SUBMISSION TO

NEW ZEALAND COMMERCE COMMISSION

On it's Draft Determination 10 April 2003

In the Matter of the Proposed Strategic Alliance

Between

AIR NEW ZEALAND LIMITED
&
QANTAS AIRWAYS LIMITED

Seeking Authorisation of Certain Restrictive Trade

Practices and of a Proposed Business Acquisition

Submitted by

Gullivers Pacific Group

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Gullivers Pacific Submission to the NZ Commerce Commission on its Draft Determination, 10 April 2003 in the matter of the proposed strategic alliance between Qantas and Air New Zealand

1.0 Executive Summary

1.1 The parties to this submission support the Commerce Commission in their draft determination to decline the application for the proposed strategic alliance between Qantas Airways and Air New Zealand Limited. The parties to this submission consider that the application does not meet the criteria for approval set down in the following sections of the Act:

- *"Section 47 of the Act prohibits mergers and acquisitions, which would have, or would be likely to have, the effect of substantially lessening competition in the market;*
- *Section 27 of the Act prohibits arrangements that have the purpose, or have or are likely to have, the effect of substantially lessening of competition, (although s61 6A provides that for the purpose of an authorisation, the Commission need not find that any lessening of competition is substantial;)*
- *Section 30 of the Act provides that any arrangements that has the purpose, or has or is likely to have, the effect of fixing, controlling or maintaining prices, is deemed to substantially lessen competition."*

1.2 Under the Act the Commission is required to consider the interests of the consumer not individual companies. The parties to this submission consider that the Commission has presented a very well researched and very well argued case. In particular, the degree of quantification undertaken by the Commission is to be commended. In our view it has produced a very balanced appraisal. The parties to this submission also wish to acknowledge the professional analysis based upon validated independent research that has been presented by Professor Haseldine.

1.3 The parties to this submission have analysed the Commission's response regarding the following areas and in general commend the Commission's analysis and findings. Any alternative perspectives are highlighted in response to the Commission's questions in the following sections: -

- Industry background
- Market definition
- The factual
- The counter-factual
- Comparison of the counter-factual and factual
- Detriments
- Public benefits

2.0 The State of the International Airline Industry

2.1 The parties to this submission consider that the global aviation industry is in a period of change, but an anti-competitive merger should not be a substitute for good governance and effective management.

2.2 A number of airlines have come to terms with the new business environment and are making internal changes to ensure that they are competitive.

2.3 The Commerce Commission noted in its draft determination that the industry in terms of FSA's was under severe financial stress. The latest results returned from British Airways indicate a significant recovery in performance. Chief Executive Rod Eddington has recently been named as the airline's industry leading executive. In making the award the judges said *"since arriving at BA, Rod Eddington has set about giving the carrier a renewed sense of strategic direction, along the way tackling the threat from Europe's aggressive low cost competitors, advancing BA's Alliance relationship within regulatory constraints, and turning around the groups flagging finances.*

2.4 "The fundamental Future Size and Shape review unveiled at the start of 2002 made an important step in creating a cultural change at BA, backed by the big idea of cutting complexity from the business.

2.5 *Most importantly it has begun the process of cultural change in the way that BA relates to its customers."* Air New Zealand could learn a great deal from the BA changes.

2.6 The applicants have submitted that the global aviation industry is in such a weak state that this anti-competitive merger between Air New Zealand and Qantas should be permitted to proceed. The global aviation industry is not in a weak state and many of its participants are thriving or recovering quickly from global events. Some participants have not adapted to a changing customer base as fast as necessary. IN the USA a prime cause of airline distress is the decline in numbers of premium fare passengers. In the third quarter of 2000 these represented 18.1% of passengers giving 55.1% of revenue versus the third quarter of 2002 being 9.7% and 38.5% respectively. This distress is not evident in New Zealand or Australia (Sabre Airline Solutions Industry Watch 2003).

2.7 An analysis of IATA/OECD statistics shows there is a direct correlation between GDP growth and passenger number growth. Over the 15 years since 1988 international airline sales growth from New Zealand has had a direct correlation to GDP growth (and decline). The multiplier ranges between 2.3 and 3.0 for growth against GDP. Similar correlations occur in Australia. As New Zealand continues to grow its GDP even at a low rate for the forthcoming years the amount of dollars available from the New Zealand market on all international air travel services grows at approximately 2.5 times multiplier of GDP growth. Therefore Air New Zealand will face an increasingly large market to service. We suspect domestic sales growth is similarly structured with a more defined elasticity of demand curve attached to it especially at the lower end of the pricing scale. This correlation with GDP is no more or no less than the influence of business cycles. Efficient businesses manage these risks and sustain their businesses in the national and consumer interest, inefficient businesses do not. The effect of this is that Air New Zealand will have an increasingly large market, both domestically and internationally, to service and share with competitors.

2.8 One of the most powerful influences we notice in markets today is market fragmentation. Over the last 50 years increasingly affluent customers have demanded an increasing variety of products and services. The same is true of airline passenger and freight customers – in fact it is truer because airline services are very income responsive. Future shifts in the tastes and preferences of consumers will certainly occur and sustainable airlines have to face the sharp edge of these challenges if they are to produce consumer benefits in a timely fashion. Maintenance of competition is an imperative to innovation and this is at the heart of the requirement to give Australian and New Zealand customers increasing real value improvements in the airline services market. This powerful influence has a number of important implications that support the ACCC and NZ Commerce Commission's view of the counterfactual and opposes the Applicants general view.

2.9 Both passenger transport and freight are subject to GDP growth or decline. The pressures that the airline industry is facing are no more or less than other businesses are facing at this time without expecting to have a monopolistic environment in which to operate. Professor Sammuelson once said, "The greatest monopoly rent is a quiet life!" Airbridges, for example, were only installed for domestic flights in New Zealand days before Ansett competition began.

2.10 Airline freight and passenger customer demands will become more diverse – we can be certain of that. The current structure of FSA and VBA will change to maintain the viability of the organisations. It is likely that the composition of services provided by future airlines will not look like a current airline. The ability of airlines to keep up with their customers is limited by the ingenuity of aircraft manufacturers and airline service providers to adapt and by the ability of Qantas and Air New Zealand to exercise market power.

2.11 This ever-changing market environment makes the airline business an inherently risky business both for the firms involved and their bankers, as the ACCC has noted. A noted global investor, Warren Buffet (the so-called "Oracle of Omaha") is reputed to have once said to his fellow directors, "If I ever suggest buying airline shares, call my psychiatrist"!

2.12 This high level of business risk is not a short-term phenomenon. It has always existed historically and it can very reasonably be expected to persist in the future. The applicant's attempts to characterise the present situation, as a special situation is provocative and unrealistic. The whole shape of the counterfactual resembles the tone of a press campaign to accompany a new competitive thrust in a risky and uncertain environment. The future demands of customers are going to be different and competitors have to 'take a punt' on where they might be because the airline cannot adapt as quickly as the consumers can. Airlines adopting new strategies would naturally prefer not to have other airlines following their strategies so they try to scare them off. We are intrigued that the applicants should use such a marketing ploy on two very experienced competition law authorities.

2.13 Demand fragmentation also has the effect of weakening economies of scale in some areas of airline service provision. The packages of services customers are demanding are increasing. In other words the number of products an airline market needs to provide is increasing. Provided market power is constrained by competition law, healthy future markets will likely involve more airlines because business organisational constraints limit the ability of a single firm to provided very diverse services. Reduced scale economies also means that the benefits of size are reduced. The national and consumer interest in supporting large airlines is being reduced over time. This is no more evident than in airline operations in the USA [**USA Today** 16 June 2003].

3.0 Benefits and Detriments

3.1 The parties to this submission support the view of the ACCC and the Commerce Commission that the proposed Alliance is unlikely to result in the economic efficiencies claimed.

3.2 The monopoly and market dominance on major routes will result in price rises. There will be reduced incentives to keep costs down and there will be a loss of innovation. The potential losses from global competition should Air New Zealand switch from Star Alliance to One World could have a serious impact on New Zealand tourism.

3.3 There is no basis for claiming tourism growth as a benefit of the proposal. We are asked to believe that under the counterfactual, where Qantas will have spare capacity in New Zealand, they will have less incentive to market New Zealand than under the factual, where capacity will be restricted, operated by Air New Zealand and Qantas will only get 22.5% of the benefit of that marketing. In fact, both Qantas and Air New Zealand are more likely to market aggressively if they are competing. A reduction in potential tourism, due to the decline in capacity, is likely to be a key detriment of the proposal. Increase in domestic prices, under the factual, will at the margin discourage some tourists from coming. Moreover, entry by VBA is unlikely to eliminate this detriment, because international tourists depend more on prices being offered by "full service" network operators.

3.4 We agree with the Commission that most of the claimed cost savings can occur without the proposed arrangement. In fact, we think there is every reason to expect that the proposal will lower operating efficiency. The proposal has a highly distortionary governance arrangement, where Qantas has control despite having a minority stake. Since Qantas keeps the full benefit of every $1 saved in its own operations, but only $0.22 of any savings in Air New Zealand, it will have an incentive to use its effective control to shift costs on to Air New Zealand. Or, if the choice is between saving $0.23 at Qantas or a $1 at Air New Zealand, the incentive will always be to undertake for a transfer of wealth from Air New Zealand shareholders – mainly New Zealand taxpayers to Qantas shareholders – mainly Australians.

3.5 This distortionary governance arrangement will also impose significant opportunity costs. Since Qantas will have the right to approve any changes in Air New Zealand's international services, it will have an incentive to induce Air New Zealand to cut services as long as Qantas itself is able to earn at least 23 cents for every dollar of net revenue lost by Air New Zealand.

4.0 The Factual

4.1 The parties to this submission strongly support the Commission's findings. The two airlines sought authorisation for an Alliance under which both would agree on matters such as flight schedules on fares on routes where both operate including the Trans-Tasman. Qantas would take up to 22.5% equity in Air New Zealand. If the proposed Alliance goes ahead the airlines would jointly control more than 90% of the market. The market would move from a largely two-airline market to an effective one-airline market. Passengers would be denied choice and increased airfares would be inevitable. Even if Virgin Blue entered the market, the Alliance would still dominate. There is no guarantee that any new entrant would be a long-term competitor. In fact the evidence indicates that the contrary would occur, which would have the effect on leaving the Alliance in a totally monopolistic position. The very likelihood of failure or withdrawal of a competitor is likely to have "the effect of substantially lessening competition" and the New Zealand consumer needs to be protected. The Commission and the Government need to look at history and take a long-term view.

4.2 In Australia the proposed Alliance would see Qantas domestic operations capture those passengers flying internationally with Air New Zealand. Qantas would increase its domestic market share and market power.

4.3 The Alliance would therefore shrink the proportion of the domestic market available to other carriers and constrain them from entering or expanding that market.

4.4 Although the market dominance of Trans-Tasman airfreight is not as great as for passenger travel, Qantas and Air New Zealand still hold around 73% of the market. The proposed Alliance is very likely to result in upward pressure on freight rates, which would not be a good outcome for importers and exporters.

4.5 The proposal assumes, and undertakings contemplate, an exclusive position for Virgin Blue or equivalent. This is asking for the Commission to approve two separate monopolies in supposedly separate markets not defined or contemplated in the markets determined by the Commission. If this is permitted it will ensure substantial monopoly profits to both parties. [Ref. Virgin Blue's – The Luckiest Little Airline Alive report by Centre for Asia Pacific Aviation – June 2003.]

5.0 The Counterfactual

5.1 The parties to this submission support the Commerce Commission's view that a less aggressive form of competition between Air New Zealand and Qantas compared to the counterfactual put forward by the applicants is the more likely outcome.

5.2 We agree that the suggested "War of Attrition" is unlikely. This is because the "War of Attrition" argument is based on a number of extreme assumptions, which do not reflect the reality of the markets for air services.

5.3 Qantas's substantial requirement for funding existing capital and market investments make the likelihood of Board approval to divert these scarce resources to activity (war of attrition) which by definition means loss of substantial revenue without any possible future recovery, extremely unlikely.

5.4 Both Air New Zealand and Qantas have sufficient funds and are making sufficient profit in non-competing markets to ensure that any "war" will be long/drawn out and mutually very damaging. This is not logical/rational or acceptable behaviour by two publicly listed companies, who are also supposed to operate ethically and in the National Interest.

5.5 Air New Zealand's financial situation has improved and with good governance and effective management it should continue to improve. The Government will continue to be a major shareholder until Air New Zealand regains the confidence of investors.

5.6 Air New Zealand has the opportunity to maximise its role in the Star Alliance and to seek other suitable partners over the longer term.

5.7 Incremental expansion by other airlines on the Trans Tasman and domestic routes is possible but Air New Zealand will continue to be a dominant player provided it focuses on customers.

6.0 Market Definition

6.1 The parties to this submission generally accept the Commission's analysis of the industry background. The parties to this submission agree that the proposed Alliance would likely result in a substantial lessening of competition in a number of markets.

6.2 The following passenger air service markets:

- New Zealand main trunk and provincial markets
- Tasman market
- New Zealand/Pacific market
- New Zealand/Asia market
- New Zealand/USA market

6.3 The analysis shown in Appendix A of current fare structures shows Air New Zealand's behaviour in monopoly markets versus competitive markets ranges from 10% premium in long haul markets to as much as 84% premium in short haul markets (see confidential appendix).

6.4 The following freight markets:

- Tasman Belly hold airfreight services market
- International air freight services market
- The domestic air freight services market

6.5 The national wholesale travel services market.

6.6 In addition the following markets will also experience a significant lessening of competition. These are: -

- The corporate travel distribution services market
- The retail/leisure travel distribution services market

6.7 The parties to this submission consider that the proposed Alliance would have a serious detriment on competition in the travel distribution services market as stated above where the competition between Air New Zealand and Qantas would be lost. Other competitors would offer limited competition and even if Virgin Blue or an alternative airline were to enter the Trans-Tasman market the brand dominance and current market share of the incumbents would make such competition inconsequential.

7.0 Conclusion

7.1 It is the conclusion of the parties to this submission that the work undertaken by the Commission and other submissions clearly indicate that the proposed Alliance is anti-competitive and does not comply with Section 47, Section 27 and Section 30 of the Act and should not be approved.

7.2 The parties to this submission have also reviewed the undertakings offered by the parties to the ACCC and consider that these undertakings are inadequate in addressing the strongly anti-competitive nature of the proposed Alliance.

7.3 The parties to this submission have responded to the questions raised by the Commission.

8.0 Answers to Questions suggested by the Commission

8.1 The Commission seeks comments on its approach of considering the two applications together.

8.1.1 The Applicants requested that the application be considered as a package. It is unusual for the Commission to deal with two applications of this type together. It is conceivable, that there may be complications that arise in appeal resulting from the differential treatment of mergers and trade practices in the legislation (trade practices can have behavioural conditions attached but mergers cannot). For example, what would happen if the appeal cleared the Alliance on the share crossholding but not the trade practises, or vice versa? Nevertheless, it is perhaps administratively efficient to treat the applications in this way.

8.1.2 Separate treatment of the applications would require that the benefits and detriments be split between the two applications – a very difficult analytical task.

8.1.3 It is to be hoped that the Courts are flexible enough to deal with the joint ness of this overall proposal in a constructive fashion. The parties to this submission would have serious concerns if the

Courts were to overturn the findings of the Commission based on adoption of the approach of considering the two applications together. Infratil have raised similar concerns from a legal and legislative perspective.

8.2 The Commission seeks comment on its market definitions.

8.2.1 We are satisfied with the approach that the Commission has taken on market definitions given that their analysis incorporates the continuum of product types and the price discrimination strategies that accompany them.

8.2.2 The markets for passenger services are fragmenting all the time, as customers become gradually more affluent over time and therefore more demanding of increased variety. There is a continuum of product types from high service first class, through low service first class, all the way through to low service 'no-frills' service. The substitution possibilities are increasing over time.

8.2.3 The parties to this submission accept and agree with the Commissions identification of the relevant passenger air services markets and of the freight markets. The parties to this submission also agree that there is a separate functional market for Wholesale Travel Distribution services and that it is appropriate to analyse that market separately.

8.2.4 The parties to this submission support the view put forward by TAANZ that there are also separate functional markets for:

(i) Corporate Travel Distribution Services, and
(ii) Retail and Leisure Travel Distribution Services.

8.2.5 We support TAANZ's view that these markets should be analysed separately and include the TAANZ market definitions as follows: -

8.2.5.1 *"Those who seek services in the travel distribution market comprise both New Zealand residents and overseas inbound travellers and almost without exception they will fall into one of two quite distinct purchasing groups; the corporate/business orientated traveller or the leisure-orientated traveller. There is a separate functional market for each group and just as the Commission concluded that it was appropriate in terms of this application to separately analyse the wholesale travel distribution services market, in TAANZ's view, it is equally appropriate that the Commission should analyse both the corporate/business travel distribution services market and the retail and leisure travel distribution services market.*

(i) The corporate/business travel market and its associated distribution services market

This is a separate and quite distinct market in its own right. It is high value and constitutes the key component (in terms of revenue) in the New Zealand domestic and overseas outbound air services market. It services primarily the New Zealand business community and government.

Market size: According to Air New Zealand and Qantas some 65% of domestic air travellers within New Zealand are corporate/business travellers, with the actual revenue collected from these travellers contributing in excess of 80% of the airlines' revenues. Corporate/business *customers are often forced to buy short notice, high cost, prime time fares on terms dictated by the airlines. It is a high value market for the airlines. The government and many large corporations spend millions of dollars annually on air travel and New Zealand companies that spend between $250,000 and $750,000 per annum on air travel are common.*

On the Tasman routes corporate/business travellers constitute approximately 35% of all air travellers and contribute approximately 60% of the airlines' revenue on this route. Qantas and Air New Zealand between them carry in excess of 90% of all corporate travellers domestically and on the Tasman. They carry 100% to key USA destinations and 55% to Asia.

Leisure travellers purchase low price advance purchase fares and travel at off-peak times. By comparison the corporate traveller is a high value high spend customer for the airlines.

The corporate market is universally recognised by the airlines and the travel distribution service industry as a separate and distinct market. Corporate travel distribution services are handled by specialist corporate travel agents, which are commonly known as travel management companies (TMCs). These TMCs provide specific services not provided by travel agents who operate in the retail/leisure market. TMCs process consolidated billing systems, manage travel supplier tender processes, process ancillary bookings and billings, *and manage loyalty programs. None of this type of work is handled by retail travel agents.*

The corporate travel distribution services market is very large in terms of volumes and revenues, it performs different functions and services for a quite distinct and different customer group to that serviced by those that operate in the retail/leisure travel distribution market. Like the wholesale travel distribution market it needs to be separately analysed.

An analysis of the effects that the Alliance will have on the corporate/business travel distribution services market leads to the conclusion that this market will be equally as devastated as the wholesale travel distribution services market if the Alliance is approved and that the consequences for the consumers of corporate travel in New Zealand will be extremely detrimental. In effect this will mean that 65% of the domestic air services market can expect to pay more for the travel requirements with a corresponding increase in the Alliance airlines' revenues. The same situation will apply to 35% of the Trans-Tasman market.

Travel management companies (TMCs) exist because they provide valuable and expert services to the consumers of corporate travel in New Zealand. In particular they:

- *Manage the purchase and implementation of the total travel requirements on behalf of their customers. This principally involves air transportation but will not* *infrequently involve the provision of other services such as accommodation and land transportation.*

- *Manage and process consolidated billing systems pursuant to which a TMC will separately pay the various providers of the component parts of the services and provide one invoice to the customer incorporating an itemised account of all of their travel requirements.*

- *Manage travel supplier tender processes for their customers to obtain the best deal for the customers in terms of price, services and ancillary benefits.*

- *Arrange and manage loyalty programs on behalf of customers.*

- *Assist in organising and co-ordinating meetings, conferences, video linkages etc. and subsidiary sightseeing or tourist activities which are the purpose of or an adjunct to the travel in question.*

Although TMCs provide other services and do more than book and manage the air travel requirements of their customers, the service that they provide in that regard, is the key element in virtually all their work. Inevitably the most significant aspect of the value that a TMC provides to its customers lies in its ability to facilitate and deliver to their customers cost savings in air travel. Their ability to do this is enhanced when there is effective competition in a market and severely restricted where there is no effective competition in a market. Under the Alliance *there will be no effective competition in the corporate air services market in New Zealand and this will impact significantly on the benefit that TMCs are able to provide to their customers and thus their ongoing viability.*

This can best be illustrated by current practice where a consumer of corporate air services puts their business out to tender. At present they will usually ask their TMC to manage the process. In the current air services market where there is competition between Air New Zealand and Qantas they will be able to negotiate price discounts/rebates from both Qantas and Air New Zealand. There is a good price tension in the current market between these two airlines and the TMC is then in a position to leverage a better deal for the customer. This results in substantial cost savings to the customer/consumer.

In New Zealand today there are about 40 government departments which are large procurers of corporate travel. Currently some of these departments have preferred deals with Qantas and many of them have preferred deals with Air New Zealand. The point is that they do have preferred deals, better price, and better service.

Under the Alliance Air New Zealand will control all pricing, discounting, rebating and routing from, to and within New Zealand. There will be no effective choice for the business/corporate traveller. The proposal made by the applicants specifically referred to and sought permission for joint tendering for corporate and government *accounts. Even the emergence of a value-based airline will not provide choice to the corporate traveller who generally will require access to the type of services only provided by a full service airline.*

The Alliance will remove competition and price tension between Qantas and Air New Zealand and will inevitably result in the Government and the business community of New Zealand paying increased fares for air transportation. This increased cost will be a cost to the taxpayer and to the New Zealand consumers of the product and services supplied by its business community. In itself this constitutes a significant detriment.

It goes without saying that the consequences for TMCs will be devastating. It is difficult to see how they will be able to survive as independent service providers to the business community.

Once the TMCs have ceased to exist as independent operators the distribution of airline services will be firmly controlled by the Alliance. The Alliance yield managers will not be constrained by the checks and balances that competition currently brings to the market and they will push the price of high demand fares up. In this market, the corporate travel market, this can be achieved without ever having to publicly declare a fare increase.

TAANZ members who operate in the corporate market anticipate that effective cost increases to the corporate consumers of air services in New Zealand will increase by between 28% and 40% within the next three years if the

Alliance is approved by the New Zealand Commerce Commission.

If the Alliance is approved air travel distribution and facilitation for corporate travellers will be controlled by the Alliance. The current independent travel agency distribution system for corporate travel will be weakened and the ability of the agency distribution system to effectively market the services of other airlines who currently (or in the future wish to) supply services to or within New Zealand will be threatened. Those TMCs that survive will not be able to run the risk of alienating the Alliance by promoting the services of other airlines. This will be a factor which will detrimentally affect the ability of such carriers to continue (or to start up) services into New Zealand.

If we carry out the same type of comparison as the Commission did in relation to the wholesale travel distribution services market (at paragraph 592) between the counterfactual and the factual it would result in:

- *the proposed Alliance having a high market share or more likely total control of the corporate business travel distribution services market;*
- *insufficient constraint (indeed no constraint) from competitors, either existing or potential;*
- *an increase in the barriers to entry to the point where they constitute an insurmountable fortress;*
- *no likely entry to a sufficient extent or within a sufficient timeframe;*
- *no constraint from buyers or suppliers.*

(ii) The retail and leisure travel market

This is a quite separate and distinct market in its own right. Although not as large in terms of volumes and revenue as the corporate travel market, it is still very substantial in size and extremely important in terms of the function it performs for hundreds of thousands of New Zealand consumers each year.

The retail/leisure distribution services market is serviced by Air New Zealand (through its direct marketing avenues, its call centres and travel centres and the internet) and by over 500 retail travel agencies which are spread across the length and breadth of the country. Most medium sized rural towns currently have a retail travel agent which services the private and leisure travel requirements of their local communities. In cities, in addition to those retail travel agencies based in the central business district, most suburbs will have retail outlets.

There is a real public benefit to consumers in New Zealand in having a strong broadly based and geographically widespread retail leisure distribution service. Many consumers in this market need assistance to handle their air travel arrangements and their leisure and holiday travel package purchases.

The retail travel agencies exist because they provide the New Zealand public with an independent, unbiased and professional distribution mechanism for travel product.

They provide expertise and choice in the distribution of air travel and other forms of travel and all travel related products. Choice in destinations and product, choice of airline, accommodation, sightseeing, etc. As agents for many principal suppliers their expertise, knowledge and training and their access to product extends far beyond that which can be offered by any one principal supplier including Air New Zealand. They invest in developing that expertise and in acquiring that knowledge for the benefit of their customers, the general public of New Zealand. For all airlines other than Air New Zealand the retail travel agent is the most important distribution channel. These other airlines rely almost entirely on retail agents for the sale of their product in New Zealand. Although these airlines primarily serve New Zealand to satisfy an outbound demand for New Zealand as a destination from their home markets, an important revenue factor for them is the incremental outbound business ex New Zealand processed through travel agents. Without this option these airlines may well decide that it is no longer viable to service New Zealand. There is no doubt that additional sales outbound New Zealand that they receive on their long haul services to New Zealand are important to route viability for these airlines.

These airlines (that is airlines servicing New Zealand other than Air New Zealand) are bringing increasing numbers of tourists to New Zealand from overseas markets, especially the fast growing Asian market. In addition to the great benefit to the New Zealand economy *from these tourists these airlines also provide a direct benefit to New Zealand consumers outbound in the long haul markets in that they introduce another source of competition. The additional competition on these long haul routes that these carriers provide has resulted in very significant benefits to the New Zealand consumer in the form of low cost long haul airfares to Asia and Europe.*

Independent retail travel agencies perform vital functions for these airlines. The existence of these airlines servicing New Zealand destinations is of considerable benefit to the New Zealand consumer.

If the Alliance is approved many retail travel agencies in New Zealand will be forced out of business. They will not be able to offer choice to the New Zealand consumer on the most significant markets that they sell into, in particular the Trans Tasman, the Pacific and the USA/New Zealand markets. Many retail travel agencies already are marginal businesses, their financial viability having been affected by the actions and competitive (in many cases unfairly competitive) activities of Air New Zealand.

Although the ongoing viability of a significant number of retail travel agencies will not be one of the major issues which the Commerce Commission will concern itself with in considering this application, there are direct and indirect detriments to these small businesses and to the communities that they serve which should be weighed and considered by the Commission.

Direct detriments will follow as a result of the closure of many of the retail travel agencies across the country with the consequential loss of jobs. It is envisaged that this will happen more frequently in rural towns. There is also the indirect detriments to those communities such as the costs to consumers in rural communities of travelling greater distances in order to access the services of a travel agent with commensurate additional cost and greater time off productive work. A further indirect detriment that will flow from the weakening of the retail travel distribution system is, as has been mentioned earlier, the impact that a weakening of the retail travel agency distribution network will have on the ability of other airlines (non Alliance airlines) to market their services and product in New Zealand."

8.3 The Commission seeks comment on the financial viability of Air New Zealand in the near term.

8.3.1 At the very least we have the fact that Air New Zealand is surviving in a very competitive market and is making a return on shareholders equity in the order of between 25-35%, which is greater than many other major public listed companies in New Zealand. The rise of the New Zealand dollar will add to this profit. A report from Cameron & Co. to the NZ Government at the time of their investment stated that every rise of 1 percentage point against the US dollar was worth $28 million to Air New Zealand. If the NZ dollar holds up at 58 cents then there will be approximately 15-cent rise, which on the basis of that report will mean an extra value-add to Air New Zealand in the order of $420 million per annum. This is yet to kick in as the US Dollar has only been rising in the last few months but we are already seeing the benefit of that, where notwithstanding a 10% drop in capacity by Air New Zealand internationally, its projected profitability is to be reduced by less than $30 million. Having forward contracts on fuel, etc also probably hampers profitability. Again this rise in the NZ dollar will really kick in once these run out. Its financial viability, of course, will be considerably improved if it reduced its staffing as has Qantas in line with its reduction in available seat kilometres. It also has just taken an extra $100 million from Qantas and it has the option of pulling another $150 million in from the New Zealand Government if it requires it. It could also go the New Zealand public with very attractive terms and raise additional funding as has Qantas and other airlines.

8.3.2 Air New Zealand has a very viable business operation in the near term if it is well managed. The New Zealand government has become a corner stone and majority shareholder with no apparent intention of taking actions that would threaten the solvency of Air New Zealand. Air New Zealand is a very valuable brand name on its balance sheet. Furthermore it is implicitly protected from competition in the Australian market, the New Zealand market and the Trans-Tasman market by virtue of New Zealand and CER Aviation Policy restricting foreign airline entry. The large government stake in Air New Zealand discriminates against competing airlines like Origin Pacific and in this way increases the viability of Air New Zealand by reducing competitive pressure. However the Auditor General has noted that currently there is a lack of accountability from Air New Zealand to their major shareholder, the New Zealand government. This does raise issues for some concern.

8.3.3 The financial position of Air NZ has already recovered very rapidly from the time of the Ansett crisis, Sept. 11 and the range of more recent airline market shocks. Airlines are risky ventures by general industry standards with the result that their financial positions have a high variance. Air NZ has just emerged from a low profit period and it is currently performing quite well in a relatively difficult international environment. It will have high and low profit periods in the future. Air NZ will survive the ups and downs though the structure and ownership of the airline can be expected to change over time.

8.3.4 However PA Consulting identified that a lack of focused leadership at Air New Zealand had delayed the synergistic integration of Ansett and Air New Zealand and savings were not realised. This highlights that leadership, effective management and good governance will determine the outcome.

8.3.5 The challenge for Air New Zealand is that it needs to undergo a culture change to compete with the formula that has made airlines such as Virgin Blue so profitable. The whole management and staff of Virgin Blue are involved in reducing costs. Virgin Blue does not have cleaners; all jets are cleaned between flights by the cabin crew; there are no company cards; no company cars; no company car parks; no company pension fund; no executive dining rooms, and check-in staff at airports also help to load jets, work in the reservations call centre and buy their own uniforms. Brett Godfrey and other managers work as check in clerks and baggage handlers once a month somewhere in Australia. "*All successful low cost carriers make sure that they put all of their resources into looking after customers and flying aircraft*", he says. "*We don't have hundreds of people managing the staff pecking order in the staff* *car park, or handing out upgrades or rather luxury lounges for politicians and union officials that are not open to the public. We just do cheap seats".* According to the Guardian article, direct comparison with Qantas, which mixes international and domestic jets in its results are difficult. But in round terms, Qantas made about AUD300million on domestic routes in the same period with about 67 aircraft of varying sizes and a margin less than half Virgin Blue. With an average of only 25 Boeing 737s in service over the past year, Virgin Blue has made Australia AUD158million (NZD181million) before interest and tax or a sales margin of 16.7% and took 29% of the market. The challenge for Air New Zealand is to undergo internal restructuring and improvement to be able to achieve this level of performance. Currently Air New Zealand employs approximately 800 staff processing approximately $500 million of travel (Source NZ Staff Magazine. These figures indicate that the level of productivity is considerably less than the average leisure or corporate travel agency. Addressing these issues should lead to improved financial performance.

8.4 The Commission seeks comment on its definition of the counterfactual.

8.4.1 We agree with the Commission's view on the counterfactual.

<u>Financial</u>

The question of sufficient capital depends on a number of factors. If the present Government as major shareholder does not strip profit from the company; they continue the approach they have adopted with Tranz Rail and other essential services; and the Management and Board act responsibly in building up the company's capital and reducing debt, then Air New Zealand has a secure future.

8.4.2 **An alternative alliance:** An alternative Alliance is possible. It is forecast that over the next 10 years China will grow to be the largest consumer of aviation services in the world and New Zealand is already a preferred partner with China's outbound tourism. However if Air New Zealand remains part of Star Alliance and they take more advantage of the Alliance than they currently do then they would not necessarily need an equity partner? Air New Zealand is already in the top 30 airlines in the world by size. There are more than 200 major IATA airlines in the world.

8.4.3 **Qantas response:** We believe it is implausible to suggest that Qantas would lead the competitive charge by increasing their capacity in New Zealand and across the Tasman without regard to the profitability of those services.

8.4.4 We accept, however, that Qantas may be willing to sacrifice some profitability on these services if it improves the utilisation and the profitability of other services on their network. However, we believe that rapid expansion on domestic and Trans-Tasman routes is unlikely to generate the desired network wide benefits (which would explain why Qantas has not done this so far).

8.4.5 It makes no sense for Qantas to carry large amounts of unused capacity on the New Zealand domestic network as a way of promoting its international services. The main trunk routes connect airports, which already offer direct trans-Tasman services. Hence, greater capacity on these routes can play no role in generating feeder traffic. Qantas could, in theory, expand onto New Zealand provincial routes. However, this does not appear to be part of the strategy, and would likely run counter to the code-sharing arrangement with Origin Pacific. Equally, spare capacity on the main domestic routes is unlikely to serve any purpose in attracting visitors to New Zealand. Hence, there is no plausible network-wide benefit for Qantas to aggressively expend its New Zealand domestic services.

8.4.6 An expansion in Trans-Tasman capacity could, in principle, generate more traffic on the Australian domestic network, and on long-haul flights. We note that Qantas has been increasing its Trans-Tasman services despite continued complaints about lack of profitability on these routes. However, it is not obvious why, in the absence of the proposed Alliance, Qantas would be any more aggressive in its capacity expansions than it is under the status quo. At present, latest results indicate that expansion by Qantas on these apparently unprofitably routes has not unduly affected Air New Zealand's financial performance. Air New Zealand's strong domestic base suggests that Qantas cannot meaningfully conduct a "War of Attrition" on the Trans-Tasman alone.

8.4.7 Overall, we concur with the Commission's view that it would be irrational for Qantas to initiate a "War of Attrition" against Air New Zealand. That is not to say that Air New Zealand may not find itself in a difficult financial situation as competition from all sources, including Virgin Blue, intensifies. However, that may occur with or without the proposal.

8.4.8 We also want to emphasise that, from the national economic welfare point of view, financial losses to Air New Zealand's current shareholders do not necessarily represent a loss in welfare. The loss in welfare would only occur if Air New Zealand could not emerge from a possible receivership as a going concern, or if the new post-receivership owners were mainly foreign. While a "War of Attrition" that would drive Air New Zealand into receivership is unlikely, a "War of Attrition" that would result in a complete exit of the existing assets and services form the market is almost impossible. We note that the Commission has paid careful attention to Air New Zealand's current balance sheet. We would argue that, whatever the weaknesses of that balance sheet, this is largely irrelevant, as new investors after a receivership would be able to re-construct the balance sheet as they see fit. What matters is that the airline is clearly viable as a going concern. This in part will be an outcome of the effectiveness of the management and in corporate strategies. We also note that there has been significant interest among New Zealand investors in taking a stake in Air New Zealand, and that the international aviation rules are likely to require that the majority of future owners be resident in New Zealand. Hence, any market outcome that would result in Air New Zealand going into receivership, but the services and the assets re-emerging as a going concern, would have almost no impact on the national economic welfare. Rather, it would represent a transfer of wealth from one group of New Zealanders to another.

8.4.9 We also note that the possibility of Qantas carrying additional capacity in New Zealand for the purpose of maintaining their network, even if individual city pair services are not profitable, is highly advantageous to New Zealand consumers.

8.4.10 However the ability of the management and board of Air New Zealand to respond to the changing market conditions will prove whether Air New Zealand has the ability to compete profitably.

8.5 The Commission seeks comment on the likelihood of the "war of attrition" counterfactual as proposed by the applicants.

8.5.1 The 'war of attrition' muted by the Applicants is a most unlikely event. In the event that the alliance does not proceed there undoubtedly will be 'price wars' and the like from time to time, just as there have been in the past. However, the behaviour of Qantas in the past exemplifies scenarios in which the company knows it has to withdraw from competition battles fairly quickly if it is to meet the earnings targets of its shareholders.

8.5.2 Competition battles are expensive for Qantas. They are only worth proceeding with if the investment can be recouped in a higher priced future environment and the likelihood of such environments arising is reducing over time. There has been significant new entry into all Australasian markets in the last two decades- some of it has been successful and some has not. The important point is that the threat of entry is growing as free trade agreements proliferate and deregulation continues apace on both sides of the Tasman. In short, the chances of Qantas recouping the cost of a 'war of attrition' are much more remote than they used to be.

8.5.3 In particular it should be noted that Qantas, after the demise of Ansett Australia achieved, according to The Age, 7 years growth in one year but their earnings per share continued on a persistent slide from 42.8cents in 2000, to 33cents in 2001 and 29.1cents in 2002. Qantas have announced a billion dollars worth of cuts to be achieved over the next two years. Their need to get their own airline into better shape means that they are not in the position to fight a long War of Attrition therefore a War of Attrition would be a highly unlikely scenario.

8.5.4 A further point is the notification that the Government of NZ has just made by way of its cornerstone shareholding in Air NZ. This commitment reduces the chances of Qantas winning a 'war of attrition' even further. It is a most unlikely event.

8.6 The Commission seeks comment on the capital requirements of entry to the main trunk market and particularly seeks comment on whether the capital requirements constitute a barrier to entry to the market.

8.6.1 It is our view that capital requirements do constitute a barrier to entry to the market. Foreign ownership laws present a major difficulty in obtaining sufficient capital. It should be noted that Air New Zealand experienced some of these issues when the government had to provide the funding to bail them out of the Ansett debacle.

8.6.2 The supply of risk capital to the trunk market is implicitly limited by legislation restricting foreign airlines from entering the related Tasman market.

8.7 The Commission seeks comment on the sunk costs of entry to the main trunk market and particularly seeks comment on whether the sunk costs constitute a barrier to entry to the market.

8.7.1 We concur with the Commission's view that sunk costs constitute a barrier to the market. Unless it is to be part of a cosy duopoly with Air New Zealand and extend the Alliance's proposed monopoly power even further the new entrant would face high sunk costs. The new entrant would be required to set up engineering ground services, computerised information and reservation system, terminal facilities, engineering facilities, advertising costs, paint aircraft, hire and train pilots and flight attendants, set up operations manuals, schedules and test flights. These have proved to be huge barriers for potential airlines competing against Air New Zealand in the past.

8.8 The Commission seeks comment on the regulatory requirements of entry to the main trunk market and particularly seeks comment on whether the regulatory requirements constitute a barrier to entry to the market.

8.8.1 New Zealand has strict regulatory requirements of the CAA as to the safety and competence of a planned service. There are regulations relating to aircraft maintenance and servicing. Maintenance must be carried out by a maintenance organisation approved by the CAA. Unless the new entrant is to be part of either a cosy duopoly with a monopolistic proposed Alliance, these would present barriers to entry.

8.9 The Commission seeks comment on the likely incumbent response to entry to the main trunk market and particularly seeks comment on whether the likely incumbent response would constitute a barrier to entry to the market.

8.9.1 The OECD Report noted in a section on predation (3.6.1) the incumbent airline would find it profitable to cost at marginal cost or below to deter a new entrant than to abandon or share the route long term. Air New Zealand has significant market power in the main trunk market and a history of putting considerable competitive pressure on new entrants. It has considerable government backing through shareholding. Air NZ has international and provincial network advantages that provide leverage into the main trunk market. It controls a high proportion of scarce Auckland landing slots. Air NZ can create an environment in the main trunk market that is a significant barrier to entry.

8.9.2 Unless the new entrant is to be part of cosy duopoly with a monopolistic organisation or part of the monopoly itself, then the new entrant will struggle to compete with one of the strongest brands in Australasia. Both Air New Zealand and Qantas have established operations with sunk costs already incurred. They enjoy some of the highest brand loyalty in either country. They have established relationships with travel distributors. Air New Zealand in particular only provides volume incentives based on "loyalty", i.e. market share and volume. It does not provide any base commission. Unless Air New Zealand is to change its approach, which is unlikely, any new entrant would be unlikely to gain industry support when the industry's remuneration is totally dependent on an incentive payment by Air New Zealand for market share and volume.

8.9.3 If history has anything to show it is that Air New Zealand has always mounted a very vigorous campaign against all competitors on the main trunk. If it does not adopt this approach because it is a monopoly the New Zealand consumer will not benefit.

8.10 The Commission seeks comment on the scale and scope required for entry to the main trunk market and particularly seeks comment on whether the scale and scope required constitutes a barrier to entry to the market.

8.10.1 It is unlikely that any new entrant would be able to match the scale and scope required for entry to the market. An effective

20-30% market share on main trunk lines would require at least 5-6 737 equivalents and the costs associated with purchasing, operating and marketing these would be substantial. Frequent flyer points are a critical element of the business market, which represents approximately 60% of airline revenue on these routes. Without substantial business traveller support it would be virtually impossible to survive. The ability to interline with an international carrier is also an important benefit. It is unlikely that any new entrant would have access to an Alliance interline agreement or to the full range of services, which would attract the necessary business and leisure consumers in order to be profitable. Ansett New Zealand was unable to achieve the required business support against Air New Zealand in over 10 years, which makes it unlikely that any new entrant would be able to achieve a profitable result for shareholders and consumers against the combined strength of Air New Zealand and Qantas.

8.11 The Commission seeks comment on availability of facilities required for entry to the main trunk market and particularly seeks comment on whether access to these facilities would constitute a barrier to entry to the market.

8.11.1 The difficulties in accessing terminal space and landing flights at Auckland airport constitute a significant barrier to the market. Air New Zealand of dominance of ground handling facilities also present a significant barrier. The monopoly in the air would be extended to supplying of engineering services, catering, aircraft cleaning and ground handling, which would inevitably lead to price increases and dynamic inefficiencies.

8.12 The Commission seeks comment on availability of travel distribution services required for entry to the main trunk market and particularly seeks comment on whether access to these services would constitute a barrier to entry to the market.

8.12.1 There is a misunderstanding in the Commission's report perpetuated by Air New Zealand that VBA's do not use travel services distribution. Virgin Blue in Australia sells through its website, call centre and through the travel agency services distribution. Although it will have an impact on wholesale travel distribution services, the major impact will be on the corporate travel distribution services market and the corporate traveller. Air New Zealand offers incentives for 'loyalty' or market share. This is a strong disincentive to support other airlines.

8.13 The Commission seeks comment on whether feeder traffic is required for entry to the main trunk market and particularly seeks comment on whether access to feeder traffic would constitute a barrier to entry to the market.

8.13.1 As the Commerce Commission notes feeder traffic has an important impact on profitability. If a new entrant is to reach the scale and size required to be a significant competitor to the proposed monopoly between Air New Zealand and Qantas, then feeder traffic is essential. There is unlikely to be sufficient feeder traffic available either internationally or domestically to compete against the monopoly in a way to provide effective competition to the monopoly. This is likely to lead to increased prices, reduced services and a significant barrier to entry. Specifically Origin Pacific would be significantly disadvantaged if it did not have feeder traffic from Qantas.

8.14 The Commission seeks comment on whether access to a CRS or GDS is required for entry to the main trunk market and particularly seeks comment on whether access to CRS or GDS would constitute a barrier to entry to the market.

8.14.1 The CRS market is changing and will be expected to continue to change over the next few years. Air New Zealand strategy of using its own Carina system to distribute airfares to the public and declining to allow the travel services distribution access to Carina is proving a significant barrier in this market. Air New Zealand has developed its own website but if search tools such as SERKO WebDirect are to be effective they need consistency of schema from Air New Zealand. In the last few months Air New Zealand has changed their schema five times and have failed to advise SERKO Technology Solutions that these changes are being made. This has the effect of web search tools being unable to access Air New Zealand's website and provide fare comparisons between other airlines. Air New Zealand's approach to GDS's and its increasing use of its own systems so that fare comparisons are not available appears to be anti-competitive. If this strategy were to continue with the monopoly it would provide a serious barrier to effective competition.

8.15 The Commission seeks comment on the availability catering services required for entry to the main trunk market and particularly seeks comment on whether access to these facilities would constitute a barrier to entry to the market.

8.15.1 We agree with the Commission's view that catering facilities are available, which do not depend on having services provided by the monopoly.

8.16 The Commission seeks comment whether loyalty schemes, either the presence of existing incumbent schemes, or a requirement to develop one, would constitute a barrier to entry to the main trunk market.

8.16.1 The lack of an existing loyalty scheme would be a significant barrier to entry and would make it difficult for any new entrance to compete. The Air New Zealand and Qantas frequent flyer programmes have been well established over years. Air New Zealand as part of the Star Alliance and Qantas as part of One World provide significant benefits to clients. Qantas has an established relationship with Visa card and Air New Zealand has an established relationship with Master card. This means that purchases of other products can be used to redeem airline seats. Loyalty schemes present a barrier in terms of switching business for customers.

8.16.2 According to the OECD, frequent flyer programmes operate like a volume discount. Once a customer has flown on a particular airline with a frequent-flyer programme, the value of subsequent flights is enhanced by the increased opportunities for free travel. "Because the marginal value of the reward increases as the customer builds up miles or points on a single airline, frequent flyer programmes encourage travellers to choose the airline that they are most likely to fly on in the future".

8.16.3 The size of the loyalty effect will depend upon how rapidly free travel is earned, on the size of the airline's network and on the location of the customer. The larger the airline's network, the more valuable is the free travel, as more opportunities are available to the frequent traveller (the nature of the destinations may also matter). The larger the number of flights offered by an airline at the customer's home city, the more likely the customer is to travel on a route served by the airline, the faster the accumulation of awards, the greater the range of possibly free-travel destinations and the more likely there will be a non-stop flight to the desired destination. Because airlines offer the largest range of non-stop flights from their hub cities, frequent flyer programmes are especially likely to be important at raising the demand for an airline at its hub cities.

8.16.4 Since customers ultimately pay for the free travel in higher prices for paid travel, we may ask why airlines don't simply offer lower fares without the carrot of free travel. The reason is that most (especially business) travellers do not pay for their tickets themselves. "Frequent flyer programmes are target primarily at business travellers, taking advantage of the principal-agent problem resulting when the traveller, monitored imperfectly by his employer, does not make the efficient trade-off between lower prices, or reduced travel time, and extra frequent-flyer plan bonuses. In essence, the frequent flyer bonus is a kickback to the purchasing agent, in this case, the employee. In a survey of travel agents conducted by the US General Accounting Office, more than half said that their business customers select flights to match their frequent flyer programme 'always or almost always'".

8.17 The Commission seeks comment whether the need to either have a recognised brand, or the requirement to develop a brand would constitute a barrier to entry to the main trunk market.

8.17.1 We agree with the Commission's view that both Qantas and Air New Zealand have strong brands in the Australasian region. Air New Zealand and Qantas have built their brands up over many years. A new entrant would have significant difficulty in matching the brand awareness together with the other barriers to entry such as capital, and access to infrastructure.

8.18 The Commission seeks comment whether the size of the main trunk market would constitute a barrier to entry to the market.

8.18.1 We agree with the Commission's view that the size of the main trunk market would constitute a barrier to entry to the market. As the Commission has recognised there is limited scope for growing the market in a population of 4 million people. Air New Zealand has established the New Zealand Express and Freedom Air dominating the domestic and Trans-Tasman VBA market. Qantas is struggling to achieve the 40% market share on the main trunk required to be profitable.

8.19 The Commission seeks comment whether access to pilots or aircraft would constitute a barrier to entry to the market.

8.19.1 We agree with the Commission's view that the availability of pilots and aircraft would not be a barrier to entry to the market but the access to capital; regulatory barriers, brand recognition and sufficient traffic would be a barrier.

8.20 The Commission seeks comment on the likelihood, extent and timeliness of entry to the main trunk market under both the factual or counterfactual scenarios.

8.20.1 Virgin Blue is unlikely to enter the main trunk market under the factual or counterfactual scenarios unless it can be profitable. If Qantas were struggling to be profitable under the existing scenario then Virgin Blue would be unlikely to enter the market without major concessions. In the factual it would be even less likely to try to compete against an established monopoly when it would have to compete against the monopoly for feeder traffic.

8.21 The Commission seeks comment on whether Virgin Blue is likely to enter the main trunk market under both the factual or counterfactual scenarios.

8.21.1 We consider it unlikely that Virgin Blue would enter the main trunk market either under the factual or counterfactual to such a level that it would provide significant competition.

8.22 The Commission seeks comment on whether Origin Pacific would be likely to expand in the main trunk market under both the factual or counterfactual scenarios. Alternatively, the Commission seeks comment on whether Origin Pacific would be likely to retrench in the event that the proposed Alliance proceeded.

8.22.1 The management of Origin Pacific have already advised that they would be likely to retrench in the event that the proposed Alliance proceeded. Without the Qantas feeder services and support from Qantas they would not be able to compete against the strength of the proposed monopoly.

8.23 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the main trunk market when compared with the counterfactual.

8.23.1 In our view the proposed monopoly will have the likely effect of substantially lessening competition in the main trunk market when compared with the counterfactual. The proposed monopoly would have a significant impact on the corporate market. Any competitors would be unlikely to have sufficient strengths to provide anything approaching 40-50% of market share, which would be required to provide reasonable competition and ensure innovation, cost effective services were available.

8.24 The Commission seeks comment on the barriers to entry to the provincial market.

8.24.1 Although the proposed Alliance does not result in an aggregation in the provincial market, we agree with the Commission's view that it will reduce Origin Pacific's ability to compete and we are strongly of the view that it would lessen competition in competitive markets and create barriers to entry and a tight distribution, which would be very unhealthy for competition.

8.25 The Commission seeks comment on whether Virgin Blue is likely to enter the provincial market under either the factual or counterfactual scenarios.

8.25.1 VBA airlines are much more likely to enter selected provincial routes like Rotorua, Queenstown and Nelson under the counterfactual. However in our view it is highly unlikely that Virgin Blue would enter the provincial market in such a manner to provide effective competition to the monopoly. There is insufficient traffic to warrant the investment, which would be required.

8.26 The Commission seeks comment on whether Origin Pacific would be likely to expand or retrench in the provincial market under either the factual or counterfactual scenarios.

8.26.1 Origin Pacific has already stated that they would not expand and would likely retrench in the provincial markets if the monopoly were allowed to go ahead.

8.27 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the Provincial market when compared with the counterfactual.

8.27.1 We agree with the Commission's findings that the proposed monopoly would have the likely effect of substantially lessening competitions in the provincial markets when compared with the counterfactual. It is unlikely that Origin Pacific would be able to compete and is not obvious that there are any other competitors likely to enter this market in sufficient strengths to provide competition.

8.28 The Commission seeks comment on the barriers to entry to the Tasman market.

8.28.1 As the ACCC cogently pointed out in its draft decision, there is still restricted multi-lateral entry to the Tasman air routes. There is no unlimited entry to these routes by wholly owned foreign airlines. Airline policy under CER accordingly involves trade diversion elements. Fifth freedom carriers are not providing much countervailing market power to the incumbents and are never likely to do so. The incumbents, accordingly, have a great deal of market power. Their Trans-Tasman market share is way above 'safe-harbours' guidelines. They can resist competitive pressures relatively easily and they can delay implementing efficient cost structures ('the greatest monopoly rent is a quiet life'). The proposed amalgamation will therefore be the provision of less efficient airline services, fewer services, higher cost operations and higher consumer prices.

8.28.2 The Single Aviation Market (SAM) agreements under CER limit competition on the Trans-Tasman routes to domestic and SAM airlines from Australia and New Zealand. Accordingly, the agreements limit access to risk capital in the Trans-Tasman market and they limit competition at the same time. The agreements, at least implicitly, favour Qantas and Air New Zealand. The agreements are not in the consumers' interests on both sides of the Tasman. The agreements are not consistent with the spirit of the competition laws of either country.

8.28.3 The SAM agreements are concentrating market power in the two incumbents. The governments are granting additional market power to the incumbents at the expensive of consumers and at least some other parts of the airline industry. The market power of Qantas and Air New Zealand is intrinsically higher, then, than the market share data would indicate.

8.28.4 The OECD Report indicates how much business travellers are driven by frequency, hub and spoke connectivity and, most important, frequent flyer programmes. Large networks enjoy both costs and demand advantages over similar networks. Travellers prefer connections between flights of the same airline to flights between distinct airlines, because "seamless" connections are typically more convenient and offer greater security in the event of delays on the incoming or outgoing flights or in the event of lost luggage. Travellers also prefer airlines with more frequent service, because they offer enhanced travel flexibility in the event of a last minute change of plans. Airlines also enhance demand for their services through loyalty programmes, such as frequent flyer programmes, which provide incentives for travellers to focus their bookings on a single airline. Such programmes benefit larger airline networks more than smaller airline networks. These programmes are especially targeted at attracting and retaining high-margin time-sensitive business travellers. Larger networks can also exploit to a greater extent the "hub and spoke" form of organisation. Hub and spoke operation allows an airline to concentrate traffic on certain routes, allowing both larger, more efficient, planes and more frequent service.

8.28.5 Airline mergers and alliances can allow airlines to lower costs and enhance demand by rationalising the combined networks, and expanding the scope of seamless service. On the other hand, airline mergers and alliances can reduce competition and enhance market power, especially on non-stop routes to and from hub airports. As is the case of Qantas and Air New Zealand's proposed alliance.

8.28.6 As a result of the above-mentioned cost and demand factors, hub-and-spoke airlines tend to be dominant on spoke and hub-hub routes, and jointly dominant (with the corresponding rival networks) on routes to and from other networks' hubs. Hub-and-spoke airlines tend to enjoy market power on non-stop routes to and from their hubs. In addition, there is a tendency for airlines to have a high share of the total traffic at their hub airports. This is the case of market power with Air New Zealand controlling hubs of Auckland, Wellington and Christchurch and Qantas for Sydney, Melbourne and Brisbane. New entry to erode this market power is difficult.

8.29 The Commission seeks comment on whether Virgin Blue is likely to enter the Tasman market under both the factual or counterfactual scenarios.

8.29.1 Virgin Blue is much more likely under the counterfactual. The Alliance with its Freedom Air VBA weapon would be a formidable foe.

8.30 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the Tasman market when compared with the counterfactual.

8.30.1 The Alliance is likely to have the effect of substantially lessening competition in the Trans-Tasman market. The barriers to entry are a lot higher than the applicants claim. Capital requirements and sunk costs are high. The failure of Kiwi International is evidence of the difficulty of competing in this market. If, as the applicants claim, both Air New Zealand and Qantas are losing money on the Tasman then there seems no logical reason why a new entrant would want to compete against a monopoly of two such strong airlines when both these competitors claim to be losing money. Landing slots are difficult to obtain at Auckland and virtually impossible at peak times. Facilities at Auckland and Sydney airports are likely to be a barrier to entry to the Tasman market.

8.31 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the NZ-Asia market when compared with the counterfactual.

8.31.1 We support the Commission's view that as the Asia to New Zealand sector is low yielding compared to other destinations, New Zealand is not a major focus for Asian airlines. The applicants submitted that a significant proportion of traffic to Asia destinations is carried pursuant to travel packages assembled by travel wholesalers. An analysis of the outbound statistics does not support this viewpoint. In excess of 60% of travel from New Zealand to Asia is VFR and business. Wholesalers would not be able to constrain the proposed monopoly.

8.32 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the NZ-Pacific market when compared with the counterfactual.

8.32.1 As the Commission has noted Air New Zealand and Qantas with their shareholding in Air Pacific and in which Air New Zealand also holds a small shareholding and Air Pacific proposed inclusion in the Alliance would have a monopoly on the Auckland/Nadi route. The only competitor on the Auckland/Nadi route, Korean Air provides less than 3% of the available capacity therefore offers no effective competition. If the proposed monopoly were to proceed the monopoly would have a dominant market share. The impact would also be detrimental to Polynesian Airlines, which currently code shares with Qantas and for whom Air New Zealand is a principal competitor. It is unlikely that any potential competitors would constrain the proposed monopoly of Air New Zealand and Qantas. Although there are package holidays for the major part of the traffic to Nadi, wholesalers do not have sufficient power to be able to negotiate airfares when the only alternative is limited capacity on Korean Air, which provides less than 3% of capacity while the wholesale market requires nearly 50% capacity.

8.33 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the NZ-US market when compared with the counterfactual.

8.33.1 As the Commission has noted, Air New Zealand and Qantas are the only current competitors in the New Zealand/US market. This would give the proposed monopoly total dominance on this route, which is an important route for New Zealand exporters and business travellers.

8.34 The Commission seeks comment on its preliminary view that the proposed Alliance would not have or be likely to have the effect of substantially lessening competition in the International market when compared with the counterfactual.

8.34.1 We consider the proposed monopoly would have competition in international markets. However, it should be noted that if the monopoly were restricted to a single Alliance then New Zealand would suffer a detriment without Star Alliance traffic and tourists coming into New Zealand. The JSA between Qantas and BA already impacts adversely on access to competitive airfares and capacity for New Zealand travellers to Europe.

8.35 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the domestic airfreight market when compared with the counterfactual.

8.35.1 We agree with the Commission that the proposed monopoly would have the effect of substantially lessening competition in the domestic airfreight market when compared with the counterfactual.

8.36 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the Tasman belly hold market when compared with the counterfactual.

8.36.1 Although the market dominance of Trans-Tasman air freight is not as great as for passenger travel, Qantas and Air New Zealand still hold around 73% of the market. The proposed monopoly is very likely to result in upward pressure on freight rates, which would not be a good outcome for importers and exporters, and would substantially lessen competition.

8.37 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the international belly hold freight market when compared with the counterfactual.

8.37.1 We agree with the Commission's view that the overall effect of the proposed monopoly on these markets is such that there is unlikely to be a substantial lessening of competition in the international belly hold freight market when compared with the counterfactual.

8.38 The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the national wholesale travel services market when compared with the counterfactual.

8.38.1 We agree with the Commission's findings and endorse the TAANZ comments on this market.

"TAANZ supports the conclusions reached by the Commission in this regard. We make the following additional comments differentiating between the role of the wholesaler and the air consolidator.

First, the wholesaler (outbound):

Outbound travel wholesalers act as intermediaries, "packaging" land content (accommodation, transportation and sightseeing) in conjunction with an airfare to produce conclusively priced holidays. These holidays are distributed and sold to the public via retail travel agents and are aimed primarily at leisure travellers. Wholesalers represent an estimated 30% of the outbound "holiday" tourism market.

The travel wholesaler's primary benefits to the consumer are:

- *Their expertise in the construction and packaging of fully inclusive holiday packages to the consumer so that the consumer acquires a product with no hidden costs.*

- *Their ability to bulk purchase air and land product ensuring competitive prices for the consumer in comparison to what they would pay on a direct basis.*

- *Their ability to sell "distressed inventory" on behalf of air and land suppliers.*

- *The investment they make in the promotion of overseas travel destinations, for example brochured product, newspaper advertising, radio and television.*

- *The specialised destinational advice they provide to the retail travel agency community in order to best inform the customer.*

The threat to the wholesaler, and therefore in turn to the consumer, under the Alliance is that their long-term survival would be highly questionable. The New Zealand market is currently served by a number of highly competitive independent wholesalers, none of whom dominate the market in the way that Qantas Holidays do in Australia.

Both Qantas (via Qantas Holidays) and Air New Zealand (via Air New Zealand Holidays) currently operate their own in-house wholesale programs, independently of each other. Under the Alliance Qantas and Air New Zealand will potentially be able to combine resources and volumes in order to dominate both markets. This would result in the closure of competing New Zealand wholesalers thereby removing choice for the consumer.

Qantas Holidays currently dominate the Australian wholesale travel market and, whilst we accept their claims that they will not promote outbound travel from New Zealand under the Qantas Holidays umbrella, they will not need to. Air New Zealand Holidays already exists and with the benefit of combined volumes, enhanced buying power and integrated systems/inventory control and in particular a common database they could effectively replicate Qantas Holidays under the Air New Zealand Holidays brand.

The consequences of this, as has been recognised by the Commission, is likely to be a change from the highly competitive wholesale travel services market that exists currently where a number of independent wholesalers (none of whom dominate the market) compete aggressively for business to a situation more akin to the Australian situation where the market is dominated by the one airline-owned supplier.

Secondly, the air consolidator:

Air consolidators are intermediary wholesale distributors of airfares and air only product. They construct multi stop, multi carrier itineraries for retail travel agents, which they on-sell to the public. They also distribute "special fares" not available directly to the retail travel agent from the airlines.

The air consolidators' primary benefits to the consumer are:

- *Their expertise in airline rules and ticket issuance procedures, reducing the risks of ticketing error. Ticketing errors can affect the consumer's ability to board a plane.*
- *Their expertise in the construction and issuance of multi stop, multi carrier itineraries.*
- *Their ability to promote and sell airfares, that due to airline regulations, is not available to the retail travel agent directly.*
- *They are the major distribution channel for fifth freedom carriers.*

The threat to the consolidator, and therefore in turn to the consumer, under the Alliance is that their ability to provide an *extensive choice of multi stop, multi carrier itineraries is compromised. In the current competitive environment customers have a wide choice of Star Alliance and One World Alliance airfares that are generally constructed by air consolidators, on behalf of the retail travel agent. In the event Air New Zealand joined the One World Alliance of carriers this would effectively remove the ability of the Star Alliance carriers to compete. The only online carrier option customers would have with Star Alliance would be Singapore Airlines, which drastically reduces the number of cities available on route to Europe, thereby removing consumer choice and options.*

The effect of removal of the Star Alliance from a consolidator's suite of airfare options, reduces the ongoing need for consolidators, which in turn reduces the major avenue for distribution for all new entrants and/or fifth freedom carriers. This would make it more difficult for new entrants/competitors to come into the New Zealand marketplace, as their distribution costs would be increased. In turn this would also affect the ability of consumers to gain access to the competitive fares these carriers currently provide and which one could confidently predict they would continue to provide."

8.39 The Commission seeks comment on its preliminary view that the proposed Alliance would result in fixing controlling or maintaining prices and is therefore deemed to substantially lessen competition.

8.39.1 The applicants have clearly stated that all aspects of pricing, passenger and freight services, including setting fares, rebates, levies and promotions, level of service fees, development of new fare products, pricing and promotion of holiday destinations, commission and agency incentives and joint tendering for corporate and Government accounts; procedures for pricing and inventory management; exchange of information on schedules, financial information, pricing, yields, seat availability, sales; operations, routing, capacity, frequencies, aircraft types, connection requirements; reciprocal code share rights, special pro-rate agreements, Qantas Holidays, freight operations, frequent flyer programmes will be co-ordinated by Air New Zealand alone for both companies on Trans Tasman and domestic routes. The level of collusion and/or coordination proposed by the applicants is of such a scale that it is likely to have the effect or likely to effect fixing, controlling or maintaining the price of goods and services and is therefore deemed by s30 to substantially lessen competition for the purposes of s27 in each of the identified markets. In our view the proposed Alliance would clearly result in fixing, controlling or maintaining prices and is therefore deemed to substantially lessen competition.

8.40 The Commission seeks further commentary and analysis on the appropriateness of the assumptions used by NECG in its model of passenger air service markets.

8.40.1 NZIER has reviewed the NECG model on behalf of the parties to this submission and considered that:

8.40.1.1 "*The NECG model of passenger service markets is flawed in very significant ways. Firstly, the evidential value of imperfect competition models in economics is lower than many other economic models. This is because there are a host of imperfect competition models available and there is little empirical evidence upon which to choose between them. Second, as*

Frontier Economics and Professor Hazledine (and the Commission) point out, NECG do not allow the model to operate in the manner that was intended by Cournot. In other words, their computations are at variance with the logic of the model itself. An alternative way of expressing this is that the NECG results appear to be based on assumptions, which are mutually inconsistent. In this sense the results are not logical "

8.40.2 The key logic of an imperfectly competitive (oligopoly) model like the Cournot variants is competition between the limited participants involving both quantities and prices. All participants are taking strategic actions based upon their expectations of what the others will do. It is inappropriate to attempt to use the Cournot model in the forward-looking environment laid out by the Applicants. NECG is attempting to evaluate a limited competition environment that their clients do not admit to (lowering quantities and raising prices). This is a bizarre situation. [NZIER]

8.40.3 Air NZ and Qantas have made three-year projections of their capacity on the various air routes. Given the dynamic market environment they operate in, the airlines know (but could not tell us) what assumptions they are making about the signalling value of these public statements to other market participants and regulatory authorities. NECG is well aware that these "forecasts" have no value as projections of actual capacity for the next three years – no interaction is being allowed for. [NZIER]

8.41 The Commission seeks further submissions on the implications of a possible switch by Air NZ to the oneworld Alliance.

8.41.1 Airline Business May 2003 stated that according to Qantas CEO Air New Zealand remaining in Star Alliance "is not feasible". This would be a serious detriment to New Zealand.

8.41.2 In a letter to the Minister of Tourism, the Ministry of Tourism noted that at present New Zealand is in a very advantageous position with both Star Alliance and One World members serving New Zealand. Star Alliance currently enjoys 22% global market share and One World 18% global market share. Air New Zealand's membership of Star Alliance results in the following benefits:

- *"Access to a feeder network from 11 other Star partners, being the broadest reach airline Alliance;*
- *A wider range of fares available to the travelling public to and from New Zealand;*
- *Access to the Frequent Flyer programmes of Star partners. In particular Lufthansa's Miles and More Programme and United Mileage Plus. Programmes generate a significant number of high yielding visitors to New Zealand;*
- *Seamless distribution and interline access to 23 domestic destinations and 11 Trans-Tasman routes for the inbound passengers of Thai, Singapore and United."*

8.41.3 Air New Zealand and Qantas give their respective Alliance's a strong presence in New Zealand. If Air New Zealand were to join One World, the Star Alliance contribution to bringing passengers to New Zealand would be significantly reduced in our top 5 tourism markets (Australia, United Kingdom, USA, Japan and Korea) with consequent implications for code-share services, marketing and frequent flyer access. Star would also lose its presence in the important outbound market of Fiji. If both airlines were to join Star, One World would be all but eliminated in terms of New Zealand's top 5 tourism markets (the remaining Cathay Pacific plays only a small role in carrying residents from the USA, UK, Japan and Korea. The demise of Ansett and the Star Alliance connection into Australia has been seen as one of the reasons for the poor performance of Australian tourism over the last 12 months. Air New Zealand and Qantas becoming members of the same Alliance will also have implications in the domestic market, where Air New Zealand and Qantas provide interconnect services for other carriers and their respective Alliances beyond the gateway cities. It may become more difficult for carriers from the rival Alliance to offer services to visitors who wish to travel beyond Auckland. We share the Ministry of Tourism's concerns and believe that the implications on a switch by Air New Zealand to the One World Alliance would be significant for inbound tourists and outbound New Zealand travellers.

8.42 The Commission seeks further commentary and analysis on the appropriateness of the assumptions used by Professor Hazledine in his model of passenger air service markets.

8.42.1 NZIER has reviewed Professor Hazledine's analysis and has concluded:

8.42.1.1 "Professor Hazledine employs a model with the same generic basis as NECG, a variant of the Cournot model. His analysis is superior on a number of grounds. Professor Hazledine's analysis was independently produced and the model is based on a professionally refereed article in New Zealand's top economics journal. He has adapted his Cournot model variant to the facts in this case in important ways. This is especially necessary with *imperfect competition models if they are to be of any practical use in examining particular issues.*

8.42.2 "Professor Hazledine's starting point is an evaluation of the way in which the Tasman market actually operates in practice. He concludes that this market is currently more competitive than Cournot. This is a very important point and a relatively robust result upon which to base his further analysis. All the other analysts based their factual and counterfactual results more on theoretical foundations rather than empirical facts concerning observed behaviour. The second important innovation employed by Professor Hazledine is to provide for the different cost structure of FSA and VBA airlines to add significant realism to the results. He then simulates the model according to Cournot logic – the model is permitted to operate as it was originally intended to by its author. Professor Hazledine's model is coarse because he lacked data, but the price and quantity results (as opposed to load factors) appear to be unbiased and very close to the more refined Commission and Gillen results." [NZIER]

8.43 The Commission seeks views on the appropriateness of Figure 2 as a stylised representation of the NECG model.

8.43.1 "The Figure 2 diagram is very helpful in summarising the various positions. It clearly demonstrates the illogical nature of the applicant's argument with respect to excess capacity." [NZIER]

8.44 The Commission seeks further commentary and analysis on the assumptions used in the price discrimination model of passenger air service markets.

8.45 The Commission seeks further commentary and analysis of the appropriateness of the assumptions used by Professor Gillen in his model of passenger air service markets.

8.44.1/8.45.1 The Gillen model has all the positive attributes of the Hazledine approach plus the added realism of being able to deal with the product differentiation issue that lays at the heart the Qantas, Air NZ and Virgin brands. Professor Gillen, a world authority on the economics of airlines, presumably chose the Hazledine framework because it was the best framework available of the Trans-Tasman market.

8.44.2/8.45.2 The model is allowed to operate in typical Cournot fashion and hence does not suffer from the rigidities imposed by NECG in their analysis. Revenue maximisation subject to a minimum profit constraint does appear to be a very reasonable approach given the long-term strategic approach of Qantas and Air NZ. [In passing it is worth noting that this objective is not consistent with a war of attrition without recoupment.]

8.46 The Commission seeks comment on its assessment of the likely sources of losses of dynamic efficiency from the proposed Alliance.

8.46.1 The Commission has identified the major losses of dynamic efficiency.

8.46.2 The potential for high degrees on dynamic inefficiency under the Alliance is very great. Both airlines have considerable market power in their own right and a virtual merger would increase their ability to alter the quantity and quality of services provided in various markets to a great extent.

8.46.3 On the supply side, airlines like Qantas and Air New Zealand are in the business of aggregating components (particular aircraft, booking systems, human resources, gates, ramps, schedules, meals, etc) into packages of services that are offered to passengers and freight forwarders. A key point about this industry is that the research and development effort required to design new services is low relative to that required in many industries. This means that the long run average costs curve of an airline is not monotonically decreasing. Airlines, including Air New Zealand and Qantas are not natural monopolies. It follows from this that a monopoly is most unlikely to lead to dynamic efficiencies. Air New Zealand and Qantas have no incentive to lever off research and development and other factors to product long term cost savings through added efficiency.

8.46.4 Contrast the retail industry with the aircraft designing and manufacturing industry. In this type of industry, product innovation is crucially important and it is very expensive to produce. Firms like Boeing and Airbus probably do gain many elements of dynamic efficiency with higher levels of market power because they have larger market shares. They face strong incentives to innovate and the innovation involves huge up front research and development costs. Air New Zealand and Qantas do not operate in such an environment.

8.47 The Commission seeks further commentary and analysis on the appropriateness of its estimates of dynamic efficiency losses associated with the proposed Alliance.

8.47.1 NZIER have noted, "*We have not been able to replicate the analysis in detail. The approach is appropriate in our view as we outline later.*"

8.48 The Commission seeks comment on its assessment of the likelihood of losses of productive efficiency from the proposed Alliance.

8.48.1 NZIER commented, *"The Commission has used a balanced and objective approach - the OECD results are a very useful basis in this context. The NECG comments are pure rhetoric, by contrast. A more detailed evaluation of the cost structures of ANZ and Freedom, for example, would likely show how ANZ's cost structure has become inflated over time as a result of its high degree of market power."*

8.49 *The Commission seeks further commentary and analysis on the appropriateness of its estimates of productive efficiency losses associated with the proposed Alliance.*

8.49.1 NZIER commented, *"We would make the same comment here as we did for question 47."*

8.50 The Commission seeks views on its overall approach to detriment assessment in respect of these Applications.

8.50.1 The overall approach used by the Commission is a very good one, as we have discussed in detail.

8.51 The Commission seeks views on its estimation of cost savings?

8.51.1 NZIER have commented "*The counterfactual adopted by the Commission is very appropriate, as we have said. However, the Commission may be over-estimating the cost savings because ANZ is in a position of high market power that offers great potential for productive inefficiency to rise under the proposal* *and cost savings to be much less. Indeed, there may be few cost savings realised for shareholders."*

8.51.2 It should also be noted that as the Government has mandated that any Alliance must be able to be separated easily there would be limited opportunities for rationalisation and cost savings. It is highly probable that the cost of implementing and maintaining this constraint will lead to higher costs that would have been incurred by each company continuing to act independently.

8.52 *How would the marginal tourist's expenditure differ from that of the average tourist?*

8.52.1 See Appendix B Ministry of Tourism Report.

8.53 The Commission seeks views on its assumption that Qantas Holidays would sell packages that include Air NZ airfares if doing so did not deprive Qantas of additional passengers?

8.53.1 According to the Qantas Holidays Marketing Plan, Qantas Holidays currently sells packages that includes airlines other than Qantas. These include Garuda and Thai Airways. There is no reason to suppose that Qantas Holidays would not sell packages that included Air New Zealand airfares if doing so did not deprive Qantas of additional passengers. Qantas Holidays would be likely to sell Air New Zealand if they were given special prorate airfares not available to wholesalers (ref QF Holidays Marketing Plan). i.e. A monopoly in wholesale pricing.

8.54 *How effective are the national tourism organisation's promotions? Can airlines promote national tourism as effectively?*

8.55 The Commission seeks views on its estimation of tourism benefits?

8.55.1 We agree with the Commission's view on the estimation of tourism benefits. On current performance from Qantas Holidays we doubt that their efforts would result in additional inbound tourists to the extent suggested. We address this issue in response to question 64 below.

8.56 How should aircraft capacity and tourism infrastructure constraints and risk affect the analysis?

8.56.1 Aircraft capacity and flight frequency are two of the most important constraints on tourism numbers. New Zealand residents take frequent holidays overseas so out-bound tourism is not a constraint on in-bound tourists – in other words the back haul is assured in this market. However, higher airfare prices and lower seat availability are a real constraint.

8.57 The Commission seeks views on its estimation of scheduling benefits?

8.57.1 To a large extent, scheduling benefits are theoretical, illusory and unobtainable. Each airline has an incentive to schedule flights when passengers and freight forwarders want them. Furthermore, the more competition exists, the more incentive they have to meet customer's needs. The proposal would result in Qantas and ANZ having less incentive to keep up with changing consumer needs – the payoff to them in a monopolistic position would be less.

8.58 The Commission seeks views on its estimation of direct flight benefits?

8.58.1 The Commission is correct. Our argument in support of the Commission is the same as our response to question 57.

8.59 *Is the Commission correct in its estimation of engineering and maintenance benefits?*

8.59.1 In our view, Qantas would continue to seek the most cost-effective engineering service arrangements. There are not many options at our end of the Pacific. The NECG views are further examples of the 'fighting talk' that occurs in the public relations arena but which bears no resemblance to a firms behaviour in competitive environments.

8.60 The Commission seeks views on its estimation of freight benefits?

8.60.1 We agree that there are significant detriments to freight forwarders and no benefits likely to arise from the proposal.

8.61 The Commission seeks views on its assessment of other benefits?

8.61.1 Yes, the fewer aircraft and lower flight frequencies that would result from the proposal proceeding would reduce noise, increase flight safety and raise security. We do not have private estimates of parameters that could be used in this evaluation but they are available from technical studies.

8.62 Has the Commission omitted any significant benefits from its analysis?

8.62.1 There are no additional significant benefits that we are aware of. However a detriment to be considered is that empirical evidence shows that where Air New Zealand has a monopoly or dominant market position on a route the premium paid by consumers varies between 10% and 85%. This is significantly more than the NECG model indicates. This would subsequently increase the detriments of the model.

8.63 *Is the assumption of full employment valid for modelling impacts on the New Zealand economy?*

8.63.1 NZIER comments as follows: *The New Zealand economy has an unemployment rate that is arguably quite close to the natural rate of unemployment at the present time. In other words, most of the current level of unemployment is due to a lack of skills and related factors. If this is correct then the rate of unemployment over the next few years will change mainly in response to unemployed people acquiring valuable work skills. The national unemployment rate is unlikely to change a great deal in response to the level of economic activity – up or down. From this perspective, a full employment assumption is the appropriate one to take in national modelling exercises using a computable general equilibrium model for example.*

8.63.2 However, there are two factors that need to be considered in specific contexts. These factors would indicate that the full employment assumption might need to be softened. The first factor relates to the tourism industry. The tourism sector of the New Zealand economy is very intensive in its employment of people with very low formal qualifications. Hotels, restaurants and retail establishments are a very large part of the tourism sector and the bulk of their employees have low qualifications levels. Furthermore, the skills required to work in many jobs in these industries can be acquired relatively quickly on the job.

These employees have many of the same characteristics as the current people who are unemployed.

8.63.3 *The second factor relates to the regional incidence of unemployment in New Zealand. Some regions of New Zealand have much higher unemployment rates than the national average, and these differences have been persistent. One reason for this is that at least some regional workforces are not perfectly mobile and resist moves to other regions where more jobs may be available.*

8.63.4 *The upshot of all this is that where a scenario is being evaluated that involves a significant change in provincial or tourism sector job opportunities, the regional unemployment rate may be affected. So, for example, a change in provincial air services or a change in tourist numbers could have a measurable effect on employment and unemployment.*

8.64 *The Commission seeks views on its use of welfare, rather than gross figures, to express benefits?*

8.64.1 *It is not appropriate to use gross income, sales, revenue or other similar concepts as measures of benefits that would accrue to the New Zealand community (economy), in this or any other policy evaluation. Economic welfare measures are appropriate measures because they avoid double counting and they net out input costs incurred in the generation of revenues.*

8.65 *The Commission seeks views on the likely effectiveness of the conditions suggested by the Applicants.*

8.65.1 The condition suggested by the applicants on tourism is, indeed, not a guarantee that the Alliance would result in additional 50,000 tourists visiting New Zealand. However, it is worse than that because even if such a guarantee was made it would not be measurable and it would therefore not be enforceable. This is simply because the counterfactual would not be observed.

8.66 The Commission seeks views on any other conditions that might be appropriate.

8.66.1 Conditions that would reduce the detriments in this case to the point where the applications were acceptable by law would also be unacceptable to the applicants. The conditions would have to be extremely draconian because the market power of the applicants is already at a very high level, even without approval for the Alliance.

9.0 Conclusion

9.1 In summary we support the Commission's view that there will: -

- Not be a War of Attrition but there will be ongoing competition;
- The entry of competition with a monopoly Alliance is less likely;
- The cost savings which have been suggested by the proposed Alliance would not be delivered;
- The likelihood of innovation and new product would be reduced;
- The tourism targets are unlikely to be achieved;
- Air New Zealand is doing well financially and is "not a failing company".

10.0 Appendices

10.1 APPENDIX A: Confidential Appendix

10.2 APPENDIX B: Ministry of Tourism Report

10.3 APPENDIX C: Virgin Blue – The Luckiest Little Airline Alive (Centre for Asia Pacific Aviation) **[CONFIDENTIAL]**

10.4 APPENDIX D: OECD Airline Alliances and Mergers

Acknowledgement

We acknowledge the work of New Zealand Institute for Economic Research in providing economic analysis and commentary for this Submission.