AIR NEW ZEALAND – QANTAS ALLIANCE PROPOSALS
PRESENTATION TO THE NEW ZEALAND COMMERCE COMMISSION
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Qualifications to comment

1. It would be appropriate, Madam Chair, for me to commence with a brief outline of my qualifications to comment on the applications by Air New Zealand and Qantas for authorisation of their alliance and equity proposals. I am not an economist – my Ph.D. from the Australian National University is in History and Politics – but with over 14 years' involvement in international aviation, I do have a reasonable degree of familiarity with the industry. So, although I shall steer clear of the arcane world of economic modelling - I am very happy to leave that to Professor Hausman - I am concerned with an empirical look at the underlying assumptions.

2. For 8 years I held the position of Head, International Air Services in the Ministry of Transport. In that capacity, and among other duties;

   - I participated, as principal adviser and later as leader of the New Zealand delegation; in over 60 bilateral air rights negotiations with 27 countries, including the early negotiations for the Single Aviation Market with Australia;

   - I conducted a major in-house review of New Zealand's international air transport policy that led to the updating of the policy announced by the Minister of Transport in 1998 - that policy, which is strongly pro-competitive, is still current; and

   - I took the lead role in devising the simpler and more efficient regulatory regime for international airlines set out in Part 8A of the Civil Aviation Act.

   In these various roles I also liaised on a regular basis with senior executives of Air New Zealand.

3. For the past 6 years I have been an independent consultant and writer on aviation issues. My consultancy clients have included government and regional authorities, airports and airlines, including Air New Zealand.

4. In the present proceeding, I have been asked to comment on the counterfactual put forward by the Applicants as compared with that adopted by the Commission in its draft determination. A review of the counterfactuals seems particularly warranted because of the detriments the Applicants claim would ensue if authorisation for their alliance proposals were denied

5. However, before addressing that issue, and given my past involvement in the negotiation of New Zealand's bilateral air rights, including with the United Kingdom, I hope I may be excused for drawing attention to an error made by the Air NZ representative when referring on Tuesday to the capacity constrained nature of the rights the airline may exercise on the Auckland-Los Angeles-London route. Contrary to his presentation on this matter, Air New Zealand is entitled to exercise, and does exercise, 5th freedom rights between Los Angeles and London Heathrow. As the Auckland-London route is probably the longest in the world, and given also its high seasonality, it would be very difficult indeed to operate the route viably without the right to carry O/D traffic between London and Los Angeles.

The Applicants' counterfactuals

6. The Applicants claim that their proposals would result in net benefits compared with the alternative scenario without the alliance – that is, the counterfactual under which Air NZ would face a capacity battle with Qantas. This is the "war of attrition", the airlines' phrase that has gained widespread currency over the past year, a war Air NZ could not win. Instead, the airline would suffer a more or less gradual decline, which could ultimately lead to its demise. There have been varying estimates of how long this downward spiral would take` but the latest pointer was provided earlier this week by Air NZ's CEO, Ralph Norris, who suggested "three to five or six years". But, however soon, the applicants have stuck by their doomsday prediction. In my view their counterfactual is flawed. I will put forward four basic reasons for this view.

7. For a start, it would be demonstrably irrational for a major listed company to embark on a course that it had insistently predicted beforehand would lead to its destruction. I think it defies belief that such a course could be justified by reference to the past habitual practice of full service airlines elsewhere in the world when that sort of commercial conduct – resulting in gross over-capacity - has been a significant contributor to the current state of financial crisis that has befallen so many FSAs. Although not limited to the United States, the problem has been particularly evident in that country – which is ironical because the US aviation industry also gave birth to a very pertinent innovation in the form of the value based airline.

8. Air NZ's low cost subsidiary, Freedom Air, was, I think, preceded only by South West, Ryanair and, just, by EasyJet. More recently, and to its credit, Air NZ has also been to the fore with its innovative Express product – a concept some have called VBA-plus. In the process, Air NZ has demonstrated the direction in which it could have options other than a fatal war of attrition.

9. My second reason for thinking the Applicants' counterfactual is flawed relates to the likelihood of Virgin Blue's early entry into the Tasman and New Zealand domestic markets. As there is no room, they claim, for two FSAs and a VBA in the New Zealand market in particular, they predict an outcome in which Air NZ will be squeezed between the bigger FSA, Qantas, and the VBA, Virgin Blue. In my view, however, the circumstances suggest that Qantas would be more vulnerable than Air NZ to impact from Virgin Blue. New Zealand is Air NZ's home market, a claim most New Zealanders would not concede to Qantas. But popular feeling aside, even Qantas' New Zealand subsidiary, Jet Connect, employing staff on New Zealand conditions, will not operate Tasman routes from Auckland, much the biggest New Zealand aviation market, and only later will extend to the domestic market. Qantas' overall costs will therefore remain above those of Air NZ. In addition, and a factor that appears to have been largely overlooked, Virgin Blue's entry will inevitably siphon off domestic Australian feed to the Tasman that, since Ansett's demise, has been monopolised by Qantas.

10. In these circumstances, I think it would be fallacious to argue that the competition between Air NZ and Qantas will come down to the issue of which has the deepest pockets. Indeed, last week, and in the wake of correct predictions of a second half-year loss by Qantas, a Macquarie Equities analyst suggested that money Qantas would save if

the alliance proposals were declined should be spent on upgrading Qantas' short-haul fleet. The clear implication was that the airline would lack the funds for such a move if the investment in Air NZ went ahead. As I note later, Air NZ's financial position has moved in the opposite, beneficial direction.

11. My third reason for resisting the doomsday prediction is that the extent of competition on the Tasman from fifth freedom carriers has been overstated by the Applicants. In this regard, I would note that:

- all so far operate only to and from Auckland;
- they do not operate with the frequency of Air NZ nor, in some cases, at similarly convenient times;
- although they all carry through traffic, the Applicants have emphasised capacity share rather than market share, apparently in order to make the threat seem greater than it is; and again,
- due to costs differential, their impact would likely be felt more directly by Qantas.

12. The Applicants have also been unrealistic in listing all the foreign airlines that could, theoretically, access fifth freedom rights on the Tasman, implying that they might elect to exercise them. The list includes airlines that formerly operated on the Tasman but withdrew, airlines that once operated separately to Australia and/or New Zealand – not across the Tasman – but also withdrew long ago, and some airlines that have never operated to this part of the world. While fifth freedom carriers do have some impact, the Tasman has been, nevertheless, an unstable aviation market. Airlines come and go, as was demonstrated only last month when Malaysia Airlines withdrew some flights via Brisbane in favour of operating to Auckland non-stop from Kuala Lumpur.

13. Finally, the assertion by the Applicants that Air NZ would be forced to pull off its international routes would be counter-productive in that it would deprive the airline's domestic services of substantial international origin traffic. Given Air NZ's advice that it carries 40% of all inbound traffic, and given that it withdrew from all international routes excluding the Tasman and South Pacific, then based on international arrivals in the year

to June 2003, the airline would lose potentially uo to 500,000 passengers on an annualised basis.

The Commission's counterfactual

14. The Commission, on the other hand, has posited a counterfactual under which Air NZ would continue to compete effectively, and remain in a position to evaluate other commercial opportunities as they arise. It is my view that this counterfactual is the more credible – and for a number of reasons which I shall outline.

15. First, Air NZ's financial position has greatly improved and been stabilised. Thus, in an Australian TV interview on 3 August, just two weeks ago, Ralph Norris was able to say, and I quote:

> *There's no doubt that Air NZ's financial position is looking a lot better. We have got a significant pool of cash in the bank, we've paid off all of our unsecured bank debt and we have been strongly cash flow positive, and we're going to turn a profit.*

16. Accordingly, in a statement to the Australian and New Zealand stock exchanges on 31 July, Air NZ reconfirmed that its profit before unusuals and tax for the year ending June 2003 would exceed the forecast announced at the airline's annual general meeting last November. Mr Norris advised that the final result – due to be announced next week – would be "comfortably on the positive side of $200 million".

17. Air NZ has argued that this financial improvement is short term and that the longer-term outlook is much less encouraging. It says that the current financial situation has been assisted by benign exogenous conditions, such as the high New Zealand dollar and low fuel prices, but such conditions are cyclical and, as the ACCC has pointed out, do not provide a basis for special treatment.

18. Moreover, by gaining its first profit on Tasman routes for five years through reducing capacity, revealed by Mr Norris in a Sydney speech on 30 July, Air NZ has shown that throwing additional capacity on a route may not be as rewarding, nor necessarily as damaging to a competitor, as the Applicants assert.

19. Air NZ has managed to reduce its costs since its recapitalisation, including through the successful introduction of its Express service on domestic routes, which will soon be extended to the Tasman and possibly to other short-haul services in the South Pacific. Referring to the airline's cost effectiveness in his Australian TV interview, Mr Norris said Air NZ was "operating near to world best practice for a network airline". This is of interest in the context of the Applicants' claim that there is no room for two full service airlines in the New Zealand domestic market. Air NZ's Express class has brought the airline nearer to a VBA – as noted earlier, a kind of VBA-plus – especially when account is taken of the modifications that Virgin Blue has made to its business model. If Express class has enabled Air NZ to expand the domestic market by 20%, it will be relevant to note whether a similar result can be achieved on the Tasman.

20. Air NZ's position on the Tasman will be further strengthened with the introduction of the new A320 aircraft from October onwards – and later on domestic routes also – with consequent operating cost savings of 15% compared with the current B737s. Meanwhile, the retention of Freedom Air provides Air NZ with a continuing low-cost operation to ward off, or at least make it difficult for competitors to enter the secondary Tasman routes. Air NZ's experience with these two lower-cost variations could possibly point the way to further development of a strongly competitive option in the future.

21. Owing to the orientation of its international network, Air NZ has largely avoided the adverse impact of wars and tensions in the Middle East and neighbouring areas that have seriously set back other airlines, including Qantas, an advantage that will continue, along with the perception of New Zealand as a safe tourism destination. This has been reflected, for example, in the fact that, even with the impact of SARS, New Zealand has enjoyed a higher relative rate of short-term international arrivals than Australia. Thus, for the year ended June 2003, there was an increase of 8.6% over the 2001 June year, that is, prior to the events of 9/11. Arrivals from our top five tourism markets – those exceeding 100,000 – all increased, most notably an astonishing 18.3% in the case of the United Kingdom.

22. Finally, if the alliance with Qantas were not to proceed, Air NZ would be able to retain its membership of the Star Alliance, and thereby continue to gain the benefits of membership of the world's largest international airline alliance by every benchmark: in terms of revenue passengers per kilometre (RPKs), total passengers carried and total revenue

earned, as well as the number of individual destinations and countries served. Moreover, New Zealanders would continue to benefit from worldwide competition between the Star and oneworld global alliances

23. For these various reasons, it is my view that the Commission's counterfactual remains more credible than that put forward by the Applicants, and that developments since the release of its draft determination have added weight to the Commission's initial assessment.
