COMMERCE COMMISSION
CHANGES TO DRAFT DETERMINATIONS
RESULTING FROM MODELLING CALCULATION AUDIT

Qantas Airways Limited
and
Air New Zealand Limited

Executive Summary, p. 12

20. The Commission's preliminary view is that the detriment to the public of New Zealand would be likely to fall within the range of $245m - $500m per annum.

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25. The Commission's preliminary view is that benefits from the proposed Alliance arise from:

- Cost savings of $35.7 million. The Commission adopted a counterfactual that does not involve wasteful capacity expansion, and a model that generates higher fare increases from those assumed by the Applicants.

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26. The Commission's estimates suggest that the public benefits attributable to the proposed Alliance are likely to be in the range of $33.5 million to $49.6 million per annum.

Net Effect

27. In the Commission's preliminary view, the overall detriment expected to result from the proposed Alliance would clearly outweigh the expected benefits. On a provisional basis, the detriments are estimated to fall in the range of $245 million to $500 million, and the benefits in the range of $33.5 million to $49.6 million.

TABLE 1
Summary of Annual Net Benefits ($M) (Year 3)

	Applicants	Commission
Detriments	-10.3	-245 to -500
Benefits	236.3	33.5 to 49.6
Net Benefits	226	-195.4 to -466.5

Detriments – Allocative Efficiency, p. 161

672. Based on all these assumptions, the model suggests that welfare losses would amount to $71 million for domestic New Zealand and $99 million for the Tasman, which equate to about 16% and 7% respectively of the revenue sizes of those markets. These losses are measured in the same way as did NECG and Professor Hazledine, that is, they represent the portions of the deadweight losses borne by New Zealanders, plus the New Zealand gain of transfers from foreigners less the transfers lost to foreigners. Together, these losses of $170 million, which represent the welfare losses arising from the reduced competition in the factual compared to the counterfactual, amount to 9% of the aggregate market sizes.

Detriments – Dynamic Efficiency, pp. 164-66

686. In the calculations below, the following assumptions are used:

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- the marginal costs of incumbents and entrants are 0.77 and 0.58 respectively for the Tasman, being those derived by Professor Gillen, and indexed to a price of one;

- the price elasticities of demand used by Professor Gillen of -1.0 for the Tasman;

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687. The preliminary results are given in Table 8. These estimates suggest that the loss of dynamic efficiency from deterred VBA entry could be between about $44 million and $121 million, which give a range of between 2.9% and 8.0% of current market revenue.

TABLE 8
Estimates of Annual Loss of Dynamic Efficiency
Stemming from Reduced Entry – Tasman ($M)

Entrant market share	Existing demand – productive efficiency gain	New Demand		Totals	Percentage of total revenue
		Consumers surplus gain	Producers surplus gain		
5% + 5%	14.269	1.877	27.787	43.933	2.9%
10% + 10%	28.538	7.510	48.064	84.112	5.6%
15% + 15%	42.807	16.897	60.831	120.535	8.0%

688. On the basis of the above table, the potential loss of dynamic efficiency from the proposal might be of the order of $44 million to $121 million. However, in interpreting these estimates, a number of caveats have to be borne in mind:

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690. Taking all of the considerations set out above into account, the Commission's preliminary conclusion is that the potential loss from dynamic inefficiency might fall within the range from $50 million to $150 million per annum. Given the market characteristics, namely that New Zealand markets are mature, there are few population centres not currently served by air transport, and Air NZ has its lower priced Express and Freedom Air services, the Commission tends to the view that a figure in the lower to middle of the range appears at this stage to be the most likely.

Detriments – Productive Efficiency, pp. 172-73

710. Some preliminary estimates can be made using the revenue and marginal cost data derived by Professor Gillen and used above in the assessment of dynamic efficiency (but extended to include the New Zealand main trunk market), and applying the Commission's 1-10% range used in the *Bodas* decision. These preliminary calculations are presented in Table 9.

TABLE 9
Estimates of Annual Loss of Productive Efficiency ($M)

Item	NZ main trunk	Tasman
Total revenue	433	1502
Variable costs (assuming MC = 0.77)	333	1,157
Productive inefficiency (1-10% of variable costs)	3.3 – 33.3	11.6 – 115.7

711. The projections are imprecise, but point to annual detriments in the range from about $15 million to about $150 million for the two market areas combined. However, these are subject to the following qualifications:

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712. On the basis of the calculations and the evaluation of the various qualitative factors, the Commission is inclined to widen the range within which productive inefficiency flowing from the proposed Alliance is likely to fall to between $25 million and $180 million per annum. Its preliminary assessment is that the outcome is most likely to be in the middle of this range.

Detriments – Conclusions on Detriments, p. 174

TABLE 10
Summary of Annual Detriments ($M)

Item	NECG's View*	Commission's Preliminary View	
		Range	Most likely
Allocative inefficiency and transfers	10.3	170	170
Productive inefficiency	Very small	25 - 180	95
Dynamic inefficiency	Nil	50 - 150	90
Totals	>10.3	245 - 500	355

*Year 3 estimate.

714. The summary of the Commission's preliminary assessment of detriments indicates that losses are thought likely to fall in the range from $245 million to $500 million per annum, with the most likely outcome being around $355 million per annum. It is accepted that these losses would not apply immediately, but would tend to build up over a time period.

Public Benefits – Cost Savings, p. 178

730. Using this formula, the Commission's preliminary estimate of cost savings is:

Cost savings = $74.625 million × 0.51 × 0.92 = $35.696 million

Public Benefits – Conclusion on Public Benefits, p. 206

TABLE 15
The Annual Benefits of the Proposed Alliance to New Zealand ($M)

Source of benefit	NECG		Commerce Commission
	Year 3	Present value of 5-year cash flows	Average annual estimate
Cost savings	74.6	332.8	35.7
Tourism	120.3	549.1	-2.6 to 13.5
Scheduling	1.8	19.7	0.36
New direct flights	7.1	26.3	0
Engineering and maintenance	30.3	151.8	0
Freight benefits	2.2	2.6	0
Total	236.3	1,082.3	33.5 to 49.6

830. The Commission's preliminary assumptions and estimates suggest that the annual public benefits attributable to the proposed Alliance would be in the order of $33.5 to $49.6 million. According to the Commission's calculations, the greatest potential source of benefits would be cost savings, and even these would be considerably less than the benefits projected by NECG.

Balancing, pp. 208-09

836. Without adjusting for the different timing of benefits and detriments (an exercise which would, given the Commission's estimates and assumptions regarding VBA entry, weigh against the Application), the implications for public benefits, according to the Commission's estimates, are clear, as the following table shows. The Commission considers that the proposed Alliance would, most likely, generate negative public benefits in the order of -$313 million per annum. Even considering the highly unlikely scenario of detriments being at the low end of the range of estimates and benefits being at the high end, net public benefits would still be -$195 million. The least favourable estimates suggest net public benefits of -$467 million. Even some of the elements of the least favourable estimates, as mentioned in the body of this draft, could in all likelihood overstate benefits and understate detriments.

TABLE 16
Summary of Annual Net Public Benefits ($M) (Year 3)

	Applicants	**Commission**
Detriments	-10.3	-245 to -500
Benefits	236.3	33.5 to 49.6
Net Benefits	226	-195.4 to- 466.5