Statement by Ralph Norris

18 August 2003

1. Introduction

1.1 Madam Chair, Commissioners, for reasons which will be traversed over the next few days, in my view and in the view of my Board, Authorisation of the Alliance with Qantas is absolutely critical to the future of Air New Zealand and because the fortunes of New Zealand's tourism industry are so inextricably tied to the fortunes of Air New Zealand, also critical to the future well being of New Zealand.

1.2 Along with other full service airlines (**FSAs**) internationally, Air New Zealand is operating in a changing global aviation industry. This change has been brought about by a wave of cross border liberalisations of aviation bilaterals which have permitted domestic and trans-border markets to be entered by a new efficient and effective airline model (presently limited to short haul routes) known as Value Based Airlines (VBAs) or Low Cost Carriers (LCCs). VBAs and LCCs are abbreviations used interchangeably throughout the airline industry to describe the same business model.

1.3 Air New Zealand operates as a domestic New Zealand and International airline. As a rough rule of thumb, its international operations comprise approximately 75% of its total flying operations while its domestic operations comprise 25%. Internationally, the airline flies to the United States (Los Angeles/Honolulu), London, Australia and to a number of Asian destinations including Japan (Tokyo/Osaka/Nagoya), Singapore, Taiwan and Hong Kong. It also provides international services to the Pacific Islands and beyond to Los Angeles.

1.4 Until the entry of Ansett NZ in 1987 Air New Zealand operated without any significant competition within New Zealand.

1.5 In 1996 a Single Aviation market (**SAM**) came into force between Australia and New Zealand. It was originally intended that it would come into force in 1993 but as I will discuss again later, the Australian Government postponed the signing.

1.6 An Open Skies Agreement between Australia and New Zealand was subsequently agreed in late 2000. It continued the trend towards liberalisation. Among other things, the Open Skies Agreement allows:

- any authorised airline (being an airline having Australian or New Zealand control) to fly without restrictions between Australia and New Zealand;
- any authorised airline to operate domestic services in Australia and New Zealand, and to carry domestic passengers on international services between airports approved for international services in each country;
- removal of limits on the number of authorised airlines that can operate services linking any city-pair combinations within and directly between the two countries, and on passengers or freight capacity on such routes; and
- removal of the limits on beyond rights that existed under the Single Aviation Market agreement.

1.7 However, the Open Skies agreement continues to impose the ownership and control restrictions that prevail under the Single Aviation Market agreement.

1.8 The Open Skies agreement has far reaching implications for Air New Zealand (and for Qantas). It permits either airline – or any other authorised international airline (including Virgin Blue) – to operate to, from and within both Australia and New Zealand.

1.9 As a result, Air New Zealand's domestic market is now wide open to competition as is the Tasman and domestic Australia. As I will describe later, this is already having major implications for Air New Zealand and for New Zealand.

2. Competition in New Zealand and its future impact

2.1 The first FSA competitor to Air New Zealand in the domestic market was Ansett New Zealand. It provided full service operations in the New Zealand domestic market from 25 July 1987 and operated using 3 B737-100 aircraft operating on the main trunk routes and two Boeing Canada Dash 8 aircraft servicing tourist regions (Rotorua and Queenstown). The B737-100's were replaced by seven Bae 146-200 and 300 series aircraft

in 1989/1990. At that time, Air New Zealand operated 26 aircraft on the domestic market, of which 11 were B737-200's with an average age of only 2.5 years). Ansett New Zealand added two further Bae 146 aircraft to the fleet in 1990/91.

2.2 However, as a FSA, Ansett New Zealand did not have the "connectivity" of Air New Zealand, that is, the ability to attract increased custom by virtue of its much broader domestic and international network of services. By way of example, Passenger A, flying Wellington/Auckland - may have chosen Ansett New Zealand for a domestic flight. However, if Passenger A wished to fly Wellington/Auckland/Los Angeles, they would have to change airlines at Auckland and fly on Air New Zealand, Qantas or another airline in order to complete the second leg of the itinerary. That need to change airlines would see Passenger A, more often than not, making the decision to fly both legs of the voyage using Air New Zealand. That is called the benefit of connectivity.

2.3 Nor did Ansett New Zealand have the benefit of "city presence". City presence arises from an airline having the greater depth of services (frequency) and breadth of services (destinations) into and out of a city, which encourages higher value customers to use one airline over another.

2.4 Ansett New Zealand with its 11 aircraft did not compete effectively with Air New Zealand on the basis of city presence, and could not compete effectively on the basis of connectivity. Add to that, the increased operating costs of Ansett New Zealand's aircraft, plus a low level of capital support and it was never an airline which was likely to stretch Air New Zealand in the short to medium term. This needs to be compared with competition from a VBA which competes almost solely on price and to which connectivity and city presence have little relevance.

2.5 Following the collapse of Tasman Pacific, Ansett New Zealand's successor, Qantas emerged as a much more formidable competitor to Air New Zealand in the domestic New Zealand market. Unlike its predecessors, Qantas is several times the size of Air New Zealand, with far greater financial resources and greater Australasian network breadth and depth. While at present it does not offer the same frequencies as Air New Zealand, its greater Australasian network depth and spread make it

inevitable that over time it will gain a connectivity and city presence advantage over Air New Zealand.

2.6 At the same time, it is now beyond doubt that Virgin Blue intends to expand onto the Tasman and the domestic New Zealand markets to compete as a VBA. As a VBA, Virgin Blue will compete with its larger FSA competitors solely on price and where connectivity and city presence have little relevance.

2.7 In a market in which two FSAs, Air New Zealand and Ansett New Zealand could not co-exist, and in respect of which Ansett New Zealand failed, it is not difficult to foresee the outcome of a battle for market share between Air New Zealand, an expanding Qantas and the expanding VBA, Virgin Blue. For Air New Zealand, also, it is not difficult to foresee in the relative short-term a "squeeze" developing, similar to that which brought about the demise of Ansett Australia - a squeeze involving exactly the same participants. That squeeze will reduce Air New Zealand's margins in circumstances where Air New Zealand overall is already failing to achieve its economic cost of capital.

2.8 The medium term outlook for Air New Zealand is therefore seriously adverse – far more so than a focus on short-term outcomes might suggest. As confidential material provided to the Commission makes clear, without the Alliance, Air New Zealand faces a struggle for survival – but which it is poorly placed to win. This material will be addressed separately in a confidential session led by Mr Roger France, Air New Zealand's Deputy Chairman, supported by the Company's Chief Financial Officer, Shane Warbrick, Eric Lucas, a Partner of Price Waterhouse Coopers and Murdo Beattie, a principal of Cameron and Co.

2.9 Air New Zealand has a short window of opportunity to solve the threat to its medium to long term survival. The only way it can do this is to be the remaining FSA in New Zealand, an outcome which it can achieve, only through the platform of the Alliance. The Alliance provides a one-off opportunity to combine two strongly branded locally based airlines into a sustainable regional group.

2.10 For the moment, the Alliance adds value for both Qantas and Air New Zealand. If Air New Zealand and Qantas are not permitted into the

Alliance now, it is unlikely that the opportunity will remain in the future. Damage from the battle between Air New Zealand and Qantas to develop sustainable networks in New Zealand is likely to substantially erode the benefits of an alliance in the future. Air New Zealand's current negotiation strengths will also dissipate as it comes under renewed financial pressure.

3. Background to Australian Domestic Entry

3.1 It is important that I explain the significance of the Australian domestic market for Air New Zealand. From the early 1990's Air New Zealand has recognised the need for it to enter the domestic Australian market if it was to achieve a sustainable market base for its operations that would see it remaining as New Zealand's international flag carrier into the foreseeable future.

3.2 Air New Zealand made two attempts to enter into the Australian market:

- The first attempt was through the development of a VBA model to be applied on the principal Australian domestic routes. That model was designed by the airline under the direction of Mr Ray Webster, then a member of the Air New Zealand management team, but now the Chief Executive of the well known VBA, easyJet, operating out the United Kingdom and into Europe. That attempted entry by Air New Zealand was positioned on the basis of an expressed intention of the Australian Government to enter into the SAM with New Zealand in 1993. Subsequently the Australian Government postponed signing SAM, removing the opportunity for the new Air New Zealand VBA model to proceed.

- The second attempt to enter the Australian domestic market was positioned through the acquisition of initially 50% of Ansett Australia in 1996 and then in 2000 the acquisition of the remaining 50% of that airline.

3.3 As is now history, Virgin Blue arrived to take up the Australian VBA space and Ansett Australia failed as a result of its inability to reduce its operating cost base and/or match the Qantas International network (also precluded by Government Regulation) prior to the entry of Virgin Blue.

3.4 The collapse of Ansett Australia in September 2001 can be seen as a classic example of the forces of liberalisation and VBA competition in operation. While it is clear that a high cost base, prior management decisions and the state of Ansett Australia's aircraft contributed to its failure, there can be little doubt that the arrival of Virgin Blue ensured that Ansett Australia was never to have the opportunity to correct its problems.

3.5 The collapse of Ansett Australia, the impact it had on the financial resources of Air New Zealand, and the consequent re-capitalisation of Air New Zealand by the New Zealand Government are now things of the past. However, it took Air New Zealand to a point where it was only hours away from receivership and brought home to Air New Zealand a number of important lessons that full service airlines around the world have and still are being called on to address.

3.6 Those lessons include:

- an FSA will not survive in the face of VBA entry unless it is prepared to adopt models which allow it to substantially reduce its unit costs of providing air services (Canadian Airlines, Ansett Australia, Sabena and others are testimony to that outcome); and

- where two competing FSAs are joined in a market by a VBA which has adopted and then maintains the well established and tested low cost model, only one FSA can expect to survive; the smaller FSA will have no clear space within which to operate – again, Sabena, Canadian Airlines and Ansett Australia provide clear evidence of that outcome.

4. Post Ansett Australia

4.1 In 2001, before the Government completed its re-capitalisation of Air New Zealand, it required the Board to produce a five year financial plan. The five year financial plan was subject to detailed scrutiny by the Crown's advisers, and was a factor in value assessments carried out by a variety of parties at the time. The five year financial plan projected a steady increase in profitability for the five year period to 30 June 2006. The key features of the five year financial plan included an assumption that the then benign competitive environment would prevail for the foreseeable future, with the capacity of Air New Zealand and its competitors growing

generally in line with demand. That view was based on an expectation that it would take Qantas and Virgin Blue some time to take up the space created by the failure of Ansett Australia.

4.2 However, by early 2002, Qantas signalled publicly that it intended to substantially increase its capacity in the domestic New Zealand market in the short term from five to eight aircraft. From Air New Zealand's point of view, the move by Qantas was a logical response to remedy what Air New Zealand understood to be Qantas's existing loss making operation (viewed as a stand alone operation). We also considered the announced increase to be reasonably conservative and likely to be a first step in a series of increases.

4.3 At the same time, Virgin Blue made a number of public statements about the likelihood of it entering into the domestic New Zealand market. Virgin Blue had already demonstrated that it had the right model to compete in Australasia. Air New Zealand therefore took the threat of entry by Virgin Blue seriously.

4.4 That it would arrive was certain for two reasons. First, the characteristic of all VBAs around the world is that so long as there are suitable markets available within a reasonable flying distance then they expand into those markets. This is particularly so when the VBA is already servicing one of the airports on that new route. Secondly, Virgin Blue was already discussing a public listing and was shortly to find itself a new strong financial partner (Patrick Corporation). From a purely investment perspective, it was clear that Virgin Blue would need to demonstrate that it could grow if it was to list at an acceptable level of value for its current shareholders.

4.5 With these two developments, the risk emerged during early 2002 that Air New Zealand could become effectively "squeezed" in its core domestic New Zealand markets between the expected growth of Qantas and Virgin Blue.

4.6 As a result, the Board of Air New Zealand required its management team to review all of the airlines operations. It wanted to determine a strategy going forward which would see the different operating segments, domestic, Pacific, Tasman and long haul making a positive contribution to

the bottom line such that Air New Zealand could achieve its targeted economic return on capital.

4.7 Achieving such a strategic plan, given the nature and current dynamics of the airline industry, was never going to be an easy task. At that time, airlines were falling over throughout the world with monotonous regularity. Confidence in the airline industry was at an all time low and for FSAs, attracting capital in the face of ever reducing economic returns on capital was nigh-on an impossible feat.

4.8 For the Board of Air New Zealand and its management team, the review of its business models required commencing at the bottom and working our way throughout the whole of the airlines services seeking new and innovative ways of achieving the desired goal.

By May 2002, management had reported to the Board in respect of the overall direction of all of the short haul routes and recommended the adoption of a new model in respect of the New Zealand domestic market – Air NZ Express.

4.9 At that time, management also advanced propositions for discussion by the Board relative to the Tasman market and recommended that the Pacific Market should be deferred for consideration in the same review as would later occur in respect of the long haul routes. It is also now history that Air New Zealand, last week, announced a new Tasman Express service incorporating:

- new aircraft (A320) with two-class configuration;
- standardised café style food available free on board;
- free in-flight entertainment for both classes;
- simplified fare structure with 12 fare types reduced to four;
- every day low fares with an average 20% reduction across the full range of lead-in fares; and
- lowest fares available through Air New Zealand’s website.

4.10 However, developing the new Tasman service has been marked by a number of issues due to the current high-load factors we now have and the low margins on our Tasman operations. Those characteristics required there must be substantial reductions in cost identified or achieved before the Tasman Express service could be safely confirmed and implemented. Further background to the new Tasman Express service can be provided in the confidential session on Tuesday.

4.11 It must be remembered that Air New Zealand is an international network carrier (75% of its operations fall into that category). It is axiomatic for such a carrier that in order to compete in the global markets, it must satisfy the basic doctrine of all such airlines:

- it must have a seamless service across its whole network;
- all material parts of its network must be connected;
- it must price competitively with others on its routes, regardless of the fact that others are subsidized on an ongoing basis (e.g. Malaysia);
- it must provide competitive levels of service and the other frills which are normally provided by competitors; and
- importantly, it must have a home market with significant city presence.

4.12 What that means for Air New Zealand is that it cannot recreate itself as a VBA in the domestic and Tasman markets without suffering substantial financial detriments over its whole network. Basic to the typical VBA model is the removal of unnecessary cost including the costs associated with connectivity between flights; seamless baggage arrangements; complex itineraries and other FSA frills. This gives the typical efficient VBA a cost advantage of about 25% over the typical efficient FSA.

4.13 The range of initiatives undertaken by Air New Zealand have had a positive effect on Air New Zealand’s trading performance. The “Express Class” strategy, while not having a material effect on total revenue, has brought about some controllable cost savings. The extension of the strategy to the Tasman should add to these cost savings.

4.14 However, these outcomes are short term and derive from a time when market conditions affecting Air New Zealand are relatively benign and there has been a temporary lull in new activity. The imminent increase in Qantas capacity; the arrival of Virgin Blue on both the Tasman and New Zealand main trunk routes and the arrival of additional major fifth freedom capacity on the Tasman will dramatically change that environment.

5. The Counterfactual

5.1 Much has been made by those who would object to the proposed Air New Zealand/Qantas Alliance about the so called "war of attrition". I would like to clarify this issue, at least from an Air New Zealand perspective:

(a) First, a war of attrition is not characterised by a major or overly aggressive battle, nor is it characterised as a substantial dumping of capacity. Rather it is a slow but steady crumbling away of the assets of a competitor by steady capacity increases which are in excess of natural growth but which allow the expanding airline to gain the benefits of increased city presence. The many claims to the contrary simply indicate a lack of understanding of the meaning of the term.

(b) Second, FSAs throughout the world (and Australasia has been no exception) have always competed against each other by way of increasing capacity and testing the other participant's resolve to respond by increasing its own capacity in response. FSAs have only limited ability to differentiate themselves. Passengers make purchase decisions, first by determining whether an airline can take them to their destination and second in terms of price and frequency of services By increasing capacity, airlines promote upgraded frequency and presence in cities in an attempt to draw market share from the FSA competitor.

The competitor normally reacts by also increasing capacity and nullifying the attacking airlines new advantage. However, sometimes the other airline will falter and not respond - perhaps it does not have the financial strength or the access to additional aircraft to allow it to respond. In such a case, the attacker gains the

advantage and inevitably claims market share. These are well tried and tested FSA characteristics.

(c) This is what Qantas has said it intends to do. If it didn't Air New Zealand would see that as a failure to take advantage of an opportunity. In evidence provided to the Commission under confidential Chapter 6 of its submission of 20 June (Figures 1 and 2 – page 13), we exampled an analysis by the Airline Planning Group showing how such competition occurs and its outcomes. David Bental from APG will discuss these issues in a later session.

5.2 It follows from what I have said that for Air New Zealand, as a FSA providing network services internationally and in domestic New Zealand, Qantas' announcement that it intended to increase services in domestic New Zealand by the addition of three 737 aircraft came as no surprise. The Qantas position is the reverse of the logic of Air New Zealand wanting a sustainable position in the domestic Australian market. Indeed, an examination of Chapter 3 of our 20 June submission makes it clear that all airlines, including VBAs, enter geographic markets with small volumes of capacity and steadily increase them. Two of the examples depicted in Chapter 3 (Figures 9 and 11 – pages 31 - 33) disclose how Westjet in Canada and Virgin Blue in Australia, as VBAs, both achieved steady growth in their presence by adopting this methodology. Virtually all airlines compete and grow in this way.

5.3 The logic of Qantas increasing its capacity in New Zealand is little understood by those not involved in the industry. This has led to a plethora of claims that our counterfactual is unbelievable or unrealistic. I venture to suggest that there are no industry experts or knowledgeable commentators who would not instantly recognise the logic of Qantas increasing its capacity in the manner suggested and this view will be confirmed by a number of experts later in the Applicants' evidence, including Dr Michael Tretheway and David Bental of APG.

6. VBA Entry

6.1 I believe it is now clearly beyond issue that Virgin Blue intends to enter the Tasman market and the New Zealand domestic market in the very near

future. In its latest submission to the New Zealand Commerce Commission, it says that it will do so and it says that it will do so in a manner that will constrain the Alliance. Evidence on this subject will be provided by a number of witnesses including:

- Dr Michael Tretheway;
- Mr Andrew Miller, the Chief Operating Officer of Air New Zealand;
- Mr David Bental, a director of the Airline Planning Group;
- Dr Clifford Winston,
- Professor Robert Willig and Dr Margaret Guerin-Calvert; and
- Mr Ray Webster, the Chief Executive of easyJet.

6.2 Some of these witnesses together with representatives of Air New Zealand and Qantas will also demonstrate that even at relatively low levels of entry (5%), a VBA will have the same impact on fares as can be expected when it achieves much higher levels of market share, in the order of 20-30%.

6.3 Air New Zealand has always been aware of the certainty of a VBA entering its markets in a material way. Once Virgin Blue became established in Australia, it became merely a matter of time when, not if, it would enter the Tasman and domestic New Zealand markets. That is the characteristic of VBAs around the world. There is no reason why Virgin Blue, which has adopted those world models, could be expected to act differently. It has been saying that it will enter for some time but it has only now admitted how close is its arrival date. It has wanted to extract a commercial price from the Applicants. However, its aircraft for entry are now close to arriving and one thing an airline like Virgin Blue cannot accept is costly aircraft without routes to fly.

6.4 In its most recent submission to the Commission, Virgin Blue has confirmed that it accepts the arguments advanced by us to the Commission in Chapter 3 of our 20 June Submission. I would suggest to the Commission that all the expert industry evidence supports Virgin Blue's entry into both the relevant markets at a constraining level and

there is no evidence that argues the negative, at least of an informed or credible nature.

6.5 Air New Zealand can understand the difficulties faced by persons who do not understand this industry to understand the logic and certainty of why Qantas and Air New Zealand, Virgin Blue and other airlines will act in the manner set out in the Counterfactual. No one joins the airline industry without taking considerable time to come to grips with its complexities and its manner of competing. The way in which FSAs compete with each other won't materially change, but the way in which FSAs compete with VBAs must change.

6.6 There is only room in the New Zealand domestic market for two airlines, one FSA and a VBA. One FSA will be forced to leave the market unless Air New Zealand and Qantas are able to sufficiently link their services such that, effectively, they become one FSA. The New Zealand market has found it impossible in the past to maintain two FSAs, it is quite illogical to believe that in some magical way it can now sustain three airlines.

6.7 There are those who would say that Air New Zealand should not enter the Alliance because it has the support of the country – "our airline" – and that the loyalty of New Zealanders will ensure that Qantas and Virgin Blue will never succeed. To those commentators I would point out that Ansett Australia was in business for over 50 years. It was an Australian airline much loved by its supporters; it had a significant frequent flyer loyalty programme; but it failed in the face of pressure from Virgin Blue which sold its product purely on the basis of price and timeliness of service, and competition from Qantas. Loyalty, and being a national icon, could not and did not save Ansett Australia.

6.8 When Virgin Blue enters the New Zealand domestic market it will result in a further reduction in fares because Virgin Blue will have the lower cost base. That is how VBAs compete. It does not have the burden of operating 75% of its business on overseas routes; it merely flies point to point. While those lower prices will further stimulate passenger numbers, analysis of VBA entry in Australia shows that the lower fares arising from the arrival of Virgin Blue has tended to cancel out the extra passengers leaving total revenue virtually unchanged. This is similar to Air New Zealand's experience as a result of the introduction of Air NZ Express.

What does change is the total industry cost, which increases by the addition of the total cost of the new entrant, Virgin Blue (plus the cost of the increased capacity of Qantas).

6.9 Now, that increased total cost and the need for a margin must be covered by materially exactly the same revenue which previously supported two airlines if the Australian experience occurs in New Zealand. Yet when there were two airlines (Air New Zealand and Qantas), only one was making a profit. I say, point me to the logic which suggests that where two airlines could not make a profit, three airlines with a greater industry cost base but no material increase in revenue, will do so.

6.10 Exactly the same situation will apply to the Tasman. In fact the effect will be greater. Simultaneously with the entry of Virgin Blue, forcing lower fares, the Emirates and Royal Brunei Airlines will be bringing into that market a huge increase in capacity (approximately 14% based on seats). The total industry cost in that market has now increased in a major way, but the total revenues to cover it, for the same reasons as set out above, will not have materially changed.

6.11 Throughout the world, entry by a VBA into markets has resulted in substantial reductions in airfares, and substantial efforts by FSAs to take cost out of their businesses and to become more efficient and effective competitors. With the arrival of Virgin Blue into the New Zealand domestic and the Tasman markets, there is no way in which the Alliance is going to result in increased airfares or decreased efficiency. I understand NECG and others using economic models suggest price increases are likely under the Alliance. That may be so in theory. But in practice, to the best of my knowledge, nowhere in the world has a true VBA entered a market and prices gone up. It goes without saying, that in such an environment there will not be inefficiency.

6.12 In the reverse, what I can say is that if Air New Zealand, as New Zealand's dedicated international carrier, cannot sustain a real presence in its international markets then New Zealand will suffer a substantial reduction in tourism which will far outweigh any detriments arising out of the Alliance.

6.13 Air New Zealand currently applies in excess of $70million in international markets every year. The Tourism Industry Association New Zealand, in its February 2003 Submission to the Commission supporting the Applications (page 6) notes that Air New Zealand's public good promotion of New Zealand has a present value of $1.4 billion. It also noted that if Air New Zealand ceased to be a separate entity, Tourism New Zealand's budget would need to rise to over $155 million per annum to purchase similar public good exposure.

6.14 Tourism amounts to approximately 9% of Gross Domestic Product and ranks second only, and then by a relatively small margin, to the Dairy Industry in terms of export earnings. Absent the Alliance, you can be certain that there will be no airline servicing New Zealand which will apply itself diligently to promoting inbound tourism in the way that Air New Zealand currently does. One of the benefits of this Alliance is that it will avoid the detriment of lost tourism as well as promote the increase in new tourism.

7. **Freedom Air**

7.1 In its draft determination, the Commission expressed concern about the impact of incumbent response on potential VBA entry, most likely, Virgin Blue. I would like to make four short comments:

- in Australia, Virgin Blue entered as a greenfield entry directly into the heartland of Qantas and Ansett Australia. It did so in the knowledge that if ever Qantas was going to react then attacking its homebase was the best way to trigger that reaction. It entered, and some commentators would say, came close to failure. But it did not fail, it forced the failure of, an admittedly inefficient, Ansett Australia and it is now the number two airline in Australia with 30% of the total market share. All that in two and half years. That was its moment of greatest risk but it did not bat an eyelid, it certainly did not back off because of a fear of incumbent response;

- Virgin Blue has stated categorically that it will enter the Tasman and domestic New Zealand markets. It says it intends to do so in a manner which will constrain the Alliance The same airline entering with the same participants as incumbents but this time it is not Qantas'

heartland but the much smaller Air New Zealand's. Air New Zealand, will be forced to fight for its survival. There are no signs that Virgin Blue has been deterred by this. Aside from trying to obtain a commercial advantage by talking up a need for Freedom to be sold, Virgin Blue has made it clear it will be entering the Tasman and New Zealand domestic markets regardless. No doubt this time, it gains comfort from the fact that it is no longer a greenfield entry; it is merely expanding from an existing base and from airports where it is already very well established. It is following the typical growth path of the VBA model;

- whatever theoretical arguments about barriers to entry were previously available to those who oppose the Alliance; arguing that incumbent response, or Freedom is a barrier is no longer open to them; and
- in any event, Freedom has never been a tool for Air New Zealand to defeat an entry by Virgin Blue. It is not open to Air New Zealand to deploy Freedom on routes operated by its mainstream services without cannibalising in a serious way those services. That matter will be discussed further in a confidential session.

8. **Fifth Freedom Carriers**

8.1 The seven Fifth Freedom airlines flying the Tasman provide a major constraint on Air New Zealand and that will continue with the Alliance. Currently they comprise 25% of available capacity on the Auckland – Sydney route and 44% of available capacity on the Brisbane – Auckland route. That capacity will dramatically increase with the commencement of the widely advertised arrivals of Royal Brunei and Emirates carriers.

8.2 Importantly, these carriers actually carry 16.7% of Auckland – Sydney origin and destination traffic (O & D) and 22.1% of Auckland - Brisbane O & D traffic. There is no way in which carriers with that level of market share can be ignored. Later in the conference, John Harrison from Air New Zealand and Peter McCumstie from Qantas will explain how fifth freedom constraint occurs in practice and in doing so they will explain, in simple terms, the complexities of yield management.

9. **The Alliance**

9.1 The Alliance provides a unique solution to the threat to Air New Zealand's survival as a competitive airline in New Zealand and on the Tasman and as a provider of international services and supporter of New Zealand's tourism business.

9.2 I would like to clear up two misconceptions which seem to be prevalent despite numerous attempts to clarify the position:

(a) First, as a result of the Alliance, Qantas will gain a maximum 22.5% of the equity shareholding in Air New Zealand. That is not a controlling shareholding, particularly when the Government of New Zealand exercises that control and says it intends to do so into the future. The arrangements provide that the equity shareholding will allow Qantas to appoint a maximum of two directors onto the Board of Air New Zealand, which will then have ten directors in all. A fifth of the Board does not give Qantas control of the Air New Zealand Board or anything like it.

(b) The second point I would like to make is that under the Alliance arrangements, it is not Qantas that will manage and operate Air New Zealand. It is Air New Zealand's management and Board which will manage the whole of Air New Zealand's operation, together with all of Qantas' commercial operations into, within, and out of New Zealand. True, there is provision for a combined Air New Zealand and Qantas committee to advise and make recommendations to the Air New Zealand management team, but that is all they can do. They cannot direct Air New Zealand to alter its operations in a way that Air New Zealand does not wish to do. In any event, that advisory committee is made up of six persons, three from Air New Zealand and three from Qantas. Unless Air New Zealand also agrees, there can not even be an advisory recommendation made to the management of Air New Zealand by that committee.

9.3 If I can summarise the position, without the Alliance, Air New Zealand will be at best competitively marginalised or at worst lost to New Zealand. With the Alliance, Air New Zealand will be able to link with Qantas as a single FSA constrained on short haul routes by the presence or potential

entry of the VBA, Virgin Blue. It will be able to achieve efficiencies which not only benefit both Air New Zealand and Qantas but which will also benefit New Zealanders.

(a) The Alliance can cease what is commonly known as wing tip flying, where both airlines compete on flights departing at exactly the same time. As a result passengers will have a far greater spread of flights throughout the day, both domestically and internationally.

(b) We will be able to achieve greater efficiencies by using a larger aircraft rather than two smaller aircraft on some routes.

(c) We can combine our available passengers and services to create new growth strategies by commencing new direct on-line flights to some new destinations which are currently only served indirectly, e.g. Auckland/Adelaide or Auckland/Paris or Auckland/New York.

(d) We can avoid both of us buying expensive aircraft to service new routes or both buying replacement aircraft where one acquisition will achieve a more efficient outcome.

(e) We can choose the most efficient operation on particular routes to ensure that inefficiency is removed from the operations.

The Alliance will not only save the airline and ensure retention of its control of its own destiny but also achieve very substantial welfare benefits for New Zealand.

9.4 Let me be clear, the threat to Air New Zealand by a combined squeeze by Qantas and Virgin Blue exists, it is real and cannot be avoided. Air New Zealand sought discussions with Virgin Blue as an alternative to an Alliance with Qantas. It did so, because the Board insisted that all potential solutions be properly tested before concluding arrangements with any party. The unanimous view of the management team and of the Board of Air New Zealand is that not only would an Alliance with Virgin Blue not save Air New Zealand from the problems it faced, but that Virgin Blue required growth to promote itself and achieve a public offering. From Australia, there is only limited growth available and the Tasman and New

Zealand domestic markets are two of the more material and stable sources of growth.

9.5 Air New Zealand's management and Board determined that an Alliance with Virgin Blue at best would be temporary, would not provide anywhere near the public benefits that this Alliance with Qantas will provide and that in any event an Alliance between a FSA and a VBA would be quite impossible to consummate. A VBA is driven solely by price, timeliness and point-to-point traffic, an FSA, particularly one with around 60% of its operations dedicated to long haul services must first provide for connectivity and seamless service and then determine price from that higher cost base. The management team considered that an Alliance with Virgin Blue would not last – it had to itself enter Air New Zealand's core domestic and Tasman markets to achieve desired growth.

9.6 The Board also required management to hold discussions with other potential suitors all of whom, including Singapore Airlines, expressed disinterest and indicated that there were no benefits for them in an ongoing Alliance with Air New Zealand. We believe that the original alliance arrangements with Singapore were driven by Singapore's desire to achieve an entry point into Australia using Ansett Australia. With Ansett Australia gone, Singapore soon lost interest in the relationship with Air New Zealand.

9.7 From a national perspective, the Alliance provides substantial supportable net benefits to the New Zealand economy:

(a) while difficult to quantify, it provides the means to maintain a New Zealand owned and controlled flag carrier having all the necessary incentives, capability and willingness to encourage tourism growth for New Zealand;

(b) it allows the parties to avoid the costs of a slow, degrading and costly battle for market share in which Qantas commits additional capacity and Air New Zealand attempts to respond to but with limited resource;

(c) it allows for improved scheduling, including more direct flights;

(d) it will lead to increased tourism in New Zealand. Without a doubt, Air New Zealand is the greatest source of tourism promotion that New Zealand has. Compared with other airlines or indeed even with the Government, Air New Zealand is the major source of promotional funding for New Zealand;

(e) it enables Air New Zealand Holidays to cheaply access the Qantas Holidays intellectual property and its vast network;

(f) it provides a basis for Air New Zealand's first class engineering services to secure greater portions of Qantas' engineering and maintenance requirements, and additionally creates leverage in servicing other third parties;

(g) it provides increased freight opportunities for New Zealand's export industry at a time when otherwise the new A320 aircraft will reduce available freight space; and

(h) finally it reduces the risk of Air New Zealand having to call on tax payers for future funding, thus freeing scarce resources for other uses. As leading international economists Professor Steven Morrison and Dr Clifford Winston state in their paper in support of the Alliance, Government subsidy is one of the more inefficient means of supporting a national airline.

9.8 All of the above benefits have been the subject of intensive economic examination and quantification by NECG, supported by some of the world's leading economists. I do not attempt to summarise here the outcomes of their deliberations, they will do so directly to the Commission over the course of the next few days. What I can say is that I have read the papers they have prepared and filed with the Commission. In particular I have read and noted the papers from Professor Willig in which he provides a damning view of the modelling work carried out for the Commission by its external expert Professor Gillen and an equally damning view of the modelling work carried out by Professor Hazledine which will be tabled in evidence to be given by Professor Willig.

9.9 I have yet to see any expert economist with an industry understanding examine the NECG model on which our benefits are based and discredit

in any material way, the model, the methodology, the implementation, or the theory upon which NECG have based their report. Of course there are available criticisms of the NECG report, but none of them go to the overall veracity of the model – a model which I am informed is utilised widely in other jurisdictions for assessment of airline mergers and alliances.

9.10 I am aware, that Professor Robert Willig, and Dr Margaret Guerin-Calvert, two of the leading economists in the world, will give evidence to the Commission that the NECG model is appropriate for the task it sets out to achieve, and that it has no weaknesses which would have a material impact on the conclusions it arrives at. Further, the benefits that flow from the Alliance are said by Professor Willig to be conservative. In his second paper filed with the Commission on 28 July, Professor Willig postulated how substantial additional benefits would be gained from the Alliance as a result of online services replacing interline services.

9.11 In its draft determination, the Commission said it did not accept large parts of the benefits associated with the Alliance, particularly tourism benefits. These have been checked, re-modelled, re-analysed and re-argued in the submissions filed with the Commission since the 10th April. I believe the arguments are even more compelling now than they were before. Evidence will be brought over the next three days by the airline and economic experts which demonstrate the overwhelming benefits of the Alliance and why it should be authorised.

10. Conditions

10.1 In the event that the Commission considers that it should gain additional comfort by imposing conditions on the grant of the Application authorising the Alliance, we have advanced a number of suggestions for conditions which might be considered appropriate. These were set out in our Submission to the Commission of 20 June 2003.

10.2 Virgin Blue, in its most recent submission of 21 July 2003, noted only two constraints to a successful and constraining entry by Virgin Blue in both the Tasman and New Zealand domestic markets. They are:

- access to facilities; and

- avoidance of a predatory/strategic response.

Our response to the former will be well covered by a combination of evidence to be given by Dr Michael Tretheway, Professor Willig and Mr Andrew Miller; the terms of an open letter of explanation and offer to Virgin Blue of 14 August 2003 (conditional solely on both New Zealand applications being authorised); and, if considered necessary, the terms of the conditions proffered to the Commission, which both airlines are happy to have imposed.

10.3 To avoid any doubt, the offer made by Air New Zealand to Virgin Blue in the above letter, relative to domestic counters at Auckland Airport, will be included as a condition of authorisation. A variation of the conditions previously provided to the Commission, revised to specify the terms of the offer of Auckland domestic counters to Virgin Blue, is now offered to the Commission.

10.4 The second concern expressed by Virgin Blue, is dealt with by my earlier evidence when I discussed the advantage a VBA has over a FSA due to its significantly lower cost base. This issue is also covered by the evidence of Dr Tretheway and that of Mr Andrew Miller. I have earlier refuted the issue that Freedom can become an effective fighting brand that will rule out entry by Virgin Blue. Again, if the Commission requires more comfort, we have advanced two very simple conditions restricting Freedoms ability to be used strategically – it will not be used on New Zealand domestic routes or to fly trans Tasman between Auckland, Christchurch and Wellington and any of Sydney, Melbourne and Brisbane for three years from when the Alliance comes in to force.

10.5 There are other conditions promoting new entry or expansion which the Commission may adopt if they wish.

11. Conclusions

11.1 The Alliance provides a platform to create a viable future for Air New Zealand. This is an opportunity that is unlikely to be available to Air New Zealand in the future. If the applications for authorisation are declined, the risks to Air New Zealand's survival as a full service airline with an international network are grave.

11.2 The arguments put forward by us are robust. We said in December 2002, when we filed the original applications, that Virgin Blue would enter the Tasman and New Zealand domestic markets in a constraining way, well within the Commission's two year time frame. Eight months later, we are giving evidence at a hearing where that outcome is assured in only a few months. In its draft determination issued on 10 April this year, the Commission found that constraining entry was not likely to occur within such a time frame. I believe the draft determination was severely tainted by that view. Far from prices increasing to the levels modelled by the Commission I believe entry by the VBA will ensure that prices are actually lower than those modelled by us in our counterfactual. To the extent that any concerns remain, these are more than met by the simple conditions the Applicants have proposed.