was relieved in many jurisdictions in the last 7 to 10 years through two primary avenues.

In some cases, such as in New York, landing slots were transferred or rewarded to new low cost carriers, thereby facilitating their entry and success.

Another is that airport privatisation enabled investment in additional airport terminal capacity in many places, generally using a common use format rather than dedicated terminals for individual airlines.

Also of critical importance; it was not until the 1990s that investors fully understood key elements of the Southwest Airlines business model. Early attempts to replicate the model were often superficial recommendations of their business format. Key lessons that were learned from the 1980s and then applied in the mid 1990s include factors such as properly capitalising the low cost carrier from inception. Many early low cost carrier attempts were seriously under-funded and ultimately failed.

Another example of an error in the business model was the 1981 entry of People Express. While Southwest Airlines began its operations with three Boeing 737 aircraft, People Express entered the market with an initial 17 aircraft and continued to expand immediately. Today's low cost carriers typically begin along the Southwest model with a small fleet of three or so aircraft steadily, although strongly building from that base, but not starting out by attempting to replicate a major airline.

The lessons of genuine focus on low cost also had to be learned and implemented. The successful low cost carrier requires that it not only start out with low cost, but focuses on continuing cost reductions. RyanAir is an excellent example of implementing this lesson. From 1995 to 2002 its focus on continuing cost reduction allowed it to reduce its break even load factor from 72% to 54%, even as its yields or average revenue per passenger fell. This focus on continuing cost reduction is often under-appreciated.

It is not enough to think of a one time cost reduction for a full service airline to make it more competitive with a low cost carrier. As the full service airline attempts to reduce its cost, the target itself is moving as the low cost carrier cost base decreases further.

While earlier attempts at the low cost business model failed, today's low cost carrier has proven to be a highly successful business model. Carriers such as RyanAir in Europe, WestJet in Canada, JetBlue in the United States, Virgin Blue in Australia, have been highly profitable, even as the industry has gone through the severe impacts of recession, terrorism, armed conflict, and SARS. This business model has now been proven to be replicable, profitable and sustainable. It has been a success for passengers by offering lower fares even for business travellers who previously were unable to avail themselves of low fares due to restrictions such as required purchase of a return fare with a Saturday stayover. It's been a success for communities which have benefitted from higher travel volumes, because of the low cost -- the low fares that the low cost carriers have introduced, creating jobs in their communities, and tourism in our areas.

The low cost carrier business model of today is also successful for shareholders who have enjoyed sustained financial returns; the sustained financial success of the low cost carriers reflected in the high market capitalisations of these carriers. Market capitalisation is obtained by multiplying the number of shares of the carrier by its share price. In Europe the airline with the highest market capitalisation is now RyanAir which exceeds the market capital of Lufthansa, the full service airline with the highest market capitalisation.

In Canada WestJet had a market cap of more than three times that of Air Canada for several years prior to the bankruptcy of Air Canada and, as you can see today, the ratio is 13 to 1, although I understand it's now about 18 to 1.

In the US the market cap of Southwest exceeds the market capitalisation of all of the non-cargo full service airlines in the United States combined, as well as individually. Perhaps most important, these market capitalisations in part reflect shareholder expectations of the future sustained performance of these air carriers.

The future growth of the low cost carriers is materialised with the large number of aircraft they have on order. A selection of nine important LCCs indicated that they have 633 aircraft on firm order, and another 616 aircraft on option. Further, a number of these carriers are preparing additional orders, further expanding their fleet capacity.

In contrast, many of the full service airlines have few aircraft on order. Many of those that do have orders in place are deferring their orders, such as Continental Airlines, which is deferring its 737s roughly between 40 and 50 of those, for delivery until after 2008. A very large proportion of the full service airline aircraft orders should also be noted as being replacements of aging aircraft, while most of the low cost carrier orders are for incremental fleet capacity with the exception of the mature carrier Southwest Airlines. The high market capitalisations of the LCCs enable them to finance such large fleet expansions, while many of the FSAs are finding that financing for operations, much less replacement or even expansion, simply is not available.

One question I was asked to address is where the low cost carrier model is going to go to next. It's my opinion that these carriers will eventually serve 50% of short and medium haul passengers. In the United States, for example, the low cost carriers currently carry 24% of domestic passengers, the figure I now understand has actually increased to 26%. These carriers are poised for further expansion. Southwest in fact just last week, when data came out, won the spot of serving more domestic passengers than any other airline in the United States; in fact than any other airline in the world.

By examining the US low cost carrier aircraft orders and their ability to finance such purchases, I project that the low cost carriers with a 15% per annum growth rate -- roughly what Southwest has achieved in the past 13 years -- will continue to grow.

Southwest, in fact, is the slowest growing among the major low cost carriers, but the full service airlines in the 1990s group at 3.2%. If they were to continue to grow at this rate, and continuing to grow at that rate is problematic, the low cost carriers will serve between 35 and 40% of the US domestic market within five years and 50% of the US domestic market within 10 years.

CHAIR: Can I just interrupt you for a minute, please, Dr Tretheway. I just want to understand what the assumption underlying this is. Is it an assumption that the full service airlines continue doing what they're doing, or is it that they will try to respond in some way, or what is the underlying assumption about the response of the full service airlines to the market circumstances they find themselves in when you make a projection such as you have?

DR TRETHEWAY: The underlying response is that, at best they would be able to grow at the rate they achieved in the 1990s; I believe equity markets will constrain that growth. Now, some of their capacity in fact could be converted into a low cost format, or perhaps it would be better described as a low fare format because it's my opinion -- which I'll describe shortly -- that they cannot get their costs down to the level of the low cost carriers. But, even so, that will simply be transferring their capacity from one format to another while the genuine low cost carriers will come to occupy in 10 years 50% of the market.

If we add the conversion of some of the full service airline capacity to a low cost. Or a low fare format I should say, then the combined market share at low fares will be dramatically larger than 50%.

CHAIR: It seems to suggest that companies don't learn. They see their market share as being significantly eroded, it's projected to continue, market strategies that don't appear to be overly successful, given their rates of return, but they just carry on. I just wonder if that really is a very likely scenario?

DR TRETHEWAY: I'm not projecting that these carriers do not learn. In fact, as we are seeing here in Australia and New Zealand, in Canada, to some extent in Europe and definitely in the United States, these carriers are learning, are reconfiguring their product, and that is included in my figure of the 3.5% growth.

Let me put it a different way. If the -- sorry, if the full service airlines did not change their business format, they could never achieve 3.5% growth; they would be moving into double digit negative territory in terms of their annual growth rates.

CHAIR: Why do companies stay in that business when the returns are so much higher in the low cost carrier business? Why do they stay in the business?

DR TRETHEWAY: I have asked myself the same question. We had a Minister of Transport in Canada who said there's a lunacy factor about the airline industry that attracts people and makes them stay.

CHAIR: It's not just the airline industry, it's everyone who funds them.

DR TRETHEWAY: It's capital markets as well.

CHAIR: Exactly, so what's the economic rationale for this behaviour.

DR TRETHEWAY: I believe the market is correcting this; that's why we've seen the failure of a number of airlines, the financial restructuring of these airlines, and I believe a consequence of that is that the financial markets will not continue to finance the growth of the full service airlines.

MS REBSTOCK: Have you seen any evidence to support that proposition?

DR TRETHEWAY: Well, the full service airlines, for example, in the United States and Canada are putting forth business plans as they come out of voluntary or involuntary restructuring, to be smaller than they were in the past. In addition, if I can use the example of US Airways, this carrier entered bankruptcy, has emerged from bankruptcy and it's becoming clear that its business plan is significantly different.

It is making a major shift of its capacity to regional jets, recognising its inability to compete against low cost carriers, and instead it's seeking much smaller, thinner markets where it believes the low cost carriers will not serve, at least not to the same degree, and they're attempting to find a niche for themselves that the low cast carriers are unlikely to occupy. As well they're shifting some of their growth into the overseas markets, which again the low cost carriers, while they may look at some services in the area they will likely focus on short and medium haul markets.

MS REBSTOCK: I might want to come back and ask a follow-up question, but I'll just see if my colleagues have any questions at this point. [**No comments**]. Please carry on, thank you.

MR PJN TAYLOR: I just have one.

CHAIR: Sorry, we'll just take one from Commissioner Taylor, please.

MR PJN TAYLOR: You referred twice, I think, to Southwest Airlines as being an immature airline. Could you just run me through why you say that?

DR TRETHEWAY: The airline is 30 years old and I'm not attempting to imply that Virgin Blue or WestJet are immature, but one of the claims that had been made in the last 15 years, for example, is that Southwest was sort of a special case because its workforce were so young; they were at the bottom of the 10 year sort of tier of pay rates. But now we have an example of a carrier after 30 years is retiring pilots, flight attendants, mechanics, customer service agents, so they now have employees throughout the 10 year spectrum, and yet they are sustaining a cost advantage vis-a-vis the full service airlines they compete with.

The important point is, their cost advantage is not dependent on hiring a bunch of young kids at the lowest sort of end of the pay scale. They are mature in the sense that they were tenured throughout the wage ranks.

MR PJN TAYLOR: I understand.

DR TRETHEWAY: Just to close on this particular slide, while I commented about the US market, I note that Canada and Europe should also witness similar market share capture as the United States. In Canada, for example, the low cost carrier share of seats sold is now similar to that of the United States. Next I was asked to comment on the impact of the low cost carriers on the full service airlines. In my opinion, one of the most important impacts they have had on the price is on the prices the full service airlines can charge and hence on their revenues. Not only do full service airlines charge low fares, they have also undermined the price discrimination ability of the full service airlines. Without their traditional price discrimination ability, the full service airlines have suffered and will continue to suffer a major reduction in their revenue base. This reduction is unlikely to be recoverable in my opinion.

Full service airlines charge different prices to different passengers. Some of the fare differences are due to different service qualities provided to different passengers, but an important part of the fare difference is due to price discrimination. 25 to 30 years ago, full service airlines recognised that some passengers had a high willingness to pay, even though all they needed was a simple return trip with no frills or flexibility. However, many of these high willingness to pay passengers were also unwilling to stayover a weekend in order to avail themselves of low fares. The carriers knew that the lower prices would attract new passengers and stimulate the market, but they desired to continue receiving the high fares and revenues from their existing passenger base.

Through the technique of attaching a restriction on the purchase of a low fare ticket they could achieve price discrimination. Price discrimination was important as the extra revenues obtained by the full service airlines could support their higher cost; in some cases support multiple high cost full service airlines in the same market, even though those markets had economies of traffic density available.

I hope you'll forgive me for using a demand diagram that's sort of ingrained into us as economists. This diagram shows the traditional graphical analysis of the economy -- of the economist to show price discrimination. Downward sloping line is a demand curve which shows that only a small number of individuals are willing to travel at high airfares. As the fare declines on the vertical axis, the number of trips that will be purchased in the market increases. The objective of the full service airlines is to find a means to segment the market so that many of the high willingness to pay passengers can be charged a high price, while offering a low price to those travellers who will travel, but only at the low price.

After extensive market research, as I indicated, the air carriers discovered that the single most effective way to segment the market was to make the low fare available only if it was purchased on a round trip basis and that the trip involved a Saturday stayover.

The modern low cost carrier has such low cost that there is not the same need for a high degree of price discrimination; the low cost carriers thus began to sell a simple product. Travellers could purchase low fares from a low cost carrier and the low fares were available on one-way tickets. They did not require the purchase of a return ticket.

The low cost carrier fare policy attracted many new travellers who would travel only at the low fares; however, by removing the return ticket requirement and therefore the need to include a Saturday stayover, many high willingness to pay travellers, including the so-called business traveller, found that they could avail themselves of low fares for the first time and enjoy a substantial benefit. This has created an enormous benefit for them as they highly value the air service, but now only have to pay a low fare.

While the high willingness to pay traveller may value extra services from the full service airline, the fare gap between the unrestricted full service airline fare and the one-way low cost carrier fare has been so large that many high willingness to pay travellers have decided to purchase the low service but low fare, low cost carrier product.

The FSAs when faced with a low cost carrier on their routes have found that they can no longer maintain their traditional high priced fare discrimination factor. Once low fare one-way tickets become available, the full service airline suffer a major reduction in the revenue premium they reaped in the price from price discrimination. Their traditional fare policies are no longer sustainable. The loss of revenue is permanent as once the one-way low fare product is in the market, it is difficult, if not impossible, to put the genie back into the bottle.

MS REBSTOCK: I'll just stop you there for a second, please, doctor. I just want to ask you about some evidence from Australia, again from Professor Forsyth, that looked at the impact of low cost carrier entry in Australia, and I think in 1999 and 2001 found that while discount fares fail, both general economy and business fares rose in real terms, and I just, I wonder what the -- whether it is a correct characterisation in some markets to say that entry of a low cost carrier had that sort of impact across the market, or whether it is very much a case where some segments are impacted quite significantly, and others actually the opposite effect?

DR TRETHEWAY: I'm sorry if I'm not quite understanding, so some were impacted significantly in the sense of significantly lower fares?

MS REBSTOCK: Yes.

DR TRETHEWAY: And others may in fact have had higher airfares?

CHAIR: Professor Forsyth reported that some economy and some business fares actually rose in real terms.

DR TRETHEWAY: Yes. My understanding is that when a low cost carrier comes into a market and a carrier faces them for the first time, they of course attempt to offer a low fare product in the market. They, as traditional price discriminators then attempt to recover some revenue by increasing the price on those passengers that they thought may have had inelastic demands. On the margin perhaps they did have inelastic demands, but as a low fare carrier comes in with ever lower prices, and the full service airline continues to increase its premium product prices, the fare gap becomes so large that even premium travellers now start to avail themselves of the low fare ticket.

While at first we see those fares going up, what we have seen in the last few years in a number of markets, Europe, Canada, now down here in Australia and New Zealand is, the full service airlines realise that that strategy that Professor Forsyth -- that initial strategy that Professor Forsyth was observing is not sustainable and they're coming into the market with uniform simplified fare structures that do not have the Saturday stayover restriction.

CHAIR: I think we'll come back to that, but please continue. Sorry.

MR CURTIN: I'm just interesting in something along the same lines, and perhaps more in the States rather than in Australia, but my impression is that there's been an extra step, certainly the low cost carriers are behaving as you suggest.

On the other side I suspect the customers are beginning to change as well, and I know we're going to have a lot of evidence on whether there are separate business and leisure passenger markets, but it seems to me at least in the States the business passengers' elasticities might almost have changed, and that the way the service providers have changed on the supply side has almost started to cause a corresponding change on the demand-side, and anecdotally you see a lot more businesses shopping around than you used to before.

I'm aware of instances where there are full-time people on board just surfing the internet looking for the cheap deal where they wouldn't have bothered five or 10 years ago. We've heard a lot on the supply side, if you like, about the changes; what would be your observation -- my feeling is -- corresponding changes on the demand-side?

DR TRETHEWAY: I believe that the change taking place in the markets today is fundamental, and it involves both the demand side as well as the supply side, as you suggest.

If I can use a piece of anecdotal evidence. A route that I travel far more often than I care to is Ottawa to Vancouver; sort of a Wellington to Perth kind of route. Air Canada's full fare economy, not business class, but full fare economy is $1,700 -- those are Canadian dollars -- so $1,900 perhaps New Zealand dollars. A lower fare was available in the market of $1,200; the difference of $500, I would like at that and say for $500 I'm not willing to give up the flexibility, it makes me less productive as a consultant and so forth.

WestJet is now in the market with a fare of roughly $350. When I compare the $1,700 unrestricted product with a $350 unrestricted one-way product I can buy on WestJet -- a very uncomfortable seat, the flight makes one stop -- it's not quite as convenient as the service I flew on Air Canada, but the fare difference is so large I changed my behaviour. I can actually justify to my clients that I'm going to save them so much money that they can afford to pay me to read the book on the plane because I can't open the computer up in the seat.

While I'm saying this perhaps a bit tongue in cheek, I think it's an anecdotal piece of information that relates -- that when the supply side changes fundamentally, consumers start to change the nature of their behaviour.

Other work I had done in a different industry in electric power where consumers were put on to time of day rates where you paid more for electric consumption in peak hours than off-peak hours, we observed over time consumers changed their behaviour. The dishwasher would run at 11 o'clock at night, not at 7 pm, the peak time for air-conditioning and so forth. I believe that that type of transition is taking place in the market, as you suggest.

MR CURTIN: Thank you.

MS BATES QC: In the June edition of the industry report from the Centre for Asia-Pacific Aviation -- are you familiar with that?

DR TRETHEWAY: Yes, Mr Harbison's group, yes.

MS BATES QC: It indicated that as far as Virgin's concerned there might be a bit of stuff happening the other way from what you describe. That is that it says.

"As Virgin has matured, the model has become more complex and tailored to suit the idiosyncratic market conditions in Australia with its higher reliance on corporate and Government travellers."

In other words, because of -- I don't know whether the market is idiosyncratic; I first ask you, do you think it is -- do you think that it's idiosyncratic with a higher reliance on corporate and Government travellers?

DR TRETHEWAY: I think that all markets have their own unique natures, but I don't see that as being fundamentally different than United States, Canada or Europe. Different market -- I mean, different routes have high business travel in Australia and the United States and Europe, and other routes, you know, up to the Gold Coast have less corporate.

MS BATES QC: Yeah, but what this little article is saying, Virgin's actually changed its modus operandi by moving closer to service provided by a full service airline. Have you seen any evidence of that sort of thing happening elsewhere?

DR TRETHEWAY: Yes. The low cost carrier, while we can put forth a stereotype of a low cost carrier, they are all very innovative, they look at the unique circumstances in their market, they all try to find an edge for themselves in the market. They are discovering that there are some services that travellers are willing, in fact, to pay a little bit extra for.

If I use another example. I understand that one of the US carriers, JetBlue, did some market research about whether the customer would value an in-flight extra service, and they looked specifically at in-flight meals versus in-flight video. And, their market research, I understand, indicated that while an in-flight meal is $5, everybody complains about it, they don't particularly like it, it doesn't add a lot of value, but for $2 they could provide in-seat personal video, and they decided to do that. In fact, I understand they've actually invested in the company that provides that technology and are now selling it to other low cost carriers and indeed some other full service airlines. I expect that we will continue to see the low cost carrier model evolve, there will be bits and pieces of additional services that will be added, but fundamentally they are not full service airlines. And Virgin Blue may add some bits and pieces, but many of those services -- hypothetically they could add business class lounges, but it would be typical for them to charge for that service rather than include it as part of package.

MS BATES QC: I think the airport lounge is something that Virgin has started to get into.

DR TRETHEWAY: But they're user-pay.

MR CURTIN: Yes.

DR TRETHEWAY: That's very different from Qantas, for example; it's a profit centre for them.

MS BATES QC: Just looking at the industry as a whole, do you think the movement's towards figuring out what it is exactly the customers' willing to pay for and tailoring the supply to suit?

DR TRETHEWAY: I believe that, as Mr Curtin has suggested, the nature of demand itself is going to continue to evolve. The smart low cost carrier will continue to look at change in demand and will attempt to tailor the product, adding value where the consumer's willing to pay for it, more likely charging specifically for that add value and giving you the option of not purchasing it; that's in contrast to the full service airline that packaged together extra value and required all their customers to consume and pay for it whether some customers wanted it or not.

MS BATES QC: Yeah, but don't they have to modify their behaviour.

DR TRETHEWAY: Absolutely, that's what they're doing right now.

MS BATES QC: So you think there'll be more of that, more of perhaps the two models moving closer together?

DR TRETHEWAY: They will move marginally closer together but the two shall never the twain meet.

MS BATES QC: What is the deciding factor there as to why they won't?

DR TRETHEWAY: The full service airline provides network services; that's very expensive to provide. That is what they do extremely well. There is about half the market that needs that network connectivity, that redundancy and to some extent the extra in-flight services that are packaged together.

The low cost carriers, using RyanAir as the most extreme, they don't even allow you to connect on their own flights in the same day; they refuse to sell a connect ticket on their airline. Others will connect within their system, and a few will provide some begrudging connection with some international airlines, but fundamentally they have designed themselves not to provide a highly connected convenient product with service redundancy. That's the fundamental difference, and there's part of the market that wants that, will buy it, and so, there is a future for the full service airline.

MS BATES QC: But they're having to provide that while they're losing revenue on their point-to-point stuff, and they're not getting that. So, it's a difficulty for them, isn't it?

DR TRETHEWAY: That's right, that's why a change has to be made. They will have a smaller market share, and if there are economies of traffic densities, I believe there are in the market, the full service airline industry throughout the world will have to consolidate and indeed we are seeing that consolidation wherever it's made possible by Government.

MR CURTIN: Just following up a little on the same theme, I wonder -- some of the alleged benefits of the arrangements that are being proposed are very much based on these connectivity and network effects.

DR TRETHEWAY: Yes.

MR CURTIN: Again, I wonder if consumers continued to value those, I think you mentioned half the market is still interested in that kind of service. I just wonder if that's likely to remain true. If you're booking on the internet or relying on some travel agent and you're going to an industry conference in a city you've been overseas, does anyone care any more how they get there?

DR TRETHEWAY: I believe that in a very short haul market you have a very high proportion of origin destination traffic. If I use examples from my home; people travelling from Vancouver to Calgary, somewhat similar to Sydney-Brisbane, for example. Auckland-Wellington would actually be almost exactly the right flying time, a large amount of origin destination traffic.

As the travel distance gets longer and longer what you find is that a larger and larger portion of those travellers are not going to where the aircraft land, but they're going some place beyond. When it comes to intercontinental -- well, while somebody here in Wellington, for example, may fly to London, England, chances are London is not the final destination. They may be going to Hamburg, to Manchester, to Cork or some other place. And, as the distance gets longer, more and more the market is going to be travelling off the major, what I refer to as "pipeline routes".

Network connectivity is essential, because they don't want to purchase a ticket on, let's say, Australian Airlines here in this region, connecting to some low cost carrier they never heard of, much less are able to find on the internet, and they don't know what's going to happen to their bags if they misconnect. Passengers do value the connected service so that they're taken care of from their origin to their destination, and as the distances gets longer, that value gets larger and a larger portion of the market wants to and will buy that service.

MR CURTIN: And your feeling is, that hasn't changed much as a feature of consumer behaviour?

DR TRETHEWAY: Correct. Because my family is in Cornwall England, they're not in London, and I'm not going to change my behaviour; I'm going to go to Cornwall.

Just to finish on this slide. This undermining of the price discrimination ability of the full service airlines has induced significant benefits for travellers, including business travellers, even those with complex multi-stop itineraries. The benefits of the low cost carriers are shared by these business travellers, because the full service airlines find they are compelled to drop their fare and fare restrictions, those travellers who remain as customers of the full service airlines reap major benefits. They now have lower fares.

Benefits are not confined only to the customer and the low cost carrier. The low cost carrier has imposed a new price discipline and a new pricing reality on the entire market and almost all consumers in the market. The hugely significant impact of the low cost carriers leave the full service airlines with difficult choices. A full service airline can attempt to match the low cost carrier price and price discrimination conditions, but without addressing the differences between its high cost and the costs of the low cost carrier. This clearly is not sustainable.

Another choice is to accept the new pricing discipline in the market imposed by the low cost carrier but also focus on reducing cost in an attempt to achieve financial sustainability.

A number of full service airlines have pursued cost reduction strategies. They have been able to reduce costs by simplifying service offerings such as eliminating in-flight meal service, reconfiguring their aircraft into single class high density seating reducing costs per seat, assuming the extra seats can be sold; seeking labour cost reductions in part through higher productivity; reducing capital costs by financial restructuring. Generally this cost reduction strategy will be at the expense of the airline shareholders as well as other investors and suppliers.

However, the full service airlines cannot get their costs completely down to the level of the low cost carriers; this is due to several reasons. While some full service airlines will replace the traditional service with low cost express type products, these services must still connect passengers to the rest of their networks and to the networks of other air carriers, alliance partners or the general full service airline industry.

Network connectivity imposes costs; it imposes significant costs. As one of many examples of these costs the ability to transfer baggage between flights of the same carrier, its lines partners and other carriers requires major investments in physical infrastructure; all those little carts running around at the airport, the baggage system, important and expensive information systems to keep tracks of the bag, plus significant costs for delivering misconnected bags or compensating individuals for lost baggage.

The President of RyanAir recently said that he believes that network connectivity adds a cost of $100 per passenger into the product that is delivered by the full service airlines.

Second, full service airlines even with simple in-flight services provide services and networks with redundancies allowing passengers to get to their final destinations on alternative flights or routings, if things are snowed in or electric power goes out in major portions of the US northeast, again imposing higher cost than their low cost carrier competitors. People value these services, or at least a portion of the market does.

Full service airlines have established operational practices and relationships with labour which are difficult to change and match from the start from scratch methods of the low cost carriers.

As well, the poor financial performance of these carriers results in higher capital cost. While financial restructuring may reduce debt and other obligations, a much higher risk premium on their future financial capital will be attached and these must be paid by these carriers relative to the low cost carriers who are also low financial cost carriers.

It is my opinion that while full service airlines can and should reduce their cost, they will never be able to get their costs down completely to the level of the low cost carriers. Further, the low cost carrier business model requires a constant focus on further cost reduction so as the full service airlines cost reduction effort achieves some success, it's pursuing a constantly moving target, and it will be difficult, if ever possible, to catch up.

I was asked to comment on how full service airlines compete against each other and how they compete against low cost carriers and how low cost carriers compete against them. Traditionally, full service airlines competed by matching each other's prices, but do so with the same price discrimination, the same return tickets, Saturday stayover requirement.

The full service airlines vigorously competed by operating extensive networks with high connectivity, with high frequency of service. They also sought to win the loyalty of frequent high willingness to pay travellers by offering high last minute seat availability at a premium price whenever possible. These partition elements impose capital and operating costs on the full service airline in their competition with one another.

In contrast, the low cost carriers compete by generally offering a very similar product, both in terms of in-flight and on the ground services, and in terms of the degree of connectivity and redundancy of their networks.

Of critical importance, the low cost carriers compete with full service airlines by simple pricing policies which have the consequence of undermining the price discrimination of the full service airlines, thus severely and permanently eroding the full service airlines' revenue base.

Third, full service airlines compete by striving to constantly -- sorry low cost carriers compete by striving to constantly reduce their costs which in turn allows them to offer still over airfares.

I was asked to comment on the characteristics of the Tasman and domestic New Zealand routes and whether these have the characteristics which would support and attract low cost carrier entry. It is my opinion that the Tasman and domestic New Zealand routes are fully consistent low cost carrier business models. I note that low cost carriers elsewhere have entered markets of the size of the markets here in New Zealand and on the Trans-Tasman. The normal pattern is for the low cost carrier to expand service from an existing well-developed traffic base and then extend their network into new markets.

Airport access is no longer an issue in this region. Wellington and Christchurch now have domestic as well as international ticketing and gate facilities available, and the Applicants are willing to facilitate access to airport facilities for domestic New Zealand operations, if necessary, to make low cost carrier entry easier and faster. I see no reason why low cost carrier service will not be developed on both the Tasman and the domestic New Zealand routes.

I was asked to comment on whether a low cost carrier would be likely to eventually enter both the Tasman and domestic New Zealand routes. I note that, while low cost carriers follow somewhat different growth strategies, a very common practice is to connect the points together in a network much more extensively than the hub and spoke practice often followed by the full service airlines. The connections may not be convenient like a full service airline, where the connections are timed for 25 minute connections, but given they fly into one city, from one point they will typically add perhaps at other times of the day flights to other cities that they serve.

For example, RyanAir, Southwest, easyJet often add a new destination and connect it to a number of existing points. Low cost carriers fill in connections in their network -- or "route segments" perhaps would be a better term.

Based on this common practice of low cost carriers to expand from an existing base and connect the dots in their network, it is my opinion that a low cost carrier will enter the Tasman and will also eventually enter the New Zealand domestic market. It is entirely conceivable that a low cost carrier would enter both the Tasman and the domestic New Zealand market simultaneously; similar to how Southwest, RyanAir, and easyJet have entered routes in their part of the world.

Alternatively, the low cost carrier might begin with only the Tasman, similar to how WestJet has added service in its Canadian markets, then subsequently connect the dots up in its New Zealand network.

Virgin Blue, of course, is a likely low cost carrier entrant into these two markets. The documents filed by the applicant show how it now serves 24 of the top 30 city pairs in Australia with a high degree of a connect the dots network. It has ten aircraft on order at a time when it has already connected many of the dots in Australia making new pursuit of new markets attractive. The aircraft in its fleet have the capability to fly the distances across the Tasman and within New Zealand. It's my opinion that when combined with the lack of entry barriers under both the Tasman and domestic routes, its expansion on to these routes is virtually inevitable. Such expansion is fully consistent with my understanding of its business model.

I would now like to summarise my conclusions in this first part of my statement dealing with the emergence, growth and impact of low cost carriers. First, it is my opinion that the low cost carriers have had the single largest impact on price competition and airline markets in the past 25 years. The impact of their low cost and availability of low one-way fares has had a larger impact than any competitive development between the full service airlines of the past 25 years. The low cost carrier presence, or threatened presence in a market, is highly desirable and of greater importance than any full service airline to full service airline competition we have seen in the past two decades or so.

Second, the expansion of low cost carriers is undermining the financial viability of full service airlines around the world. The undermining of their traditional price discrimination with low fares only available on a restricted round trip ticket has resulted in a significant, and I believe permanent loss of full service airline revenues. Especially vulnerable have been the smaller full service carriers such as Canadian Airlines International, Ansett, Swissair and Sabena. As the low cost carriers increase their share of passengers carried, the full service airlines will be forced into smaller shares of the passengers in the market. They will need to consolidate, or some of them will need to exit the industry.

Outside of the United States consolidation can largely only be achieved by some form of cross-border transaction. The large number of FSAs in the world today are a consequence of historical Government policies which restricted national ownership of airlines and regulated them. But in deregulated markets, with ever expanding low cost carrier networks -- services, means must be found to allow the full service airlines to consolidate or achieve the benefits of consolidation.

Third, it is my opinion that low cost carrier entry under the Tasman and domestic routes is inevitable. It is my opinion that low cost carrier will enter these routes regardless of whether the Applicants' request for authorisation is granted. The Applicants are willing to facilitate access at airport facilities at Auckland to ease and speed the desirability of entry of these carriers on to these routes.

Fourth, the low cost carrier not only provides low fare benefits for their own customers, because of the price discipline they impose on the full service airlines, they induce benefits for those travellers who fly on a full service airline. When a low cost carrier enters a market the traditional full service airline pricing policies with return Saturday stay-overs is impractical. This results in the availability of low fares, even from the FSAs, because fares are available on a one-way basis, even those full service airline travellers with multi-stop itineraries are beneficiaries.

I now turn to the second set of questions I was asked to address.

MS REBSTOCK: Can you just wait for one second. I just wanted to ask if there are any further questions at this point.

MR CURTIN: This may be cropping up in your next section, but I know Mr Dixon earlier was referencing what the Director General of IATA was saying, which was something similar to what you're saying, that some way needs to be found to facilitate the necessary shrinkage or consolidation of the excessive number of owned FSAs, and I suppose my question would be, either now or at the end of your next part, and speaking to you as perhaps a competition economist, why should we allow consolidation rather than just let the competitive forces leave the most efficient FSA standing?

DR TRETHEWAY: Yes, not just in airlines but in any market, if consolidation or a higher share of the market is the optimal outcome, that can be done by having carriers exit the market, or another market outcome is to allow a merger, and the role of competition law of course is to look at whether such mergers, or in this case alliances or other type of practices produce benefits.

I think it would be incorrect to look at any merger and say, we should always just let the market sort it out by driving somebody out of business. Some mergers, or some transactions of this type do produce benefits. That, I think, a critical question is, while we all might be tempted to sort of, at least myself kind of a rabid market economist, to let the -- I'm grasping for the right euphemism to use here, but sort of let's see who's going to survive in the market; it is the case that many mergers or transactions produce net benefits, and that I think should be the focus.

In this transaction I have looked at some of the benefits that are put forth, I am especially persuaded by the benefits to travellers of on-line direct services, there's no question that consumers highly value those, better connectivity of the network, greater redundancy of service, and the tourism benefits of being able to sell with multiple powerful brands, I think those are genuine benefits that might lead you to consider that simply letting one of the carriers fail might not be the optimal case in this particular circumstance.

MR CURTIN: Can you point us to any examples in the States or Canada where mergers of this type were argued to have had demonstrable benefits and were let through and did have benefits at the end of the day?

DR TRETHEWAY: Well, I think this merger -- it's not a merger, sorry; I think the proposed investment and alliance here is fundamentally different than any of the mergers in North America.

If we start with Canada, sort of going top to bottom; Air Canada acquired Canadian Airlines International and merged it into it. It was difficult for me to see benefits of that because these two carriers completely overlapped their domestic network; variations between them were really really minor, and even in their international markets both flew to Japan, both flew to the United Kingdom, both flew to Hong Kong, the major market, so it's hard to see that there were benefits.

The same in the United States; you know, America and TWA getting together, these are carriers that in some ways, while they provided somewhat different services and had some unique routes, there's some overlap in terms of their services. This transaction is not a merger. This transaction is one that's going to retain two separate carriers with a different domestic home focus. With two powerful brands; I don't think the value of the Canadian brand and the Air Canada brand, because of the overlap, was going to get them anything more in overseas markets. But the type of tourism market coming down here, New Zealand is a distinct product from Australia, although product that very high proportion of travellers want to purchase in a combined package.

MR CURTIN: Would it almost be analogous to code sharing in the States, rather than merger arrangements?

DR TRETHEWAY: Code shares are very complicated. There's many different types of code shares; some produce great benefits, others produce others, but they do not end up with the parties to the code share having a financial stake in the success of their partners.

I tried to come down here from Vancouver via Honolulu. Air New Zealand wasn't able to sell me a ticket; they code shared in the first segment of the route with Air Canada. Air Canada had a seat available but not that it could get me all way down here. Even though they're code shared partners, they seem unable to complete service offering for what I might add is a very high fare ticket that I had to purchase.

When an investment is made, and there's a financial incentive now for Qantas in this case to sell this market, I think that's fundamentally different than code share relationships.

And maybe this isn't a completely relevant example, but you know in shipping we also see like vessel sharing and so forth, and it's not the same thing as when one invests in the other and they want to see the success of the other partner.

MR CURTIN: Thank you.

CHAIR: I'm just going to take one last question from Commissioner Bates and then we'll take a tea break.

MS BATES: When you started out today I think -- I think you said there wasn't much point in a VBA trying to replicate a major airline, and they should start with say two or three planes.

DR TRETHEWAY: Not two; three would be better.

MS BATES QC: What?

DR TRETHEWAY: Sorry, not two, three would be much better.

MS BATES QC: But it was a small number, and build up from there. Why do you say that?

DR TRETHEWAY: When we observe People Express start with 17 aircraft almost overnight, that's a lot of capacity because your typical low cost carrier will start up with very short haul routes, one hour, so you have 17 aircraft, so that's 170 flights you're going to operate on your first day, or your first month, or kind of a very short period of time that you phase in.

There's lots of problems you've got to iron out of the system, you know, pilots get sick, have you got it worked out about where you're going to find a replacement pilot and so forth, how are you going to sell 170 route segments all of a sudden from scratch. It makes far more sense to start out with three aircraft. Where you're selling 30 segments, maybe a little bit less because you want some redundancy in case an aircraft fails.

Now, your marketing people can really go out and focus on a launch service with these three aircraft to these four cities rather than to 21 cities and start to establish a market presence in those markets. It gives you a chance to collect data and find out how is the market responding.

MS BATES QC: Do you think that's how Virgin will enter the market?

DR TRETHEWAY: I think you'd be best to ask Virgin that question, but I would -- if they were to ask me for my advice, I would not advise them to start out with 17 aircraft, whether it would be starting out with three or five. They have a somewhat larger base, they're not starting from scratch.

MS BATES QC: Because they've got Australia, but --

DR TRETHEWAY: Correct.

MS BATES QC: But you'd advise them to start small first and see how they went?

DR TRETHEWAY: Yes, but not too small because, as I said, they already have an established presence. The point I was trying to make earlier is when you establish the very first time.

MS BATES QC: They have an established presence in the Australian market.

DR TRETHEWAY: Yes.

MS BATES QC: But not here.

DR TRETHEWAY: For example, if they were to start with five aircraft in this market, that's not such a large percentage increase in their overall corporate operation as opposed to, you know, going to 17 aircraft from 0 in the case of People Express -- well, I mean, mathematically it was infinity, but it was a huge order of magnitude difference in start-up.

MS BATES QC: The ACCC in its Draft Determination said that on -- even on Virgin's best case scenario the Applicants would be operating at almost six times the capacity of Virgin Blue in year 1 and four times its capacity in year 3. And it went on to say:

"While such an outcome would mean that Virgin Blue had emerged as a competitive factor in the Trans-Tasman market, it could hardly be regarded as a significant competitive constraint on the Applicants."

I'd just like to ask you for your comments on that conclusion.

DR TRETHEWAY: A number of carriers -- WestJet would be a good example -- but RyanAir, easyJet, all sort of fit this pattern. When they get to the stage of about 30 to 40 aircraft, demonstrated they're able to add aircraft in their fleet safely and profitably at the rate of roughly one per month or ten per year, that's a 30, 40% rate of growth in the market.

Virgin, I think, could add a significant number of aircraft to their fleet because they're already at that stage; they have pilot training programmes in place now and so forth.

MS BATES QC: But, just saying you accepted ACCC saying four times capacity in year three, do you think that -- would that be a -- would that be an effective constraint, do you think?

DR TRETHEWAY: Sorry, a constraint on their safe operation? I'm not quite understanding.

MS BATES QC: No, a constraint on the Applicants.

DR TRETHEWAY: Absolutely.

MS BATES: ACCC didn't think it would

DR TRETHEWAY: I disagree with the ACCC, yes. I observe that when, you know, I was going to put it in the vernacular, it's probably not good.

MS BATES QC: You can.

DR TRETHEWAY: When a low cost carrier enters a market and puts in the availability of one-way tickets, the cat's among the pigeons, and it's difficult even with a small level of capacity in the market for the small service airlines to withstand that. In fact, some of the other testimony that had been put in place showed the impact of a small amount of entry by a low cost carrier and the dramatic and immediate impact it had on the fare structure of the full service airlines where the subsequent increases in capacity did not have much additional impact. It's that first sort of flight on a route or the first aircraft in the market that really has the dramatic impact.

MS BATES QC: Yeah, I think that's probably right, that though not all the VBAs have had the stamina to withstand the onslaught, have they, the onslaught of the incumbents bringing fares down and just actually driving them out?

DR TRETHEWAY: The record in the 1980s was, most of the VBAs or low cost carriers were not successful largely because they didn't have the business model right at that time.

I would like to comment though that when a full service airline comes into a market you might need a lot more capacity for that full service air line to act as a competitive constraint because they're competing on the same dimensions and there is this effect of city presence and so forth; it takes a while to build up.

But a low cost carrier comes in and undermines price discrimination with a one-way fare; you can't resist that. That small amount of capacity changes everything in the market.

MS BATES QC: Thank you.

CHAIR: I'd like to break now for afternoon tea and ask people to be back in 20 minutes. So, we will resume at 20 minutes before the hour, thank you.

Adjournment taken from 4.20 pm to 4.42 pm

CHAIR: I'd like to resume the Conference now, and what I would like to suggest we do is, I would like to ask Dr Pickford on behalf of the Commission to put questions to Dr Tretheway and then followed by Professor Gillen, and then I would like you, after they've done that, to go back and pick up any points in your presentation that don't get covered in the questions, and I'd like to proceed on that basis.

Before we do that, can I say that it is my intention to handle the session on VBA entry and expansion and the impact of VBA entry in the morning at 8 o'clock and, when we finish the current session, we will go to the confidential session, if I'm correct, on engineering and maintenance, then we will do the counterfactual discussion on Qantas expansion, followed tonight by confidential session on the counterfactual, and that is the revised agenda for today and starting at 8 o'clock in the morning.

So, I will now hand the floor to Dr Pickford to put questions to Dr Tretheway, please.

DR PICKFORD: I've got a couple of questions, Dr Tretheway. One is, you referred to the primary impact of VBAs on FSAs as being one of introducing one-way low fares. You're probably aware in this part of the world, Air New Zealand has done something similar with its Air New Zealand Express service, both on domestic main trunk New Zealand and also proposing to do that on the Tasman. To what extent has this move by Air New Zealand preempted the product price base which you might expect a VBA entrant to want to occupy?

DR TRETHEWAY: I think it's fully consistent with anticipating what I view to be inevitable entry, and then rather to wait for the moment of actual entry to anticipate it and to actually introduce the new response policy in advance of entry.

DR PICKFORD: But, has that not made it more difficult or that much more difficult for Virgin Blue to enter? How will it change Virgin Blue's strategy given that its space has been sort of preempted by Air New Zealand?

DR TRETHEWAY: Well, we observe for example in Canada where Canada's put similar pricing policies in place and now made them extensive across its entire domestic system, that WestJet and other low cost carriers continue to enter markets there, so it doesn't seem to be a preemptive move. I also understand that Qantas has similar policies in place and that Virgin has entered some routes subsequent to that policy.

DR PICKFORD: In your original submission, written submission, you characterise FSAs as being long-run profit maximisers but in the short-run, very short-run are likely to be revenue maximisers. But we have a paper of yours which you presented to the Hamburg Aviation Conference earlier this year in which you argue that, although LCCs set long-run prices to maximise profits, full service operators tend to engage in short-term prices with decision systems that lead to, in practise, revenue maximisation such that prices are too low and they don't cover their costs. There seems to be a slight contradiction between that paper and what you've been saying today.

DR TRETHEWAY: No, I don't view there's a contradiction at all. In my statement here I indicated that in the very short-term for a single flight. Flight 387 on the 19th of September, the airline seat management systems are revenue maximisation systems, and that's true for FSAs as well as for low cost carriers. So, in the very very short time period the pricing exercise is a revenue maximising pricing exercise. Both FSAs and VBAs then engage in profit maximising behaviour when, for example, on a monthly basis they look at how did we perform, you know, with the seat management system and so forth. So, both types of carriers are then making decisions in a time period that's profit maximisation.

What I said in my Hamburg paper is that in the very long-term, when the full service fare lines -- not every one, but many of them, have deployed new aircraft, they have not enforced into the decision-making process that there's an assumption that we'll buy the new airplane because we'll get higher prices, they have not ensured that that's the case, and I think it's a discipline that they have not enforced on the route managers. Route managers are the people looking at routes on, say, a monthly or semi-monthly basis for these routes performing profitably. They have allowed them to slip back into variable cost pricing.

My observation has been that many of the full service airlines never get themselves back into full long-term pricing decisions. Some airlines have -- and one that I actually cited that day in Hamburg when I presented the paper was, Qantas is an airline that has consistently sought to make sure that it's engaging in long-term prices that are covering the full cost of capital. That's reflected by the superior financial returns relative to its FSA competitors, although not relative to many other industries.

DR PICKFORD: I think you've also characterised competition between FSAs as one of capacity competition. And, thinking about that, this might be a way of actually characterising the outcomes as being closer to revenue maximisation than profit maximisation; that carriers compete to sort of become number 1 on a route, they tend to expand capacity ahead of their rivals, forcing prices down to perhaps a level lower than you would expect with profit maximisation. So, again, it seems there are some ways of looking at airlines which might suggest they are nearer to revenue maximisation than profit maximisation.

DR TRETHEWAY: I don't see the capacity maximisation as tautologically equivalent to revenue maximisation at all.

Revenue maximisation basically says we'll take all costs as being fixed. I think in capacity competition it's one of many elements or dimensions in which they compete. You'll still be asking the question as to whether this level of capacity that I deploy will cover my cost of capital, or at very least my variable cost, and as soon as you're into variable cost coverage you've moved away from revenue maximisation at that point. Revenue maximisation is only looking at price and nothing else.

Variable cost, which perhaps you would play, in economists jargon "the capacity game" by deploying capacity, that capacity still will need to cover variable cost and that is short-run profit maximisation. It may be that some of the carriers, especially those that are no longer with us, never got themselves into long-run profit maximisation making a full contribution to capital. So, I don't think that there's any conflict in my statements in my views that capacity competition is not revenue maximisation.

DR PICKFORD: You also state that LCC entry has two impacts on FSAs; one is a diversion of some FSA customers to the LCC, and the other is the change by the FSA in its ability to price discriminate. I've often read that there is a common accepted impact also of LCCs in terms of expanding the size of the market; it encourages people to fly because of the low fares who would otherwise not have flown. Do you not agree that's the case and an important aspect of LCC entry and expansion is in terms of expanding the market rather than simply taking a share off the FSAs?

DR TRETHEWAY: Yes, that's fully consistent with my views, that as an LCC enters the market there is two effects first they divert some traffic from small service airlines, and secondly they generate completely new traffic.

DR PICKFORD: Thank you very much.

PROF GILLEN: Professor Tretheway, I just want to get to the point that Michael just made. My understanding is that the low cost carriers in fact stimulate the market and then they may start grabbing market share from full service airlines. Would you agree with that?

DR TRETHEWAY: No. My observation has been pretty consistent that the first flight that a low cost carrier offers will typically have some customers on that flight who would have otherwise travelled on the full service airlines.

Not to be trite about this, but there's always some customers that say, jeez, they lost my bag the last time, if there's ever an alternative, I'm going to get on them. There will be some of those customers even on day one where the low cost carriers service offering is exactly, for example, the right time or at right budget that they will avail themselves of that because the elimination of price discrimination.

I would agree, however, that often the low cost carrier's initial impact in the market is the stimulation and that the diversion increases as they add more capacity in the market and the frequency of service comes up. Then it's a little more easy for, shall we say the business traveller to avail themselves of, you know, the low cost carrier's product. But I do observe that, on the very first day there's some diversion that will take place.

PROF GILLEN: If we go back to an earlier statement of yours, that a low cost carrier would generally enter with three flights, for example.

DR TRETHEWAY: No, I did not say "three flights"; "three aircraft". That's very important.

PROF GILLEN: Therefore, they're going to enter the market as a soft competitor. WestJet is a good example of this in a number of different market sin Canada, and under those circumstances that entry strategy is designed specifically not in a sense to upset the large elephant, that what you don't want to do is invite a retaliatory response.

Is that a fair characterisation of the way that some low cost carriers enter markets?

DR TRETHEWAY: It may be that some carriers do, but I observe that they're not always a soft competitor.

WestJet, for example, has entered a large number of markets where there was no previous non-stop service available. I'm not sure how familiar you are with Canada, but routes such as Calgary to Colmox, where there was no previous FSA carrier operating on the route; in that sense they're not a soft competitor at all. All of a sudden that service offering attracted a number of travellers who otherwise would have been flying on the FSA through an alternative and inconvenient gateway, such as Vancouver. In fact WestJet, I understand my staff took a look and found that about 40% of the routes it operates, it's the only carrier on the route. It's not just cherry picking the very largest routes; it's looking for opportunities. A route that's unserved that seems to have enough traffic, especially after stimulation by the low airfares may attract its entry. Sometimes it is a soft entry, it will come in with just a little bit of capacity. I think it depends on where the opportunities are best for the carrier.

PROF GILLEN: Earlier in your statements, and this is certainly true in your report as well, and I want confirmation of this; that in the absence of low cost carriers, Canadian Airlines, Swissair, Sabena and Ansett, would they have survived in the marketplace in your view?

DR TRETHEWAY: If you just allow me to think through these one by one. Absent the entry of the low cost carrier WestJet, I believe Canadian Airlines International would still be flying today, barring the complicating impacts of September 11th and so forth, but yes, I believe it would be.

What were the others?

PROF GILLEN: SwissAir.

DR TRETHEWAY: SwissAir; it may have been more complicated, they undertook a series of financial transactions that may eventually have done them in. Nevertheless, the impact of easyJet in Zurich and especially in Geneva eroded the part of its revenue base where it made its best profits.

I understood its long haul international services were marginally profitable, made a lot of its profits because of the customer loyalty in the Swiss originating short haul markets and that's what easyJet picked off. Maybe it would not have been flying just because of the financial transactions but its prospects would have been much better. Sabena, I can't say anything kind about them. It's probably an airline that should have left the market 30 years ago. Its a carrier that was uniform -- continually unable to do anything to rectify its costs, but in the absence of the low cost carrier its Government may have found other means to continue to support it; I don't know.

And what was the fourth one?

PROF GILLEN: It was Ansett.

DR TRETHEWAY: I believe that the low cost carrier entry was a very important factor in the difficulties it faced.

PROF GILLEN: You would not disagree on both Ansett and Canadian.

Let me get to another question, and it's one that's puzzled me for a while. If you look in the literature one of the things is -- size matters when you enter an industry. One of the things that you've argued is that when a low cost carrier enters a market it tends to bring down the fare structure, average price, including business class fares.

I'm wondering, two elements here; one is that, does it matter at what level, or how much capacity you enter at? And secondly, are the reductions in fares the same over the short-term as they are over the long-term?

DR TRETHEWAY: I may have to come back to the second question in case I forget it. The first question was about, does scale of entry matter?

In work that you and I, for example, did with our colleague Tae Oum, we found that there's significant economies of traffic density in airline markets, but limited economies of scale meaning the size of network that you operate. That research was based on data of network air carriers competing against each other. We did not have low, low cost carriers in the database, and in any event the low cost carriers that failed in the 1980s seemed not to have failed because their costs were too high; economies of scale were not the factor. They failed for other reasons, mostly reasons of not understanding the management model.

I don't think that size matters for entry. In fact, as I was indicating earlier, a low cost carrier, People Express, attempted to operate at a large scale and ultimately failed and I believe the scale of its entry was one of a number of factors contributing. Whereas those carriers, Southwest, WestJet and so forth, that all entered with say three aircraft initially and built steadily, many of them have done actually quite well and, as promised, I forgot the second question.

PROF GILLEN: When you observe decreases in fares do you think that those are long-term decreases or short-term decreases?

DR TRETHEWAY: Decreases in fares after low cost carrier entry?

PROF GILLEN: That's correct.

DR TRETHEWAY: I believe those are permanent decreases. Someone undermining the price discrimination. I think it's very difficult then to go back; I've yet to see a low cost carrier re-impose the requirement for return tickets with Saturday stay-overs, and secondly a key part of the successful low cost carrier business plan, which is why they're successful this decade, or the last decade and a half, last decade versus the previous decade, is a policy of continual cost reduction.

Mr O'Leary, the CEO of RyanAir, made a fairly outrageous statement; that is, he believes that some day he'll pay people to fly. His goal is to continue to get fares down, down, down, by getting his costs down, down, down and making his money on ancillary services. That may have been an over-simplification but it underscores the key element of the business, or a key element of the business models continue to get costs down so we can get fares down to continue to stimulate the model to get traffic density up.

PROF GILLEN: I want to come back to the long return versus short-run in a moment. But one of the important issues, it seems to me, is that in a number of your responses you are referring to RyanAir and easyJet and Virgin Blue as if there was this, I won't call it a homogeneous low cost carrier model as you've already alluded to, but the notion that for example RyanAir goes into markets which are essentially leisure markets and easyJet expands capacity by increasing frequency on a route between major centres; those are two fundamentally different ways that you're entering the market, and you would expect that you're going to have substantially different impacts on fares, as well as full service airline strategic response; is that a fair comment? Would you agree with that?

DR TRETHEWAY: There's some elements in that I would agree with. RyanAir's entered a number of leisure markets, but it's also entered a number of markets that are fundamentally business type markets; you know, examples would be London to Brussels, Stanstead to Charleroi, London to Lubeck, and you know, to serve the Hamburg market; I would never think of Hamburg as being a leisure market.

A fairly substantial portion of its network in fact are connecting major business centres. I think easyJet is very clear that they tend to not go after so much the leisure destinations as they do the business destination, but I see it much more of a mix rather than a stylisation of one versus the other. Was there a part of the question that I forgot?

PROF GILLEN: No, you remembered it all.

Let me go back to the long-run versus short-run. Martin Dresner and Bob Wendel have done a couple of papers, actually several papers and I know that you're familiar with them, and what they found is that when low cost carriers enter markets fares fall and the amount by which they fall and the strategic response of the incumbent carriers varies with how much capacity was entered with. But what they also found is that the level of fares after the initial entry was lower than after the longer term. And that doesn't correspond with what your understanding is?

DR TRETHEWAY: Yes, perhaps this is a good clarification. When a low cost carrier enters a market, as is the case with full service airlines I might add, there is a period of time where, just to build a market awareness, they come in with some really great bargain fares. And so, when you look at data you'll say, gee, when they entered this first year fares are a bit lower because that included the five month promotion period after which the promotion ended and the fares went up, and you're not picking a full year's worth of that in the second year.

I agree that that find is there, but I also believe, if my two former students had done the research using full service airline data on exactly the same basis, they would find the same result, that when Air Canada goes into a new international destination, it promotes that destination in part by offering some very low fares, in part to offset the fact that they don't have -- haven't had the fares on sale for a full year before the flight. So, there's a promotional effect, and I see there's a promotional effect as opposed to a market structure effect. Sorry, I'll try and slow down.

MS REBSTOCK: When a major New Zealand newspaper reports you speaking with a slow American drawl, you can blame me.

PROF GILLEN: Another question; and this goes back to your beginning of your presentation where you looked at the penetration of the low cost carriers and your claim that they are going to be 50% of the market in 5 to 10 years, what you would expect, and this goes back to a comment by one of the Commissioners, is that the full service airlines have to be learned at some point; the Southwest model is 30 years old or more, and so what you would expect is that they're going to respond in a different way, and we're observing that right now. United's responded differently, Lufthansa, even Air Canada is finally learning they have to do things differently.

And, I was a bit surprised you would expect that the growth rates would continue to be at the level that they have in the past, given first of all that if you look at both Australia and Canada, that you had two major failures, and those clearly had to help the new low cost carrier entrants. And secondly, the fact that we are observing very different strategic responses on the part of the incumbent carriers, particularly the full service airlines. Would you comment on that?

DR TRETHEWAY: A lot of research that indicated that the way the US airlines responded to entry by Southwest was different than they responded to the other low cost carriers in the 80s, and I think fundamentally they recognised that most of those low cost carrier's experiments were just stupid business plans and they didn't have to respond the same way they did with Southwest.

With Southwest, they recognised these guys are here to stay, we better make a bit of room for them in the market, there's kind of some characterisation like that.

I believe these growth rates are sustainable at least in the next five years. And I say that for a few reasons. One is, in the next five years the low cost carriers are going to take delivery of a huge number of aircraft; as I indicated, roughly 600 aircraft. They have that financing largely in place.

The full service carriers are deferring orders as rapidly as they can negotiate them and come to terms with the manufacturers, or the lessors that they had contracted to take those aircraft, and I believe that those carriers -- in fact, if you look at their business plan, they call for lower levels of capacity by the full service airlines in the next five years. So I put this together and say, the full service airlines are going to grow in a very limited way, if at all, and some of that they themselves are going to convert to a low cost format.

The low cost carriers which are profitable, which have huge market capitalisations which are able to get financing for the delivery of these aircraft which continue to find routes with new opportunities, many of which have no non-stop service at the moment; they're going to continue to grow, and the growth rates I projected were not the growth rates we're seeing today for RyanAir, WestJet, easyJet that are in the, you know, 40, 50% range.

I projected the lowest growth rate for low cost carriers which is that of Southwest which is mature in the sense of having been a long live basis. To be honest, I think I probably underestimated the penetration of the low cost carriers in the next five years; it will likely be greater than 15%, but it won't be the 40% we're seeing with WestJet today. That will attenuate maybe to 20%.

PROF GILLEN: Have you gone long on the stock in those airlines?

DR TRETHEWAY: I don't invest in airlines, it would undermine my ability as an expert witness.

PROF GILLEN: One of the issues you also raise in your report, and you've alluded to a couple of times today is the notion of economies of density and certainly the work that you and I and Tae had done years ago id use only full service airlines data. Would you agree that you're going to find very different economies of density for low cost carriers than you would for full service airlines?

DR TRETHEWAY: Yes. And the reason is that the full service airlines -- part of the service package are a package of ground services, business lounges as an example, and there are economies of operating those that, the more flights you have, the more you can spread them over.

In contrast, the low cost carriers, while they do have fixed station costs, there's only one station there, it's the only -- they only advertise once in the newspapers on Saturday, so there's some degree of economies of traffic density, because the station specific value is less for them than it is for the full service airlines; I suspect that when we have the data and estimate it, we'll find that the economies of traffic density are somewhat less for the low cost carriers than for the full service airlines.

Did I say that right? For the low cost carriers it will be less than for the full service airlines, but they'll still be there.

PROF GILLEN: So the marginal value of a passenger is much higher in terms of lower cost for an FSA than it is for a VBA?

DR TRETHEWAY: That's a much more complicated question that has to do with marginal -- the expectations around revenue and prices; it's not just cost driven.

PROF GILLEN: I understand that, but from a cost basis, if you're holding revenues constant, the marginal value of the passenger to an FSA is greater than for a VBA, simply because of the differences in the economies of density.

DR TRETHEWAY: The marginal value is purely a revenue question, it's not a cost question.

PROF GILLEN: Okay, I'll leave that. If you look at the evolution of the business model, and you've described it very well, and as a matter of fact from the descriptions it seems that the low cost carriers should have double --

DR TRETHEWAY: The low cost carrier model?

PROF GILLEN: Yes. Even the low cost carrier model, but it's an evolution of the business model. If you look at hub and spoke FSA, after deregulation it was a consequence of how we change the rules of the game. And you indicated that with greater deregulation, particularly in Europe and in other jurisdictions, we observe the evolution of a low cost carrier. So would you see that what we're seeing is essentially the evolution of the airline business model from hub and spoke carrier evolving towards low cost carrier model and then at some point we're going to evolve perhaps to a hybrid; Virgin Blue being an interesting illustration of that?

DR TRETHEWAY: Yes and no, and I don't mean to be evasive about this. I agree that the whole airline business model is changing. The airlines in the past, as I stated in my Hamburg paper, forced everybody to buy this wonderful full service product, even those that did not need it. And what the low cost carriers have is, they've broken us out of that and those travellers, even business travellers who don't need the full services, can now avail themselves of a lower cost, lower service package. That's requiring the full service airlines to evolve their business models, we're seeing in New Zealand with the Express type products.

However, as I indicated earlier, I do not believe the two models will converge. There will be elements that they will take from each other; the Express product has learned a lot from the low cost carrier model. Low cost carrier JetBlue is learning some things, saying people will actually sit in their seats and not complain about the meals if you give them a video instead, and I can do that really cheap. So they're going to learn from each other.

Fundamentally the full service airlines sells network connectivity to the world and that imposes a level of cost that I don't believe they can ever escape. It also provides a level of value that, if they market properly, they will be able to obtain higher revenues for. So the two models will, you know borrow from each other but they will still remain fundamentally different products. A network product versus a very simple product.

PROF GILLEN: So, you don't see VBAs creating interline arrangements with international carriers?

DR TRETHEWAY: I would be skeptical of the emergence of that. That's not to say that they will never provide some connecting services. But I don't believe they're going to invest in the baggage information systems and all of that. They'll do this on an opportunity basis, primarily a network carrier will pay for all of the interline expenses; they won't incur them at all.

The network carrier -- to kind of put this clearly, it's my view that what the network carrier will do is, they will deliver the bags to the low cost carrier and deliver them as if they were the passengers there, so the low cost carrier does not have to invest in that baggage information, display system and so on.

PROF GILLEN: One final question: What's your understanding of the long-run fleet planning cycle for a carrier?

DR TRETHEWAY: Sorry, could you be more specific because I could go on for a course?

PROF GILLEN: I'm trying to understand the difference between short and long-run, and if you're looking at a carrier and they plan their fleet around their routes, and so at what point can you think of that cycle changing, or do you view it as being continuous that they're buying and selling aircraft all the time?

DR TRETHEWAY: My understanding of most full service airlines is, they typically will have a fleet planning group that's pretty much in existence all the time, but they will go through periods when, for example, the 727s are kind of getting old and we really have to make this decision and that modelling work we may have done over the last two years now I need a bigger group to bring that to a final basis, and then negotiate a deal.

So the size of the department kind of goes up and down depending on what stage they are in the fleet cycle. But they seem to be there all the time, and the fundamental question they have to ask is the long-term question, and that is, if we make this investment, can we recover revenues that are sufficient to cover the cost, fully allocated costs, including capital? I believe all airlines do that.

Where my criticism in the Hamburg paper was, is that I then see many full service airlines, and I use Qantas as an example of one that does not follow this practice; that then don't enforce that they recover those revenues when the fleet is actually deployed. That's where they get themselves into long-term trouble, and that's why we see such a weak airline industry today.

They could get away with it while they could all engage in the same price discrimination, but when the low cost carriers came, and you can't get away with that price discrimination any more, the economic viability of those type of full service airlines who don't enforce a long-term pricing discipline is gone.

PROF GILLEN: So, the long-term pricing discipline is 1 year, 2 years, 3 years, 5 years, 10 years?

DR TRETHEWAY: Yes.

PROF GILLEN: Okay, thank you.

MR CURTIN: I don't know if this has been entered into the record anywhere, and I don't know even know if it's true, that Virgin Blue will behave a bit like Virgin Atlantic does, I mean they're the same family of company, but do you have any evidence on what the Virgin Atlantic does on its routes and why?

DR TRETHEWAY: Well, Virgin Atlantic is a very different carrier. It operates long haul intercontinental routes. I seem to recall looking at their fleet actually just the other day, and I think they've got like, one A320, I'm not sure why they've got that; and all the rest are like 8340s, I think there's a few 747s that they're getting out. That operation is very different.

A low cost carrier operating short and medium hauls turns the aircraft, operates many flights in the day, so connection time is very important. Virgin Atlantic lands and they don't need to use that aircraft again for like another 8 or 9 hours, so the type of things that type of carrier focuses on is different.

While they share a brand name, there's also Virgin

Express which is sort of based in Brussels, it's a little ambiguous in some ways. They share a brand name, but they're not really operated like a family of airlines the way, say, United Airline operates Air Wisconsin; it's a feeder carrier that it wholly owns. The holding isn't even like Virgin Atlantic to Virgin Express, it's Mr Branson's holding company of something or whatever has investments all over the place, but I wouldn't characterise them as being the same, and I don't think that Virgin Atlantic would be a relevant exemplar of how Virgin Blue might operate, and certainly not Virgin Express.

MR CURTIN: Okay, thank you.

CHAIR: What I would like to ask you now, Dr Tretheway is to return to your presentation, focus on key points in your submission please that haven't already been covered.

DR TRETHEWAY: Yes. I was asked a second set of questions on the factual versus the counterfactual, and what I will do in the interest of time is, I will go through this very quickly.

While the New Zealand Commerce Commission postulated in the factual that there would be no entry by a low cost carrier, I simply observe that we have observed this entry by low cost carriers throughout the world in very small markets, in markets with single FSAs and in markets with multiple FSAs and even markets where the FSAs were outright merged and presumably created significant market power, in the Tasman and New Zealand domestic, it appears to me that the conditions are present for low cost carrier entry. There is a successful low cost carrier present, it's well capitalised. And the Applicants are willing to provide access to airport facilities at Auckland should that be a constraint on their entry or their speed of entry.

The Commission in the Draft Determination in the counterfactual postulated the market would be perfectly competitive. I think it's incorrect to model any airline model as being competitive; that's a term in economics that I don't believe is applicable anywhere in the world; no airline market has sufficient competitors and today it's my view that the single most important thing in competition in any single airline market is whether or not there's a low cost carrier present or seriously threatening to be present in the market in inducing a response.

Very briefly, in the counterfactual my opinion, and how the market would evolve, is that it would start as it is today with two full service airlines; Qantas would expand into domestic New Zealand and I might add that they're already executing the counterfactual by continuing to deploy capacity in this market, and we're also seeing significant Fifth Freedom entry in capacity coming in on an important Tasman route.

It's my view that it is virtually inevitable that a low cost carrier will enter even in the counterfactual, and in the consequence of this with the reduction of the revenue base available to the two full service airlines, one of these will have to leave. It's difficult for me to conceptualise the conditions under which they could get their costs down so far that they could survive both of them in a healthy way, sustainable way, against entry by a low cost carrier. So, in my opinion eventually the outcome is the same as the factual and counterfactual; that is, eventually both end up with one FSA competing against a financially strong low cost carrier.

I have two conclusions. The first, which for continuity I label as "conclusion 5", the assumption that there would be a monopoly with the requested alliance is unrealistic in my opinion, entry by a low cost carrier is inevitable. Furthermore, the alliance provides some access to facilities that can facilitate and speed entry by a low cost carrier.

The second conclusion in this part is that the assumption that, without the alliance markets would be perfectly competitive, is also unrealistic. Low cost carrier entry and expansion undermines the ability of markets to support multiple FSAs in domestic New Zealand.

For New Zealand in particular, the virtual inability of Air New Zealand to earn on a sustained basis its cost of capital in long haul international service would make its continued financial viability doubtful because it would not have the revenue returns from the price discrimination it used to be able to, that will no longer be available. Its revenue based in the domestic market will be permanently eroded.

So the inevitable domestic revenue erosion means that Air New Zealand will need to dramatically reduce its costs and/or exit the industry. It's my opinion that if the requested alliance were denied, a low cost carrier will eventually enter the market and Air New Zealand will eventually exit the market.

The counterfactual does not lead to an outcome that is more competitive than the factual. Both will end up with a full service airline and a low cost carrier. The only issue, in my opinion, is the path taken to get there. One path is slow and painful without the alliance, and I might add without the benefits that the alliance could provide.

The other path would be more quickly. It would deliver those benefits to consumers, tourism and the carriers while maintaining and enhancing the brands of both Air New Zealand and Qantas. Thank you.

CHAIR: Thank you for that, Dr Tretheway. Can I just -- I wanted to follow-up a comment up made in passing going through that, and that related to Canada, and you made a comment that there was a merger that presumably created considerable entry barriers. I know you're familiar with the Canadian merger case. Is it your view that that merger did create considerable entry barriers for the VBA?

DR TRETHEWAY: I would say that the merger created considerable market power, and the problem in neutralising that market power is the presence of some important entry barriers.

Canada, unlike the progressive policy in New Zealand and Australia, does not allow right of establishment of airlines in the country. Only Canadian capital can be used to establish an airline in Canada. It's my opinion that, absent that entry barrier, that regulatory entry barrier, it's a choice of Government; a number of regional airlines in the United States and possibly a major carrier would have come into the market in Canada and established a competitor to Air Canada that would provide feed for international services and possibly done the low cost carrier model in a different way. These markets are very different because of the regulatory barrier to entry in Canada.

MR CURTIN: You mentioned in one of your slides there that the smaller FSA would go to the wall looking ahead. I think you automatically then went on to say, well, that's Air New Zealand. But in the New Zealand market, who is the smaller FSA --

DR TRETHEWAY: When I say "the smaller FSA" I think of it not in terms of the small subset of routes, but rather a larger set. The way I look at this is that, Qantas essentially replicates Air New Zealand throughout almost its entire network, as it continues to expand in the domestic market and the Trans-Tasman, as it offers their version of an express type product in both of those. Where Air New Zealand flies, Qantas tends to fly as well and get people there, maybe not quite as conveniently and certainly not with the same market brand. It's hard for me to think of an example anywhere in the world where an FSA that completely overlaps another FSA was not the survivor.

CHAIR: Dr Tretheway, I wondered if you'd had a look at the NECG model, and I'd like your view on the appropriateness of using a Cournot approach in that model.

DR TRETHEWAY: I was not asked to review and critique the NECG model. I have read the documents, not in quite the same critical way and so forth. The characterisation of competition between FSAs, as being Cournot or capacity based, is consistent with the empirical evidence that I have read; for example, work by Professor Anming Zhang and Jim Brander at the University of British Columbia, among others I might add; and it's also consistent with my intuitive observation of the industries that the full service airlines tended to match price with each other to try and neutralise that as a competitive element, and competed very much in terms of network scope and frequency of service and in-flight services. I believe that the extension of the -- the development and growth of the global alliance is a good manifestation of that; you try and compete by, in some ways, offering more and more capacity or access into the system.

MS REBSTOCK: I just want to talk about also the way you have modelled the competition between a VBA entrant and a full service airline. How would you see the use of a Cournot model to model that?

DR TRETHEWAY: While I confess that I'm not a modeller and I haven't thought that particular question through.

CHAIR: Well, you've thought about how full service airlines compete, where a Cournot model is appropriate to model that, and I take your point that you haven't thought it through and you're not a modeller, but you obviously do have views on the appropriateness of that model for one bit. So, if you have a view on the other, I know they haven't asked you to do it, but you're here as an expert witness, so I'd ask you for your independent view on that, please, if you have one?

DR TRETHEWAY: The reason why I'm hesitant is just, there's a lot of subtleties in oligopoly modelling and game theory. If I was asked to sit down and develop a model of FSAs and low cost carriers, to be honest I'd probably sit down for about two or three weeks and think about that.

But, not to evade the question, my view as a fundamental aspect of the competition between them is the removal of price -- of the type of price discrimination that the FSAs had in the market. That fundamentally relocates the firms in the market at a different price point. At that point, however, they deploy capacity, and they continue to compete on capacity, and we see that in the low cost carriers throughout the world where they add capacity on a route and they will continue to add capacity as the extra flights continue to cover their fully allocated costs on the route, and then they will add another element of network connectivity, so you start from a base and then you start to expand into another market.

My sort of kind of top of the hat sort of reflection is Cournot modelling seems to have some elements for, that that would be appropriate, but again there's so many subtleties about modelling, I'd really need to think it through.

CHAIR: Does it have any elements that don't seem appropriate to you?

DR TRETHEWAY: [**Pause**]. Well, there is the fundamental difference in the price competition; initially they come in with significantly lower costs which allows them to offer fundamentally different prices, but I'm not sure I'd characterise it with what economists call betrand markets where you compete exclusively on price, because I don't think it's that simple.

CHAIR: What about using the route-by-route basis for the analysis; are there any issues there?

DR TRETHEWAY: Could you explain the question a little bit more please?

MS REBSTOCK: I might just ask Professor Gillen on this point; you raised the question of the route-by-route basis as opposed to an aggregate basis?

PROF GILLEN: I think the issue is, is that you can look at markets as a set of aggregates and therefore achieve averages across routes, or you could look at individual routes; you could look at Sydney-Wellington and Auckland-Brisbane for example, and work out the conditions on those individual routes, and are there strengths or weaknesses for choosing a more disaggregate approach verse an aggregate approach?

DR TRETHEWAY: Traditionally when we look at competition in airline markets we've always looked at city pair market. It's complicated because when you buy a television; you buy a television, you look at the market for televisions, but in airline services you'll often use a particular route combined with another route segment to get to your true origin destination market.

Nevertheless, broad aggregates of the domestic New Zealand, versus the Trans-Tasman, versus Los Angeles, versus the rest of the world, sort of that four way characterisation, there seems to be some common elements on both the supply and demand side of that. I can see the usefulness of looking at market behaviour and outcomes on the sort of, shall we call aggregates basis. I'm not sure if I'm fully understanding the question?

PROF GILLEN: I think one of the issues, for example, might be is on a route-by-route basis you might not capture the kinds of network synergies you've alluded to throughout your task, whereas on the aggregate basis when you get the equilibrium values you're capturing some of those network relationships because of the -- at the aggregate level because they're going to be contained within the equilibriums.

DR TRETHEWAY: I'm sorry, I'm just not getting it.

PROF GILLEN: If you were to look at the route between Sydney and Wellington and the route between Sydney and Perth, and as opposed to looking at the aggregate of those, then you solve your Cournot model and presumably the equilibrium values you get are presumably going to be somewhat different. On the one hand you're going to look at individual values on the routes.

On the other hand you're going to be looking at the values of prices of outputs and costs you're getting on the aggregate of those routes. The equilibrium values may differ in part, in part because in the aggregation you may capture some network effects. Whereas, if you look at the individual routes you wouldn't necessarily get that

DR TRETHEWAY: It strikes me the question is one about modelling, and I'm not a modeller in that sense. What I can say is that, when you look at performance on a route you often have to consider what's happening beyond that one origin -- you know city A to city B sort of route segment. And that is a complicated exercise, there can be double counting involved. And looking at things on an aggregate basis can eliminate the double counting, but then it might conceal important information about how routes are performing or how carriers are behaving and so forth. I'm just -- I'm not a modeller.

CHAIR: Leaving aside the modelling your statement initially was that you believed it was -- had advantages because it picks up the connectivity benefits.

DR TRETHEWAY: Sorry, what has advantages?

MS REBSTOCK: Using a more aggregated approach, does it have that advantage of picking up what you've described as a key feature for these airlines, the benefits of the connectivity.

DR TRETHEWAY: Yes, although I wouldn't look at it in aggregate in isolation, I think you have to look at aggregate and in micro detail.

CHAIR: Are there any other aspects other than the ones we've talked about that you might be concerned about in terms of using a Cournot approach to model the issues that we're looking at, are there any others that come to mind?

DR TRETHEWAY: Again I'm not a modeller. If you put specifics to me, but I'm not someone who can sit down and kind of write out Cournot model equations.

CHAIR: No, I'm not asking you to write out the equations, God forbid if I ever did that. It has been known to happen in our hearings, but it wouldn't be me asking it. Any further questions? [**No comments**]. That leaves it for me to thank you for your presentation and for taking questions from the Commission staff and our external experts. So, thank you very much. It was a very useful discussion.

DR TRETHEWAY: Thank you for your courtesy.

CHAIR: Now, I think we're moving on to the -- it will test my understanding of what we agreed and I thought we were moving now on to the confidential session, is that correct?

MR PETERSON: I think the aim is now to move to the engineering and maintenance session, but mindful of your earlier comment about wanting as much to be done in public as possible I've spoken to Qantas and they are happy to have this section brought forward in the public session, followed by the public session of the counterfactual and then the last session of the day the confidential session.

MS REBSTOCK: That's very good, I'm pleased you've taken that decision. So, we will not close the session. The session now will be open on the engineering and the maintenance presentation.

MR PETERSON: We may just need a minute or two to set up.

CHAIR: Okay, we'll take two minutes to set it up, thank you very much. [**Short adjournment**]. I'd like everyone to please be seated. And I would again thank the Applicants for making this an open session. I think it is important that that happen wherever it can, and I would ask you now to introduce the parties who will be speaking.

MR PETERSON: Thank you, Madam Chair. As indicated, this section will be dealing with engineering maintenance; it's a session presented by Qantas.

At the table on your far right is Brett Johnson the Qantas General Counsel; in the middle is Paul Edwards, Executive General Manager of Strategy and Network, and on Mr Edwards' right is Peter McCumstie, Group General Manager for Commercial Planning. Just to complete the picture, on the other side is Mr David Bental from Airline Planning Group; Mr Bental is there principally for the next session.

MR EDWARDS: Afternoon. I look after the strategy, network and alliance issues for Qantas; as such, I'm part of Geoff Dixon's Senior Executive Team. He's already outlined to you earlier today the views we have on the alliance with Air New Zealand.

Jointly Qantas and Air New Zealand have already outlined to you what we'll do together. This process requires us to tell you what the most likely scenario would be if the alliance did not eventuate. While circumstances change quickly, this is the most likely counterfactual. Firstly, I just want to go through the engineering side of the equation for you.

The key elements we consider when allocating work to an external supplier hinge around firstly the competitiveness of the offer, and secondly, the broader relationships behind that offer. External suppliers of engineering and maintenance participate in a very competitive market and often there is not a lot of differential in pricing. Other influences often determine the outcome.

It's also worth noting that the collapse of Ansett created an urgent requirement for work, and that pressure won't last forever, so there's been quite a peak in the level of maintenance activity. In a situation where we are not allowed to cooperate with Air New Zealand, there would be no incentive to give them work; there would actually be an incentive to not give them work. We would have no desire to increase the efficiency of the ANZUS business so they could give lower rates to Air New Zealand and generate profits for the Air New Zealand group and then use those extra profits to compete more vigorously with us. We would have a desire instead to build strategic relationships with other parties if we cannot build strategic relationships with Air New Zealand.

Whereas, under the factual, where we are allowed to cooperate with Air New Zealand, we would have an incentive to give them work. They would retain their preferred external supplier status as we would have a shareholder relationship with Air New Zealand and the engineering and maintenance relationship would support this broader relationship.

An increase in efficiency for ANZUS would lower costs for Air New Zealand, increase their airline profits, which would then in turn be shared by Qantas.

CHAIR: I just want to be clear on one thing, and maybe you can help me. The current arrangement between the two companies, can you describe it? I mean, leaving aside the factual and the counterfactual, can you describe what the arrangement is without causing -- if it doesn't cause any problems in terms of confidentiality?

MR EDWARDS: No, quite happy to. The current arrangement is that Air New Zealand are one of our external suppliers that we use for work when we can't accommodate that work within our own resources. Over the last 12 or 18 months, as we have been working through this exercise, we have tried to be good potential partners and we have erred in favour -- perhaps erred is the wrong word -- but we have voted in favour at times of giving them the work instead of using other external suppliers.

CHAIR: So, what percentage of the work would they be undertaking for you now?

MR EDWARDS: They would be undertaking, my guess is 70, 80% of our external work.

CHAIR: Is that increasing or declining?

MR EDWARDS: That's -- it's increased, and that's what I was explaining before about the Ansett situation, where there is just so much work that had to be done, that we --

MS REBSTOCK: But it has a percentage of the total; leaving aside whether it's growing or falling, the percentage has also been rising?

MR EDWARDS: The percentage that has come to Air New Zealand has risen, yes.

CHAIR: And the reason for that is, what? Is it value for money, is it -- what is the reason that it's happened in the recent past, the growth and the percentage of your business that goes to Air New Zealand?

MR EDWARDS: A big part of the reason has been the fact that we've been in a courting phase, if I can use that expression, where we have been trying to build relationships between the two businesses.

CHAIR: So, they didn't necessarily compete successfully on price, quality and whatever else you value?

MR EDWARDS: There have been occasions over the last 12 months where we could just as easily have given the work to another external supplier, but we decided in the interests of building the relationship to give it to Air New Zealand.

CHAIR: Okay, thank you.

MR PJN TAYLOR: Could I just -- don't answer this if it's confidential, but can I take it that there's no cost disadvantage to Qantas, though, in so doing?

MR EDWARDS: No material cost differential, yeah.

MR PJN TAYLOR: Thank you.

MS BATES QC: What percentage of your maintenance and engineering work is actually out-sourced?

MR EDWARDS: That's not a simple answer -- not a simple question to give an answer to because there are so many various parts of it; for instance in some of the particular E and M functions we use external suppliers, you know, virtually all of the time. I don't think I'd want to go on the record publicly on how much.

MS BATES QC: You can't even give an indication?

MR EDWARDS: Not in a public session.

MS BATES QC: You can in a confidential session. We'll save it till then.

MR CURTIN: If I may, you'll have to excuse my total ignorance on this, but I don't even know who the other suppliers are in the engineering and maintenance market, if you've got a fleet of planes in this part of the world what are your choices?

MR EDWARDS: Singapore Technologies have an exceptionally good operation based in Singapore, Haikou have a very good operation up in China.

MR CURTIN: Is that it effectively?

MR EDWARDS: Yeah, they would be the two major.

MR CURTIN: Other than Air New Zealand presumably and then your own in-house?

MR EDWARDS: That's right.

MR CURTIN: It's not practical, for example, to take planes to the States or anywhere else?

MR EDWARDS: We've taken them to Ireland on other occasions to get work done, so.

MR CURTIN: Delighted to hear that.

MR EDWARDS: So, we wouldn't have an objection of taking them to the States.

MR CURTIN: But, in practise you'd have a shortlist of three-ish in this part of the world?

MR EDWARDS: That's right.

CHAIR: Don't try to earn favour with one of the Commissioners.

MR EDWARDS: It's a long day.

CHAIR: Please continue.

MR EDWARDS: We'll just go back to the start, if you don't mind.

MS REBSTOCK: We're so far ahead that it won't make any difference at this point. [**Pause for technology**]. We'll just try and touch on the high points here as my Chief Executive stole a fair bit of my thunder earlier.

The strategy behind the counterfactual is very clear. Qantas has to secure and develop the profits from its home base in Australasia, and it has to have a strong competitive position in the New Zealand market. It's an extension of a long-term commitment Qantas has had to New Zealand.

Internationally we've been involved here for something like 60 years since the days of TAL. Our participation in the domestic market is however more recent. Although we have been here for more than 10 years in one way or another.

As I said earlier, we work with Ansett New Zealand primarily for network tourist benefits, then we entered into a franchise arrangement with Tasman Pacific which started to take us into the local market. Then in 2001 we started here in our own right. We would have started earlier but not as the third full service airline in such a small market.

We had to slow our development down when Ansett collapsed and we had to grow our domestic business in Australia by more than 50% overnight. Since then we have steadily built a solid basis for an airline based in New Zealand serving both the Tasman and domestic markets. Later this month seven Boeing 737-300 aircraft will be operationally based in New Zealand. This has created lots of jobs in New Zealand, local pilots, local flight attendants, local support staff. The vehicle that we use for this JetConnect will employ nearly 200 people later this year.

There are sound reasons for growing our business in domestic New Zealand. As I said before, we need to protect and build our network profit. The market in New Zealand is an integral part of our home market. Throughout Australia there are customers who want to travel throughout New Zealand and throughout New Zealand there are customers who want to travel throughout Australia. We want to be able to serve all those customers, travelling both throughout Australia and New Zealand and those who are connecting to the world.

Our presence here at the moment is too small. We need to build frequency of service to increase our presence. Our share of revenue is less than our share of capacity, and David will elaborate on that a little bit further.

Within our plans for domestic New Zealand we're moving ahead with implementing them progressively. We've already introduced a new fare structure. We're continuing with our plans to build our fleet and expand our business. A review is underway of our network and product as part of an overall review of the Qantas worldwide operations. We'll discuss this in more detail with you as we get into the confidential session.

We also have plans for the Tasman, wide-bodied aircraft will be used for all of the Auckland services and most of the Christchurch services. JetConnect will be used for 737 operations on the Tasman. As we've changed our fare structure in Australia, and now in domestic New Zealand, next will be the Tasman. Obviously we'll also go into some further aspects of those as we get into the confidential session.

Any questions, Madam Chair, before we hand over to David to...?

MS REBSTOCK: I just wanted to get a sense of, if the alliance proceeds, what happens to the existing and planned capacity that you've got in the domestic market? What happens under the alliance?

MR EDWARDS: Under the alliance we have said that we will continue to operate five aircraft domestically in New Zealand.

CHAIR: What have you currently planned?

MR EDWARDS: We've got -- we'll have seven aircraft here by later this month, two of which will be being used on the Tasman. So, that will leave the five here.

CHAIR: What do you have planned at this point, if the proposal does not go ahead?

MR EDWARDS: Confidentiality.

CHAIR: Okay, we'll come to that then, thank you.

MR PETERSON: Madam Chair, just before David speaks, I think it's just important for the Commission's clarification to point out, the work David has done has been to review the Qantas counterfactual and bring to bear his industry expertise on considering the planned -- whether the planned capacity expansion is rational. So, in other words, it was his expert review after the Qantas expansion plan was put in place by the Qantas commercial team.

CHAIR: So, it's looking at whether the planned expansion as described in the application, in the counterfactual is rational?

MR PETERSON: Precisely.

MR BENTAL: Thank you, Madam Chair. What we were asked to do is look specifically at the theory of city presence. So, we'll provide an overview of the theory of city presence, and then we'll come back under the confidential session and talk about the quantification of the value.

City presence has to do with what passengers value. This includes competitive fares; it includes minimum travel to destination, short connect times, on-line connections, it includes schedule options which are among the key -- is the number of available destinations, the frequency of flights and the availability of inexpensive fares on the preferred flights.

When a carrier increases the breadth and the depth of service, the carrier delivers the passengers the benefits of city presence. When the capacity increases, we get better frequencies, we get an increased number of destinations and we get access to more low fares. This is described as the concept of city presence, and I think the -- some airlines discuss the concept as city presence; I think we've heard

Mr Dixon earlier describe that as "critical mass", which is pretty much the same concept; different name.

As a carrier gets bigger in the city, what you see is that the benefits accruing to that carrier tend to increase, and they eventually translate into better financial performance. In fact, the following graph illustrates the value derived by the first place carrier in a city. What this illustrates is the actual share on the Y axis and the fair share on the X axis, and as you can see in nearly every instance -- and here we're using the US domestic experience because of the existence of data to analyse the phenomena -- but what you see is that on average the number one carrier in a city receives a 17% premium over the number two carrier.

CHAIR: Can I just ask you to comment on why this -- these results would be transferable to the markets here and Australasia?

MR BENTAL: I think the reason carriers compete to become large in cities have to do with the same underlying characteristics that would apply in New Zealand. Namely, if a carrier is large in the city, there's a tendency for people to invest in the frequent flyer programme; there's a tendency and the ability to go to corporations and get the corporation to travel the airline, the ability to provide incentives to agencies to travel on the airline; and the ability to provide the breadth of service, the new destinations, the additional seats, and the additional frequency to the traveller allows the airline to get a positive share gap. So, I think the fundamental reasons would apply in New Zealand the same way they would apply in the US, in Canada, in Europe.

CHAIR: So when you do the calculation, what exactly is the calculation based on? How do you generate the result?

MR BENTAL: Absolutely. The calculation is based on looking at what the expected share of revenue is in a city. The reason we look at expected revenue is because it's a better indicator than the percent capacity. The percent revenue allows you to quantify the value the carrier is providing, not only on very short segments, for example Wellington to Auckland, but also a segment to Sydney continuing on to Bangkok, for example. And this is, we've found, a much better proxy for the ability of a carrier to provide value in a city.

CHAIR: How do you -- where do you get the expected revenue number from?

MR BENTAL: The expected revenue is based on a concept called QSI. QSI is the measure of the carrier's service in the city on all O&Ds. QSI was developed by the USDOT; it's a concept that is currently used by nearly every major carrier out there to quantify the expected share on different O&Ds. Once we derive the expected share on specific O&Ds, we sum it up to the city level to derive an expected revenue in the city.

CHAIR: Okay, I'll let you continue, but we'll come back and just see if there are further questions on that.

MR BENTAL: Absolutely. Actually in terms of the theory of city presence, this is my last slide, and I'm going to transfer this to Paul who's going to discuss the detail of the capacity changes in the counterfactual. So, if you want to ask some questions, this may be a good time.

PROF GILLEN: I have a couple of questions. The QSI doesn't take into account competitive strategies between firms, does it?

MR BENTAL: What the QSI takes is the strategy; the way the airline has published it in the most current schedule.

PROF GILLEN: So, essentially a capacity division.

MR BENTAL: It's capacity, but again it's dangerous to look at a capacity share; we're looking at a capacity as adjusted for where the capacity in a sense is going.

PROF GILLEN: I don't understand that, I'm sorry.

MR BENTAL: Absolutely. I think it's very important to differentiate between a seat going a very short distance. So, for example, an airline that offers a segment between Wellington and Auckland using a 737, that airline may offer 120 seats on the 737 going to Auckland and may get a certain amount of revenue. Another airline that offers a 737 between Wellington and Sydney offers the same 120 seats, but because the passengers go a much longer haul, the share of city revenue is a lot higher and that's what QSI captures by looking at every O&D out of the city.

PROF GILLEN: So that, if you have stage length economies, for example, that you've just suggested, how -- what happens then if you have three carriers operating on the route rather than two? How does the QSI take that into account?

MR BENTAL: QSI measures the share of those airlines by looking at a few different aspects of the service. This includes the type of airplane, it includes the type of connection, how fast the passenger gets to the destination.

In a sense what QSI tries to do is mimic the GDS display. The higher the GDS -- that's global distribution system -- so, when a travel agent for example logs on and tries TO see who's flying between two cities, the non-stop for example is the number one line and that's what QSI tries to measure.

PROF GILLEN: When you're talking about expected revenues, that's price times quantity, where do the prices come from?

MR BENTAL: The market size, which we call -- which is the input into the total city revenue, came from Air New Zealand, and it's proprietary Air New Zealand data.

PROF GILLEN: I'm trying to understand whether in fact the prices that you're using reflect the degree of competition in the market or not?

MR BENTAL: The prices that we're using are the actual average fares for every O&D out there, the actual fares, and we're also using the actual number of passengers.

PROF GILLEN: One final clarification. When you estimated this model in the US, how did you take into account both the presence of low cost carriers in the market and to what extent did this data reflect hubbing? There is this argument that says hubs -- you have a hub premium, so does the data take account of those differences between hub and non-hub airports?

MR BENTAL: What you tend to see is that, when we do this by city you tend to see that the carrier who's the hub carrier, the revenue share they have out of the city is less than the capacity share. I think this is something we will discuss just a little bit in the counterfactual. But this does take into account hubbing, it does take into account the connectivity over those hubs, and it does take into account the frequency and service and the number of seats for example.

PROF GILLEN: Okay, thank you.

MR PJN TAYLOR: I'm just looking at your submission and the write-up below that slide. Did your research determine any time lag between the investment in capacity by the second market position?

MR BENTAL: Yes.

MR PJN TAYLOR: Could you comment on that please?

MR BENTAL: I think I do agree with, I think it was Mr Norris who suggested that you get the value of city presence usually three to four years after the investment. Now, the value increases as you get toward three to four years, but you get the full benefit in our estimation after three to four years.

MR CURTIN: By coincidence, I had a somewhat similar question. I see what your graphs say, but I was wondering if another explanation might be first mover advantage. If I assume that the person who's got the most routes now out of -- into or out of the city, it's plausible they might have been the first to service it. I was just wondering if it's able to distinguish the explanation you've got from the explanation that it's just demonstrating a first mover advantage?

MR BENTAL: I believe that while in the airline business first mover advantage gives you some benefit, because of the fact that it is a fairly competitive marketplace, what you tend to see is that airlines that come in, not necessarily first, but come in with a higher degree of presence in the city, breadth and -- of service in the city, tend to overwhelm the first mover advantage.

MR CURTIN: Thank you.

MR PJN TAYLOR: I'd just like to follow-up. On the assumption, the second the mover comes in, puts capacity on, meets frequency and done this wingtip to wingtip flying, does the current first place market position, does it always get to an equilibrium, or does the incumbent have some sort of advantage, any sort of advantage?

MR BENTAL: I think the -- from looking at the historical data, it would suggest the incumbent does have an advantage, and I think this is why you tend to see the capacity wars all over the world being very prolonged wars because it does take some time, but what you tend to see is, the value at the end on a city level tends to overwhelm the cost incurred in getting there quite often. And I think this is why you do see a lot of airlines merging, you do see a lot of alliances, one of the biggest issues within alliance is getting some of the value.

Further, I would like to say that when we model this, and when airlines look at this, we do model this as a zero sum game. So, the value that the airline derives comes from a different airline; it does not come from increasing fares or market power, but it's always a zero sum game in which you get it from the other airlines, and this is pretty standard of all people using this analysis.

MR PJN TAYLOR: Thanks.

DR PICKFORD: I'm still having a bit of difficulty understanding the graph. Perhaps the difficulty comes from not fully understanding how those two axis differ from each other. If you could define them, perhaps again that would help.

MR BENTAL: Sure. The Y axis is the actual revenue that the airline derived from the city. So, this is an actual revenue based on the USDOT 10% sample, so we know exactly how many passengers the airline is carrying and we know how much those passengers are paying. On the X axis is our estimation of what the revenue should have been on a first fair share scenario. What this clearly indicates is, as you get bigger in the city you tend to get what Paul just referred to as a positive share gap. You get more revenue in the city than the expected amount of revenue in that city.

DR PICKFORD: Then again, how do you calculate the fair share?

MR BENTAL: The fair share revenue is looking at every O&D out of every city, taking a look at the total revenue in that city and then allocating on an O&D level that revenue by the QSI measure. Once we know the expected revenue on an O&D basis we sum it up to the city to get the expected revenue.

DR PICKFORD: So that means that the line of dots you have on the graph, their position depends crucially on how you apply a QSI measure?

MR BENTAL: The thing about QSI, that it applies the same exact measures to all airlines, so while I would agree maybe shares would shift but they moved -- they would move for all airlines at the same direction. So, I do agree with you that there's some issue about the exact measure, and some airlines may use different QSI measures, but we apply them to all airlines at the same time. So, that tends to make that possibility less of an issue.

CHAIR: Please continue.

MR PETERSON: I think it's now that we're moving into the confidential session.

MS REBSTOCK: Okay, we will break for ten minutes and I would ask that anyone who has not signed a confidentiality undertaking leave the session. Obviously, anyone employed by the Applicants is able to stay.

Hearing adjourns for confidential session at 6.20 pm