COMMERCE COMMISSION CONFERENCE

APPLICATION BY AIR NEW ZEALAND LTD AND QANTAS AIRWAYS LTD FOR AUTHORISATION TO ENTER A STRATEGIC ALLIANCE AGREEMENT AND APPLICATION BY QANTAS AIRWAYS LTD TO SUBSCRIBE FOR UP TO 22.5% OF THE VOTING EQUITY IN AIR NEW ZEALAND LTD

COMMISSIONERS: Mr Paula Rebstock (Acting Chair)
Ms Denese Bates QC
Mr Donal Curtin
Mr Peter JM Taylor

[9.09 am]

CHAIR: Good morning ladies and gentlemen, can I just check that everyone can hear me.

I'd like to welcome everyone to the Commerce Commission's Conference being held in relation to the application by Air New Zealand and Qantas Airways who are seeking authorisation to enter into a Strategic Alliance Agreement and related agreements in the application by Qantas Airways seeking authorisation to subscribe for up to 22.5% of the voting equity in Air New Zealand.

I am Paula Rebstock, I'm acting chair of the Commerce Commission and I will be chairing this Conference.

With me are Members of the Commission who will be making the determination on this matter. They are Peter Taylor to my right, Denese Bates QC to my left and Donal Curtin also to my left.

Also assisting us with this matter are a number of

Commission staff and the Commission's external advisors. They are seated at the table to my right. Our external advisors include Hugh Rennie QC, Doctor Mark Berry and Professor David Gillen. Further on in the proceedings further external advisors will join the Commission.

Janet Whiteside and Fritha McKay are available if any person requires any assistance during this Conference, and they are seated at the top of the table.

I would like to welcome everyone, particularly those who have travelled from outside Wellington and those who have taken the time to meet with Commission staff and make written submissions on this matter. We are very appreciative that the Commission has access to the industry experience which is before us and look forward to an informative week.

As I've already said, this Conference relates to applications from Qantas Airways Limited and Air New Zealand Limited who I'll refer to from this point as "the Applicants".

The applications for authorisation were registered by the Commission on 9 December 2002. The Commission sought initial views of interested parties on the competitive implications of the applications. The Commission then issued its Draft Determination on 10 April.

The Draft Determination outlined the Commission's thinking to that time, and identified issues on which it sought additional information and views.

Following release of the Commission's Draft Determinations, interested parties were asked to make submissions on the draft by 9 May 2003. At the request of the applicants, the Commission considered the work required and made a revision to the timetable so that submissions were to close on the 20th of June. The submission process was further enlarged to allow third parties to have time to consider submissions put forward by Qantas and Air New Zealand, and have the opportunity to make cross-submissions. Cross-submissions were due on 18 July.

I would like to note that the Commission received a number of late submissions and had late response to some of its information requests. The Commission will give whatever weight it considers appropriate to this late information given the limited opportunity for the Commission to test it.

I recognise that there is a vast array of complex issues raised by the applications. The Commission will do its best to make its Final Determination on these applications as soon as possible, and I'd like to note that at this stage we anticipate doing so by the end of September.

I would now like to make some brief comments on the procedures for this Conference. For those of you who attended the pre-Conference meeting, much of this information will be repetitive, however it bears repeating.

We have set down five and a half days for the Conference aiming to complete the Conference by midday next Monday. An indicative timetable has been made available to all interested parties. The order of submissions will start with the Applicants and then as far as practical, given the availability of parties, follow with those who are generally supportive of the application and then those against. The Applicants will then have the right of reply, and I will note that in the right of the reply the Commission generally does not pursue further information other than points of clarification.

I will do my best to ensure that everybody is given a fair opportunity to present their case. If necessary, some adjustments may be made to the timetable and proceedings may need to run into the evening.

A full record of this Conference will be maintained by both transcription and tape recording. Could any person speaking please do so from one of the microphones available and speak clearly and precisely. I would also ask that each speaker state their name and the party they are representing so that we can identify them clearly.

As you can see, there are a large number of people attending this Conference. I would ask that everyone, and especially persons not engaged in presenting, keep noise to a minimum during the Conference. I would also request that all cellphones are switched off. Even if the sound is turned down they still interfere with the microphones, so I would ask that they be switched off.

At this Conference we will be using video conferencing facilities for two of the Applicants' presenters. The video conferencing facilities will allow all attendees at the conference to see and hear the person presenting. However, I note that the presenter will only be able to see the Commissioners. There will be a brief set-up time allowed to arrange the video conference links.

It's not proposed to close this Conference venue during the lunch breaks. However, a Commission staff member will be in attendance during those times. We will have tea breaks at appropriate times during the day. Tea and coffee will be available in the area to my right -- I think at the back of the room -- and Commissioners and Commission staff will not be available for discussion during these breaks.

These Conferences are designed to allow the Commission to test the submissions put forward by interested parties with questions and for parties to highlight the key points of their arguments and their submissions to the Commission. It is not an opportunity for new evidence or submissions.

In some cases the Commission will request additional information to be provided by the presenting parties. At the time that this information is requested a date for delivery of this information will be agreed and noted as part of the record of the Conference. Other than specific requests from the Commission, the Commission considers that this Conference marks the end of the submission process for this authorisation.

S.64 of the Commerce Act requires that the Commission shall provide for as little formality and technicality as possible. The Conference is not intended to be an adversarial proceeding. There will be no cross-examination, there will also be no questioning of Commissioners or Commission experts and staff by any party. There will, however, be an opportunity for questioning of presenters by Commission members, staff and the Commission's external advisors. While the public are welcome to attend during open sessions, they do not have speaking rights or the right to ask questions.

Commissioners have read all of the submissions carefully, so please make any summaries of submissions as succinct as possible. We do not wish, and indeed may not allow you to read your submissions to us. It would be appreciated if speakers focused on the key issues in their addresses to the Commission and kept to the time allocated to them. I would like to point out that the Commission can consider only those issues within its jurisdiction and accordingly we do not wish to hear submissions on any matter which is not directly relevant to the applications and so within our authority.

It is expected that a number of experts will be attending and presenting at this Conference. I would like to stress that their role is as experts in their field; an expert is not to act as an advocate for any particular party. If the Commission considers that experts are in fact acting as advocates for a particular party their submission will be treated as though they are part of that particular party's submission rather than as expert opinion.

As it will be necessary to consider material which is confidential, the Conference will be closed during that discussion to all persons except for Commission members, staff and external advisors, the party providing the confidential material and to legal counsel and relevant experts who provide appropriate confidentiality undertakings.

I emphasise, however, that we have a strong preference for as much as possible for this Conference to be heard in public sessions.

I will be very careful in those closed sessions to not allow evidence to be heard that can be heard in an open session; so, I would urge all parties to assist me in that matter.

Please note that transcriptions of all public sessions will be made available on the Commission's website as soon as possible after each day's proceedings. If you have specific information contained within your submissions that is confidential but that does not require an entire confidential session, please note the status of the information before commencing to discuss it so that we may consider, and, if necessary, rule that it be excluded from the public transcription record. And can I say that given the extent of the confidential information, if parties become aware during the proceedings that confidential information is being discussed in an open forum, I would ask that you notify me immediately even if it means interrupting the proceedings at that point.

I will pause now so that the cameras, both still and moving, can be switched off. No photography of any type will be allowed during the remaining sessions of these proceedings. So we'll just give it a second. [**Pause**].

Before we proceed I would like to ask if anyone has any questions relating to the procedure for this Conference or any issues that I have raised? [**No comments**].

If any questions on procedures or the agenda do arise during the Conference, please don't hesitate to contact either Fritha McKay or Janet Whiteside.

The Commission has been looking forward with some interest to hearing the submissions that will be presented today. I'd like to thank you all once more for your attendance and begin by asking the representatives for the Applicants to present their submission. I believe Mr Norris, you will be presenting the opening address and I'll now hand you the floor.

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Applicants

MR NORRIS: Thank you Madam Chair. Madam Chair, Commissioners, for reasons which will be traversed over the next few days, in my view, and in the view of my board authorisation, the alliance with Qantas is absolutely critical to the future of Air New Zealand, and because the fortunes of New Zealand's tourism industry are so inextricably tied to the fortunes of Air New Zealand, also critical to the future well-being of New Zealand.

Along with other full service airlines internationally, Air New Zealand is operating in a changing global aviation industry. This change has been brought about by a wave of cross-border liberalisations of aviation bilaterals which have permitted domestic and trans-border markets to be entered by a new efficient and effective airline model presently limited to short haul routes known as value based airlines or low cost carriers. These VBAs and LCCs will abbreviations used interchangeably throughout the airline industry to describe the same business model.

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

Until the entry of Ansett New Zealand in 1987, Air New Zealand operated without any significant competition within New Zealand. In 1996 a single aviation market came into force between Australia and New Zealand. It was originally intended it would come into force in 1993, but as I will discuss again later, the Australian Government postponed that signing.

An Open Skies Agreement between Australia and New Zealand was subsequently agreed in late 2000. It continued the trend towards liberalisation. Among other things, the Open Skies Agreement allows any authorised airline, being an airline having Australian or New Zealand control, to fly without restrictions between Australia and New Zealand; any authorised airline to operate domestic services in Australia and New Zealand, and to carry domestic passengers on international services between airports approved for international services in each country; removal of limits on the number of authorised airlines that can operate services linking any city-pair combinations within and directly between the two countries, and on passengers or freight capacity on such routes; and removal of the limits on beyond rights that existed under the Single Aviation Market Agreement.

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

The Open Skies Agreement has far-reaching implications for Air New Zealand and for Qantas. It permits either airline or any other authorised airline, including Virgin Blue, to operate to, from and within both Australia and New Zealand. As a result, Air New Zealand's domestic market is now wide open to competition, as is the Tasman and domestic Australia. As I will describe later, this is already having major implications for Air New Zealand and for New Zealand.

The first full service airline competitor to Air New Zealand in the domestic market was Ansett New Zealand. It provided full service operations in the New Zealand domestic market from 25 July 1987 and operated using three B 737-100 aircraft operating on the main trunk routes and two Boeing Canada Dash 8 aircraft servicing tourist regions, Rotorua and Queenstown.

The B737s were replaced by seven Bae 146-200 and 300 series aircraft in 1989/1990. At that time, Air New Zealand operated 26 aircraft on the domestic market, of which 11 were B 737 200s with an average age of only 2.5 years. Ansett New Zealand added two further Bae 146 aircraft to the fleet in 1990/91.

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

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

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

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

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

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

The medium term outlook for Air New Zealand is therefore seriously adverse; far more so than a focus on short-term outcomes might suggest. As confidential material provided to the Commission makes clear, without the alliance Air New Zealand faces a struggle for survival, but one which it is poorly placed to win.

This material will be addressed separately in a confidential session led by Mr Roger France, Air New Zealand's Deputy Chairman, supported by the Company's Chief Financial Officer, Shane Warbrick, Eric Lucas, a partner of PricewaterhouseCoopers, and Murdo Beattie, a principal of Cameron & Co.

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

For the moment, the alliance adds value for both Qantas and Air New Zealand. If Air New Zealand and Qantas are not permitted into the alliance now, it is unlikely that the opportunity will remain in the future. Damage from the battle between Air New Zealand and Qantas to develop sustainable networks in New Zealand is likely to be substantially -- or to substantially erode the benefits of an alliance in the future. Air New Zealand's current negotiation strengths will also dissipate as it comes under renewed financial pressure.

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

Air New Zealand made two attempts to enter into the Australian market; the first attempt was through the development of a VBA model to be applied on the principal Australian domestic routes. That model was designed by the airline under the direction of Mr Ray Webster, then a member of the Air New Zealand management team but now the Chief Executive of the well-known VBA easyJet operating out of the United Kingdom and into Europe.

That attempted entry by Air New Zealand was positioned on the basis of an expressed intention of the Australian Government to enter into the single aviation market with New Zealand in 1993. Subsequently the Australian Government postponed signing the TSM, removing the opportunity for the new Air New Zealand VBA model to proceed.

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

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

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

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

Those lessons include: A full service airline will not survive in the face of VBA entry unless it is prepared to adopt models which allow it to substantially reduce its unit costs of providing air services; Canadian Airlines, Ansett Australia, Sabena and others are testimony to that outcome; and where two competing FSAs, or full service airlines, are joined in a market by a VBA which has adopted and then maintains the well-established and tested low cost model, only one full service airline can expect to survive; the smaller full service airline will have no clear space within which to operate; again, Sabena, Canadian Airlines and Ansett Australia provide clear evidence of that outcome.

In 2001, before the Government completed its recapitalisation of Air New Zealand it required the Board to produce a five year financial plan. The five year financial plan was subject to detailed scrutiny by the Crown's advisors and was a factor in the value assessments carried out by a variety of parties at the time. The five year financial plan projected a steady increase in profitability for the five year period to 30 June 2006.

The key features of the five year financial plan included an assumption that the benign competitive environment would prevail for the foreseeable future with the capacity of Air New Zealand and its competitors growing generally in line with demand. That view was based on an expectation that it would take Qantas and Virgin Blue some time to take up the space created by the failure of Ansett Australia.

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

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

That it would arrive was certain for two reasons. First, the characteristic of all VBAs around the world is that, as long as there are suitable markets available within a reasonable flying distance then they expand into those markets. This is particularly so when the VBA is already servicing one of the airports on that new route.

Secondly, Virgin Blue was already discussing a public listing, and was shortly to find itself a new strong financial partner in Patrick Corporation. From a purely investment perspective it was clear that Virgin Blue would need to demonstrate that it could grow if it was to list at an acceptable level of value for its current shareholders.

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

As a result, the Board of Air New Zealand required its management team to review all of the Air New Zealand operations. It wanted to determine a strategy going forward which would see different operating segments; domestic, Pacific, Tasman and long haul, making a positive contribution to the bottom line such that Air New Zealand could achieve its targetted economic return on capital.

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

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

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

At that time management also advanced propositions for discussion by the Board relative to the Tasman market and recommended that the Pacific market should be deferred for consideration in the same review as would later occur in respect of the long haul routes. It is also now history that Air New Zealand, last week, announced a new Tasman Express service incorporating new aircraft with a two class configuration, standardised cafe style food available free on board; free in-flight entertainment for both classes; a simplified fare structure with 12 fare types reduced to four; every day low fares with an average 20% reduction across the full range of lead-in fares; and, the lowest fares available through Air New Zealand's website.

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

It must be remembered that Air New Zealand is an international network carrier. 75% of its operations fall into that category. It is axiomatic for such a carrier that in order to compete in the global markets, it must satisfy the basic doctrine of all such airlines. It must have a seamless service across its whole network; all material parts of its network must be connected; it must price competitively with others on its routes regardless of the fact that others are subsidised on an ongoing basis, an example being Malaysia; it must provide competitive levels of service and the other frills which are normally provided by competitors; and, importantly, it must have a home market with significant city presence.

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

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

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

CHAIR: Mr Norris, I'd like to stop you for just a minute and ask -- the Commission would like to ask you some questions and then we'll let you take us through the rest of your presentation.

I want to go back to some of the background that you've given us about Air New Zealand's strategy in the past, and I want to get a sense of your own view about Air New Zealand's objective in entering this strategic alliance. What I want to ask you is, it seems to me that you've presented to us that the need for this has increased quite substantially because of the possible entry of the VBA airline in the Tasman and domestic New Zealand, and the thing I have trouble understanding is, what is the strategy based on when it's based on going into an alliance with another full service airline?

It seems to me that if full service airlines have difficulty responding to VBA entry, going into an alliance with another full service airline, which seems to have even more difficulty than Air New Zealand in responding to the challenge is an interesting strategy, but I am having some difficulty understanding it.

So, I'd like you to address that point, if you would, please.

MR NORRIS: Certainly, Madam Chair. If you look at where our argument is leading to is the fact that the issue for Air New Zealand going forward is not so much VBA competition, but it is the fact that two full service airlines competing against the VBA is in the long-term, medium to long-term, untenable. We can see situations that have occurred in other markets where -- for example, Canada where Canadian Airlines and Air Canada are competing against a VBA.

The situation for us is that there will always be a requirement for, we believe in the medium to long-term, for a full service airline offering. A VBA at this stage addresses the market in sectors up to about 3 hours in length. That comprises something like 25% of the business that we currently undertake as far as the available passenger seat kilometres that we have available; the other 75% is long haul, which is primarily a full service airline domain. I'm not aware of any significant VBA operator, other than what could be deemed as charter operators, operating in a long haul basis.

So, the issue for us is the fact that, in this marketplace we see in the future that the ability to compete will be based around a full service airline offering and a

VBA offering. Our view is that Air New Zealand, in conjunction with Qantas within the alliance, that we propose can provide a very strong FSA offering for the long to medium term, again in competition with the value based airline offering which is based around the short haul routes.

Our business is about a combination of regional, jet services, so we've got our -- jet services which cover the main trunk, our regional services and our international services. So, we are a full service model with a network based model rather than a value based model.

So that's where we're coming from on the basis that we see the future based around an FSA using the combined strengths of both from a market perspective, that is the markets that we address, the tourism markets etc of New Zealand and Australia being best served by the alliance.

CHAIR: You've talked a little bit about the difficulty you face now in transforming the nature of Air New Zealand given your full service offering, but also an attempt to lower your costs and possibly take up some product space that a VBA entrant will want to occupy.

I just wonder, and I'm not going to ask you the question, if you did ever enter into negotiations with another airline such as Virgin Blue, but what I would like to ask you is, just from a theoretical perspective -- just a hypothetical sorry, not theoretical -- hypothetical; how would you weigh up as Air New Zealand an alliance, a strategic alliance with a full service airline such as what you're putting forward to us, as compared to possibly a strategic alliance with a value based airline? How would you weigh up those two options, and did Air New Zealand consider that hypothetical? What is the preferred strategy for Air New Zealand?

MR NORRIS: Madam Chair, in the balance of my address I'm actually going to address that particular issue specifically, as well as some of the other options that Air New Zealand has looked at as it's gone through this process, including the one that you have just mentioned.

CHAIR: So you will come to that?

MR NORRIS: I will come to that.

CHAIR: Okay, I think Commissioner Bates would like to ask a follow-up question, please.

MS BATES QC: Yes, just following up from Commissioner Rebstock's first question to you, I just want to put to you a statement in the ACCC's Draft Determination and ask you to comment on it. It's at paragraph 9.84.

"The Commission -- that's the ACCC -- does have a concern, however, with the potential impact of the combined resources of Air New Zealand and Qantas under the proposed arrangements. Under the proposed arrangements the alliance partners can strategically allocate their resources in such a way as to maximise the competitive pressure on Virgin Blue at the critical early stage of entry while at the same time minimising the financial risk associated to either partner, especially the risk to Air New Zealand whose capacity to absorb losses on the Trans-Tasman route is certainly lower than that of Qantas".

What I'm asking you is whether or not you agree with that statement?

MR NORRIS: Well, I think theoretically that is obviously a possibility. We have balanced that by making undertakings or prepared to make commitments and undertakings in regard to capacity caps in order that that type of action upon Virgin Blue would not be instituted by the two airlines so to give them a fair opportunity to establish themselves, so we have said that we are prepared to put in place capacity caps, put in restrictions on how we use Freedom Air and also to act to provide them with access to slots and terminal capability within both New Zealand and Australia.

MS BATES QC: But do you agree that it would be more difficult for Virgin to compete with the proposed alliance than with two FS -- full service companies?

MR NORRIS: I believe, and the way that we have structured the alliance and the undertakings that we have put in place, that is largely obviated.

MS BATES QC: Without that, what would the decision be, do you think?

MR NORRIS: The other important dimension to this application is, and in regard to the ACCC, there is obviously a renewable; that is, for a specific term, and, therefore, the -- I mean, if the two airlines were to act in such a way that they were to abuse their position, that would put at significant risk to a further approval being given on the renewal of the arrangement in three to five years time.

MS BATES QC: Would you not agree, you don't have to go to the extent of abusing your position to work together to oppose Virgin Blue?

MR NORRIS: Well, effectively we're operating under the joint venture as an integrated airline, so from the point of view of the services that are being provided into, within and from New Zealand under the application, so effectively we are seen as one rather than seen as two.

MS BATES QC: And then -- I just have to follow this up -- do you think that would make it easier or more difficult for Virgin?

MR NORRIS: I think, if you have a look at the statements Virgin Blue have been making in recent times, they see the situation as one that they can compete in very adequately. I think, if you look at the situation in Australia, when they entered Australia there were two --

MS BATES QC: Can I please take you back to the question. Do you think that it will be easier for them to compete with the merged entity or with the two entities?

MR NORRIS: I personally think it would be easier for them to compete against the merged entity .

MS BATES QC: So, you disagree with the ACCC's statement?

MR NORRIS: Given the conditions that have been put in place, I believe that it is easier for them to compete with a merged entity.

MS BATES QC: What about without those conditions?

MR NORRIS: I think that's the reason why we put up the conditions.

MR P TAYLOR: Mr Norris, I wonder if you could assist the Commission by referring to the issue of cost and the relationship between the three airlines, in terms of the Tasman.

MR NORRIS: Well, at this stage, in regard to specifically cost?

MR P TAYLOR: Just the cost base and the advantage for the...

MR NORRIS: I think, if you look typically on a VBA situation, you have a cost advantage of something in the order of 25% on a typical VBA versus a typical FSA. The work that Air New Zealand has done in regard to Tasman Express, we have probably reduced our cost base vis-a-vis a VBA, the differential now is probably around 15%, so, there is still a significant margin, cost difference between a VBA and an FSA.

MS BATES QC: I've got a few more questions for you. One is on the nature of the VBA model itself, and I was looking at the publication that was in your application, the Centre for Asia-Pacific aviation industry report. Under the sub-heading "Virgin model becomes more complex", it says:

"As Virgin has matured however the model has become more complex and tailored to suit the idiosyncratic market conditions in Australia with its high reliance on corporate and Government travellers and traffic focus on east coast routes. By doing so the airline has moved closer to the product characteristics and operational profile of a vertically integrated full service operation".

It goes on to say "it's developed a pseudo network structure with interconnecting services that is very different from the classic point-to-point low cost model". Do you agree with that?

MR NORRIS: I would agree with that. In some respects it's similar to what Southwest Airlines have done in the United States in regard to a pseudo network interface, but that has still enabled Southwest to be a very cost-effective airline.

MS BATES QC: So, do you see Virgin developing along those lines, vis-a-vis this market; the New Zealand market?

MR NORRIS: I can't comment on what Virgin Blue may do.

MS BATES QC: You started off by saying that -- and this may be a self-evident answer but I wanted to ask you anyway -- why you think that the fortunes of the tourist industry are so inextricably tied to the fortunes of Air New Zealand?

MR NORRIS: Well, Air New Zealand provides a domestic network of

24 locations around the country. In many respects another entrant in the market may not choose to service all 24 destinations. We have 18 offshore destinations that we service into New Zealand, and our prime raison d'etre is to bring traffic to and from New Zealand. We spend something in the order of $70 million a year offshore promoting New Zealand as a destination with the various expenditures that we incur doing that, and certainly that is about 90% of the funds that are expended by international airlines in promoting New Zealand. We don't think that any other airline would spend that sort of money promoting New Zealand specifically; it would be part of an overall advertising budget.

MS BATES QC: Would you do it if it wasn't a profitable thing to do?

MR NORRIS: It's profitable for us to do because of the size and scope of our New Zealand operations, but I think that I will refer to some of that in my address going forward.

MS BATES QC: Okay. Just a couple points of clarification. You say that 75% of the flying operations are international, 25 domestic. How do the actual revenue from domestic and international break down?

MR NORRIS: At the moment, domestic provides -- is profitable, whereas over the last 5 or 6 years the international airline has been, from a passenger services perspective virtually -- has been a negative.

MS BATES QC: I thought that. Do you have any percentages?

MR NORRIS: I don't have those percentages offhand. We can come back to that.

MS BATES QC: And a final question; I'm curious to know why, if Qantas is signalling that it's going to compete more vigorously, why has it not done so earlier?

MR NORRIS: I think it's probably best to ask Qantas that; that view.

CHAIR: I just want to follow-up with a few more questions. You talked about the initial two attempts by Air New Zealand to enter into the Australian market, and the first one was a VBA style entry attempt that failed. Then you went on to talk about the Ansett Australia experience and I just wonder, why did Air New Zealand strategy vis-a-vis entry into the Australia change so radically from VBA style entry to taking on what was arguably a fairly high cost airline?

MR NORRIS: I was not involved at the time that that took place. I became a board member in late 1998. The decision to undertake the purchase of the first half of Ansett took place in 1995/96.

CHAIR: Do you have anyone else with you today that can answer the question?

MR NORRIS: I'll pass over to Andrew Miller.

CHAIR: Just before we do that, could I just ask that you introduce the other members of your party that are sitting at the table please.

MR NORRIS: On my right is Shane Warbrick, the company's Chief Financial Officer, and on my left is Andrew Miller our Chief Operating Officer.

CHAIR: And at this table, just so everyone in the room knows?

MR P TAYLOR: Philip Taylor from Bell Gully representing Air New Zealand and Torrin Crowther.

MR PETERSON: And Andrew Peterson representing Air New Zealand, and representing Qantas with Sarah Keene.

MR MILLER: The statement that Ralph made in terms of the original reasons why Air New Zealand tried to access the

Australian market by using a VBA type model, that was thwarted by the Australian Government in the fact that they didn't sign the SAM, Single Aviation Market Agreement. Air New Zealand being in a population of 4 million and Australia being a population of 20 million, Air New Zealand was very keen to extend its reach to gain more economic value out of the region, and at that time it was deemed necessary to try and find -- make an acquisition, and obviously the company made a 50% acquisition of Ansett Australia and then subsequently the other 50% to control at 100%, that being the -- as far as the board at that time were concerned, being the only possible outcome in terms of accessing entry and value from the Australian market.

CHAIR: So when you switch to an approach based on another full service airline, Ansett, it wasn't because you thought that was a better strategy than the original strategy that was developed which was a value based one? Is that fair to say?

MR MILLER: It was the only alternative available that the board had at that time to be able to gain that necessary economic reach.

CHAIR: So you still had the view that the initial strategy, which was, a VBA entry into Australia was the appropriate strategy but that option was not available to you?

MR MILLER: That option was denied to Air New Zealand.

CHAIR: But if that option had been available in 2000 -- well, 1996 and then 2000, do you think you would have preferred the VBA model for entry into Australia rather than what you did in terms of purchasing a full service airline.

MR MILLER: In hindsight that would have been the case, but by that time Air New Zealand was already a 50% equity owner and committed at that time to acquire the other 50%.

CHAIR: So, at that particular time you thought the best strategic alliance you would have, or ownership in another airline in another country, would have been a VBA airline?

MR MILLER: No, at that stage we had already acquired a 50% --

CHAIR: No, I know that. But going back to the original purchase; your preferred strategy was a value --

MR MILLER: The original approach; our preferred strategy was to acquire or build up an airline with a low cost to gain access to the market; very similar in the way -- as Virgin Blue did in Australia.

CHAIR: What I'm having difficulty with is why in those periods, whether it was a strategic alliance or a merger, or acquisition, or whatever you want to call it, at that point in time the preferred strategy for Air New Zealand was to have in Australia an arrangement of some sort with a value based airline, but now the preferred strategy is for Air New Zealand to go into a strategic alliance with a full service airline; and I'm having difficulty understanding at which point it became the preferred strategy to go into an alliance, or an arrangement, or a merger, or acquisition with a full service airline rather than a value based.

MR NORRIS: If I can enter at this point. My understanding is that Air New Zealand was given little choice other than being told that its option to enter the Australian market at that point in time in 1996 was through Ansett.

CHAIR: Is that the situation now then? That you have little choice and so you are seeking a strategic alignment with a full service airline, and if you had a choice you might get greater value in a value based airline?

MR NORRIS: As I said a little earlier, Madam Chair, I will address that issue in the balance of my address --

presentation.

CHAIR: I hope we do come back to that question, otherwise we'll be following it up shortly. But I'd just like to ask our staff and external advisors if they have any questions at this point in time? [**No questions**]. Thank you, please continue Mr Norris.

MR NORRIS: As I said, the market conditions affecting Air New Zealand are relatively benign and there has been a temporary lull in new activity. The imminent increase in Qantas capacity, the arrival of Virgin Blue on both the Tasman and New Zealand main trunk routes and the arrival of additional major Fifth Freedom capacity on the Tasman will dramatically change that environment.

Much has been made by those who would object to the proposed Air New Zealand Qantas alliance by the so-called war of attrition. I would like to clarify this issue at least from Air New Zealand's perspective.

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

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

The competitor normally reacts by also increasing capacity and nullifying the attacking airline's new advantage. However, sometimes the other airline will falter and not respond; perhaps it does not have the financial strength or the access to additional aircraft to allow it to respond. In such a case the attacker gains the advantage and inevitably claims market share. These are well tried and tested FSA characteristics.

This is what Qantas has said it intends to do. If it didn't, Air New Zealand would see that as a failure to take advantage of an opportunity. In evidence we've provided to the Commission under confidential chapter 6 of our submission on the 20th of June, figures 1 and 2 on page 3, we exampled an analysis by the Airline Planning Group showing how such competition occurs and its outcomes, and this has really between United Airlines and US Airways, and also TWA. David Bental from the Airline Planning Group will discuss these issues in a later session.

CHAIR: Can I just ask you, how long do you think this steady crumbling away of assets takes before it reaches the point which its war of attrition is won?

MR NORRIS: It's probably a matter of some years, probably something in the order of, I would imagine, 3, 5, 6 years, it may be sooner, it may be longer; it depends on the aggressiveness of the increasing capacity from the player that is in the position to -- with the deepest pockets.

MR CURTIN: I wonder if I can follow that up. I appreciate the war of attrition has been thrown around as a term, and people have understood different things.

I was wondering; both parties in a war of attrition must have at the back of their minds ultimately the fact that the cost of capital are meeting their cost of capital has got to bite at some stage, and both parties must see that there is some limit rather than dumping another million shells on the other party's position.

Isn't there some kind of economic bound as to where the parties will stop rather than grappling each other and falling over the precipice?

MR NORRIS: Well, it comes to the point as to what the difference in strength is between the two parties, and I think David Bental will actually give some good examples of that in regard to what has happened in other markets where this type of competition for city presence has taken place, and I think that that will I think give a very clear understanding to the Commission of the thinking behind full service airline approach to this type of situation.

MR CURTIN: Thank you.

CHAIR: I'd like to follow that up as well, if I may. You talk about it depending on the economic strength of the different parties, and I wonder how much does it matter, the economic strength of the various parties in the particular markets they happen to be in, or is it the economic strength overall?

Because, you compared -- talked a little bit about what happened to Ansett facing Qantas in Australia, but arguably in New Zealand, of course, Air New Zealand is the Qantas of

Australia, so what is it that matters? Is it overall economic strength across all markets, or is it the particular market that you happen to be looking at?

MR NORRIS: I think in this situation here that we have a single aviation market that allows both Qantas and Air New Zealand to effectively operate almost as domestic airlines in one another's markets. The Australian market is a significantly bigger market than the New Zealand market and so therefore the challenge for Air New Zealand, given its limited resources in regard to Qantas, is very much more difficult to expand its ability in its own right into the Australian marketplace, when you take a view such as Qantas that New Zealand becomes part and parcel of that Australasian network.

CHAIR: I'm now thinking about the New Zealand domestic market. In terms of who has what sort of market power and strength in the New Zealand domestic market, what is it that matters? Your current position in the New Zealand market, or is it your overall position, and how do you weigh those two bits up?

MR NORRIS: At the moment our position in the New Zealand market is relatively strong and as I've said the situation is, that is brought about by a relatively benign competition environment. But if you roll forward over the next 2 or 3 years you can see a situation where Qantas, with its larger network presence, its larger connectivity in this part of the world, will bear weight on the New Zealand domestic market as they go through a process of lifting their capacity because it's in their interest to do so, to take the further on-traffic out of New Zealand into their larger more diverse network in other parts of --

CHAIR: What I'm trying to get a sense of is, how important is connectivity in city presence within New Zealand to protecting your market share in New Zealand? How important is it as opposed to connectivity offshore, in protecting your domestic position within New Zealand?

MR NORRIS: We are a network airline so our network is our total network, which is the regional network, short haul and also Tasman and long haul. So, it is an integrated network. So therefore, if one part of the network -- core of our network, which is our home part of our network, comes under significant threat then it does have the ability to significantly -- or will significantly weaken Air New Zealand.

CHAIR: Yet, if Qantas doubles the capacity in the New Zealand domestic market, will they be able to match Air New Zealand's market position domestically? And to what extent? How would you quantify their ability to match?

MR NORRIS: Well, capacity share tends to track market share, so what will happen is that there will be a reduction in Air New Zealand's market share, a reduction in its revenue base.

CHAIR: I'm trying to understand; if they double their planes in New Zealand -- which I believe they're not even threatening to do that, they're threatening to nearly double them -- how close will they come to matching Air New Zealand's own presence in the New Zealand domestic markets?

MR NORRIS: If they double their current situation they will -- on the jet services, will equal or exceed our current position in the New Zealand domestic market.

CHAIR: Across the whole of the domestic market?

MR NORRIS: On the routes that are serviced by jets, the main trunk routes, they will be -- they would have greater capacity than we would.

CHAIR: Okay. And that takes account of any projected increases by Air New Zealand over the upcoming period?

MR NORRIS: That's based on --

CHAIR: Where you are now?

MR NORRIS: Where we are now.

CHAIR: We'll come to that later, I think the issue of what you might have to track. Please continue.

MR NORRIS: It follows from what I've said that for Air New Zealand as an FSA providing network services internationally and in domestic New Zealand, Qantas' announcement that it intended to increase services in domestic New Zealand by the addition of three 737 aircraft came as no surprise. The Qantas position is the reverse of the logic of Air New Zealand wanting a sustainable position in the domestic Australian market. Indeed an examination of Chapter 3 of our 20 June submission makes it clear that all airlines, including VBAs, enter geographic markets with small volumes of capacity and steadily increase them.

Two of the examples depicted in our evidence in chapter 3, figures 9 and 11, pages 31 to 33, disclose how WestJet in Canada and Virgin Blue in Australia as VBAs both achieved steady growth in their presence by adopting this methodology. Virtually all airlines compete and grow in this way.

The logic of Qantas increasing its capacity in New Zealand is little understood by those not involved in the industry. This has led to a plethora of claims that our counterfactual is unbelievable or unrealistic. I venture to suggest that there are no industry experts or knowledgeable commentators who would not instantly recognise the logic of

Qantas increasing its capacity in the manner suggested, and this view will be confirmed by a number of experts later in our evidence, including Dr Michael Tretheway and David Bental of APG.

I believe it is now clearly beyond issue that Virgin Blue intends to enter the Tasman market and the New Zealand domestic market in the very near future. In its latest submission to the New Zealand Commerce Commission, it says that it will do so and it says that it will do so in a manner that will constrain the alliance. Evidence on the subject will be provided by a number of witnesses, including Doctor Michael Tretheway, Mr Andrew Miller our Chief Operating Officer, Mr David Bental, a director of the Airline Planning Group, Dr Clifford Winston, Professor Robert Willig, and Dr Margaret Guerin-Calvert, and Mr Ray Webster, the Chief Executive of easyJet.

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

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

In its most recent submission to the Commission, Virgin Blue has confirmed that it accepts the arguments advanced by us to the Commission in chapter 3 of our 20 June submission. I would suggest to the Commission that all the expert industry evidence supports Virgin Blue's entry into both the relevant markets at a constraining level and there is no evidence that argues the negative, at least of an informed or credible nature.

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

CHAIR: Excuse me Mr Norris, we'll just have a question, please, from Commissioner Bates.

MS BATES QC: Just going back to the ACCC's determination and a statement in it I'm just going to ask you to comment on; it's at paragraph 9.97. It says:

"Based on the applicant's estimation of their schedules if the proposed arrangements are approved and if the assumptions about Virgin Blue's presence is proved correct, this is effectively a best case scenario in terms of the level of Virgin Blue's competitive constraint, the Applicants would be operating at almost six times the capacity of Virgin Blue in year one and four times its capacity in year three."

Is that statement accepted by the Applicants or are we going to hear some evidence that contradicts it?

MR NORRIS: We'll come back to that, if we can; I don't have that information off the top of my head.

MS BATES QC: That's fair enough. I'll remember.

MR NORRIS: But I think the important issue here is that we will be presenting evidence that does demonstrate that the entry of a value based airline to a level of -- low levels of entry of only 5% do have a significant impact on pricing.

MS BATES QC: Did you present that evidence to the ACCC?

MR NORRIS: No.

MS BATES QC: So that that's some evidence they didn't have?

MR P TAYLOR: They didn't have it supplied in the 20 June submission, so it was through subsequently.

MR NORRIS: There is only room in the New Zealand domestic market for two airlines, one FSA and VBA. One full service airline will be forced to leave the market unless Air New Zealand and Qantas are able to sufficiently link their services such that effectively they become one FSA.

The New Zealand market has found it possible in the past to maintain two FSAs. It is quite illogical to believe that in some magical way it can now sustain three airlines.

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

When Virgin Blue enters the New Zealand domestic market it will result in a further reduction in fares because Virgin Blue will have the lower cost base. That is how VBAs compete. It does not have the burden of operating 75% of its businesses on overseas routes; it merely flies point-to-point. While those lower prices will further stimulate passenger numbers, analysis of VBA entry in Australia shows that lower fares arriving from the arrival of Virgin Blue has tended to cancel out the extra passengers leaving total revenue virtually unchanged. This is similar to Air New Zealand's experience as a result of the introduction of Air New Zealand Express. What does change is the total industry cost which increases by the addition of the total cost of the new entrant -- in this case Virgin Blue -- plus the cost of the increased capacity of Qantas.

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

CHAIR: Can I just stop you there for a second. If I understand, your submission is that at most New Zealand will support two airlines. And I just wonder, if that's the case, then -- and if the Commission accepts that submission -- it seems to me that you've presented us with a powerful argument that the best bet to ensure that New Zealand gets as much public welfare as possible, would be to ensure that Virgin Blue can enter and drive down costs and prices, and if one airline has to go to the wall, well, it might as well be the most inefficient one, and allow the new entrant space to compete.

And I just want to put it to you, why is that -- why is it obvious that Air New Zealand should somehow be treated differently to any other firm in this country, that it either competes or it leaves the market?

MR NORRIS: The issue here is the fact that Air New Zealand is a relatively low cost provider as an FSA. The situation we have here is our view that, if we look at the fact that this airline does operate with 75% of its services offshore which are marginal in performance under the current model, we are in a position where we can compete reasonably or effectively in the domestic market.

This company has to look very seriously at what it is going to be if this authorisation does not go forward. That is, Air New Zealand as it currently is constructed and the benefits that it provides to the New Zealand tourism marketplace, and what the flow-on effects may be are in your hands. But from my perspective I would suggest that Air New Zealand is a very effective domestic operator, but its position at the moment, as is compounded by most long haul airlines, it does have difficulty making a reasonable return on its capital.

So when we look at Air New Zealand as a whole, that is the issue for this company going forward.

MR P TAYLOR: Some of this takes the airline into an area of confidentiality that will be covered in detail with detailed financial resource during the confidential session.

CHAIR: That's fine, I just want to follow this up and if you can't answer it until the confidential session, please tell me.

If I understand your submission correctly here, Virgin Blue, on your submission will enter, and because of its lower cost structure than even you have with your changes in your strategy will force prices down in the New Zealand market?

MR NORRIS: That is our belief.

CHAIR: But your submission is; is even compared to the VBA entrant, Virgin Blue, that Air New Zealand can compete effectively?

MR NORRIS: I'm saying that on an FSA basis we are a very -- we are an effective competitor. Our view is that, in the best interests of Air New Zealand going forward, and this will be obviously touched upon in the counterfactual as Mr Taylor has mentioned, we will cover this in more detail.

CHAIR: I will then want to come back to this issue, because it still leaves for me the question, what is it about Air New Zealand that somehow requires that -- in a situation where this economy, if you are correct, can only support two airlines, what is it about Air New Zealand that suggests it should get different treatment? If it can compete, fine, if it can't, there's room for two airlines, and the VBA entrant is the one that you suggest will lower costs and lower prices and increase consumer welfare; why should this Commission allow an arrangement that arguably increases entry barriers to that VBA entrant who is going to bring about these consumer benefits?

MR NORRIS: We don't believe that this alliance will actually negate those benefits. Our belief is that, it's not a case of New Zealand not being able to support a single VBA. Our view is that there's an FSA and a VBA and we believe that a single FSA versus a VBA, because of the fact that they operate as different types of airlines, the models are different and different for different reasons. That is, that people have a requirement for greater frequency, they have a requirement for interconnectivity, they have a requirement for longer haul services being dovetailed into an itinerary rather than a purely point-to-point low service model that is provided by a VBA.

So we're not saying that this would in any way shape or form prevent the people of New Zealand benefitting from the opportunity of having the option of a VBA offering.

CHAIR: Do you accept the proposition that it is the entrance -- possible entrance of a VBA that is now driving innovation, lower prices generally, improvements in consumer welfare in New Zealand? Do you accept that general proposition, that that right now is what is driving the latest round of competition in this market?

MR NORRIS: It's partly that. It's partly also our view and contention that FSAs have to modify their service offering as well without taking away the elements that are valued in that full service airline model, and certainly the work that

Air New Zealand did in the early part of last year when it first started upon the move to Domestic Express and Tasman Express and going through the process of re-inventing itself, was obviously taken against the background of the market, where the markets were going, and making sure that there was an appropriate strategic response.

CHAIR: I just want to make sure I understand that comment. Is that because there are some segments that won't benefit from VBA entrance and, therefore, for consumer welfare to improve in New Zealand we need to see improved offerings in the, for instance the business sector and various other -- is that what you mean about the need for full service airlines to continue to improve their offerings?

MR NORRIS: I don't see that they're actually -- they're actually mutually exclusive, the VBA model and the FSA model. There's actually a lot of poor FSA models out there. So I don't see that you have one at the expense of the other. For a market to be served appropriately going forward it seems to me that there will be two models; an efficient FSA model and the VBA or LCC model.

CHAIR: What drives the efficiency in the full service model, in the bits that are being contested by the VBA in a situation like this where we have two airlines? If your predictions are right?

MR NORRIS: What drives the efficiency on the VBA is, it doesn't have the additional costs that a full service airline has. I mean, one of the issues that you get with a full service airline is that it carries a lot of legacy cost because of the fact that it is what it is, and it's become that over time where a lot of complexity has been built into the business.

Whereas if you start with any new business, generally speaking you will take the view that it's a clean sheet of paper, you will develop a model that is as simple as you can make it and, therefore, will have a lower cost base and generally you find with VBAs, they have Greenfield start-up options that don't necessarily occur to a -- happen as far as an FSA is concerned, so there are labour arrangements, and cost arrangements generally are at a lower level.

CHAIR: My question was really, what drives the improvements in product offerings and efficiency in the full service airlines segments that aren't being contested by the VBA? What drives that? A market with one VBA and one full service airline?

MR NORRIS: I think if you look at the full service airline -- there are two pieces to this. It comes down to what people are prepared to accept on a short haul versus a long haul environment. In a short haul situation they're probably prepared to take less leg room, less quality of meals, no in-flight entertainment and there's a sector of the market that will appeal to. There are other parts of the market who are the more affluent traveller, the business traveller who are looking for a more comfort orientated requirement, one looking at a loyalty arrangement rather than the value based approach which is a transaction by transaction approach.

So, the costs that you get being -- or the competition to date in the full service airlines has been based around facilities, it's been based around seat comfort, it's been based around in-flight entertainment, it's been based around quality of meals and belonging to alliances and providing frequent flyer loyalty programmes. Those have been the competitive elements that have driven competition, which has been more about, as you've gone through that process you've actually added cost and made the business model more complex.

MR CURTIN: Following up, if I may, your comment about legacy issues, I appreciate your point about newcomers and blank sheets of paper. Just following up your legacy comment; I mean many industries in the 90s went over to more aggressively searching out productivity and trying to generate positive EVA and all the rest of it, and you've been in it in other roles.

Do you think there's anything in the structure of the airline industry that encouraged the FSAs not to pursue that in the way that perhaps it was happening in other industries through the 90s?

MR NORRIS: I think, if you look at the aviation industry, there has been significant productivity gains over the last 25-30 years that have come through larger aircraft, lowered the price per seat per kilometre, lower efficient engines and things of that nature, so there has been productivity improvement. But if you look at what's happened with the overlay of aggressive competition, a lot of it's subsidised internationally, you've ended up with a situation where all the productivity improvements have generally gone back to the consumer, and that's largely one of the reasons why it's been difficult for long haul airlines in particular, or airlines that have a significant component of long haul to cover their cost of capital.

So, I think it's been a situation -- market distortions have had -- the bilateral arrangements and things like that have had impacts on some of those cost issues in the driving for revenue rather than the seeking out of the cost reductions.

MR CURTIN: Thank you.

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

Throughout the world, entry by VBA into markets has resulted in substantial reductions in airfares, and substantial efforts by FSAs to take cost out of their businesses and to become more efficient and effective competitors. With the arrival of Virgin Blue into the New Zealand domestic and Tasman markets, there is no way in which the alliance is going to result in increased airfares or decreased efficiencies.

I understand NECG and others using economic models suggest price increases are likely under the alliance. That may be so in theory, but in practice to the best of my knowledge nowhere in the world has a true VBA entered a market and prices have gone up. It goes without saying that in such an environment there will not be inefficiency.

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

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

Tourism amounts to approximately 9% of domestic gross product and ranks second only and then by a relatively small margin to the dairy industry in terms of earnings. Absent the alliance, you can be certain that there will be no airline service in New Zealand which will apply itself diligently to promoting in-bound tourism in the way that Air New Zealand currently does. One of the benefits of this alliance is that it will avoid the detriment of lost tourism as well as promote the increase in new tourism.

CHAIR: Can I just clarify with you, Mr Norris; you talk in that bit of your submission about sustaining the presence in international markets of Air New Zealand. I'm not clear actually what's going to happen to Air New Zealand's international routes in the face of alliance, particularly those that are loss-making.

Are you suggesting that you're going to maintain --

MR P TAYLOR: That again is going to be something for the confidential counterfactual. It is covered in that session and it does deal with future strategy.

CHAIR: Right. And it is confidential material that you are going to present?

MR P TAYLOR: Yes.

CHAIR: Thank you.

MR NORRIS: In its Draft Determination, the Commission expressed concern about the impact of incumbent response on potential VBA entry; most likely Virgin Blue. I would like to make four short comments in that regard.

In Australia Virgin Blue entered as a Greenfield entry directly into the heartland of Qantas and Ansett Australia. It did so in the knowledge that if ever Qantas was going to react, then attacking its home base was the best way to trigger that reaction. It entered, and some commentators would say came close to failure, but it did not fail, it forced the failure of an admittedly inefficient Ansett Australia and it is now the number 2 airline in Australia with 30% of the total market share. All that in two and a half years. That was its moment of greatest risk, but it did not bat an eyelid; it certainly did not back off because of fear of an incumbent response.

Virgin Blue has stated categorically that it will enter the Tasman and domestic New Zealand markets. It says it intends to do so in a manner which will constrain the alliance; the same airline entering with the same participants as incumbents but this time it's not Qantas' heartland but the much smaller Air New Zealand's.

Air New Zealand will be forced to fight for its survival. There are no signs that Virgin Blue has been deterred by this aside from trying to attain a commercial advantage by talking up the need for Freedom to be sold, Virgin Blue has made it clear it will enter the Tasman and New Zealand domestic markets regardless. No doubt this time it gains comfort from the fact that it is no longer a

Greenfield entry; it is merely expanding from an existing base and from airports where it's already very well-established. It is following the typical growth path of the VBA model.

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

CHAIR: Can I interrupt you for one second. I'd like to take any further questions up to this point and then I would like to take a 10 minute break to allow our transcripters time to rest. Can I just check with my colleagues whether they have any further questions up to this point.

MR PJN TAYLOR: You are going to discuss in the confidential session, I think, what happens if alternative survival becomes a question mark?

MR NORRIS: Yes.

CHAIR: One of the things I would like to just check with you is; we talk a lot about this Ansett failure, and make comparisons to what might happen here. But it seems to me at least possible that the biggest factor for Virgin Blue's ability to expand in Australia was the exit of Ansett.

When I look at the proposed alliance, Virgin Blue isn't going to have that advantage, and if it was a key advantage, which some suggest it was, by opening up product space offerings for Virgin Blue, it seems likely that it will be much harder for Virgin Blue in New Zealand than it might have been in Australia.

I just wonder if you can comment on what was the experience in Australia up until Ansett exited the market? What was the entry conditions that Virgin Blue faced? How much of the market had they been able to gain?

MR NORRIS: Well, the situation for Ansett in Australia had been one where their competitive position had been deteriorating from aggressive competition, but fair I must add from Qantas in the fact that Ansett went from a position of having the larger market share in the Australian marketplace, in excess of 50%, to a market share at the entry of Virgin Blue of -- in the very low 40s. With the entrance of Virgin Blue the Ansett market share continued but fell away quite sharply to around 35, 36% and that came off the top of its revenue. But the fact of the matter was that Virgin was making very good headway.

At the time that Virgin entered there was another VBA entered the market at the same time, Impulse, so it was a pretty -- it was a reasonably crowded marketplace.

CHAIR: Which of the companies had the cost advantage? Ansett or Qantas?

MR NORRIS: Qantas had the cost advantage.

CHAIR: So it's not surprising, is it, that the full service airline that lost to a greater extent was the one with the cost disadvantage, is it?

MR NORRIS: Well, in the marketplace there; I mean, as far as costs have been concerned -- and I haven't got the figures at my fingertips -- but if you go back to a situation when Ansett had a higher revenue base, it had a cost base, it was able to obviously sustain that revenue base. The reason for

Qantas getting an advantage over time was the fact that it was able to increase capacity, and it also had the benefit of a significantly greater network power.

CHAIR: I understand those points, but what I want to be clear of is, Qantas had the cost advantage over Ansett when Virgin entered in Australia?

MR NORRIS: Yes.

CHAIR: And you think this might be significant to how they fared?

MR NORRIS: Absolutely, it was part of what happened over a period of time.

CHAIR: What I'm troubled with, when I think about what happened here, of course absent the arrangement is, that's not the circumstance here. It seems clear to me, and undoubtedly we'll come back to this, but I'm talking in general terms, it seems clear to me, please correct me if I'm wrong, that Air New Zealand has a substantial cost advantage over Qantas in the domestic market. And I wonder then how relevant this comparison is to what happened to Ansett, and I value your comments on that.

MR NORRIS: In regard to Qantas, certainly I don't know specifically what their cost base is; I mean, we obviously make some assessment, but Qantas has taken an alternate course here in New Zealand with the creation of a New Zealand based cost base around a company called -- an institute called Jet Connect, and so, they recognise the fact that this is a different market and are approaching it in a different manner.

MR P TAYLOR: And your assessment of that?

MR NORRIS: My assessment of Jet Connect's costs, would only be an assessment, but I imagine that they're probably not too dissimilar to Air New Zealand.

CHAIR: What's the capacity of Jet Connect, in the New Zealand market?

MR NORRIS: Market share at the moment for Qantas in New Zealand on -- is around 25%.

MR NORRIS: The capacity, they have around about --

MR MILLER: In the total market, just the jet market?

CHAIR: I think that's what my colleague was going to pursue.

MR NORRIS: The jet market; they have six 737s in New Zealand, five that are scheduled; so I think the sixth is a spare. Is that right? Yes, at the moment, against 11 aircraft that we have in the marketplace at the moment, in that market.

CHAIR: What I would like to do now is adjourn for 10 minutes, it will be a very short break, come back and I propose to carry on with this session until 1 o'clock, which is when we will break for the lunch. I know that we're taking a bit longer, Mr Norris, but it's quite helpful for us to be able to put the questions directly to you. So we're appreciative of your patience in that respect.

Can I just say before you leave that the toilets are around the corner to the left of the lift, and you do need one of these cards or you'll get locked into that, or actually will never even get into the corridor. So, I think they're available at the back of the room. Thank you very much.

Adjournment taken from 11.50 am to 12.10 pm

CHAIR: I'm just going to reconvene the session now. I am aware that when we did the introductions we did not introduce Mr Dixon who's been on the video conference patiently waiting for us to come to his session. So, I would just like to welcome you and thank you for being available to the Commission this morning, and on that note Mr Norris we will continue with your presentation.

MR DIXON: Thank you Madam Chair, I look forward to talking later.

MR NORRIS: Madam Chair, if I can restart. I'll now cover the issue of Fifth Freedom carriers.

The seven Fifth Freedom Airlines flying the Tasman provide a major constraint on Air New Zealand and that will continue with the alliance. Currently they price 25% of available capacity on the Auckland to Sydney route and 44% of the available capacity on the Brisbane to Auckland route. That capacity is increasing with the commencement of the widely advertised arrivals of Royal Brunei and Emirates.

Importantly, these carriers actually carry 17%, or just under 17% of the Auckland-Sydney origin and destination traffic and just over 20% of Auckland-Brisbane origin and destination traffic. That is the traffic that is specific to those particular city pairs.

There is no way in which carriers with that level of market share can be ignored. Later in the Conference John Harrison from Air New Zealand and Peter McCumstie from Qantas will explain how Fifth Freedom constraint occurs in practice, and in doing so they will explain in simple terms the complexities of yield management.

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

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

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

The second point I would like to make is that under the alliance arrangements it is not Qantas that will manage and operate Air New Zealand, it is Air New Zealand's management and board which will manage the whole of the Air New Zealand's operation together with all of Qantas' commercial operations into, within and out of New Zealand.

True, there is a provision for a combined Air New Zealand and Qantas committee to advise and make recommendations to the Air New Zealand management team. But that is all they do. They cannot direct Air New Zealand to alter its operations in a way that Air New Zealand does not wish to do so.

In any event, that advisory committee is made up of six persons; three from Air New Zealand and three from Qantas. Unless Air New Zealand also agrees, there cannot even be an advisory recommendation made to the management of Air New Zealand by that committee.

CHAIR: Can I just stop you there for a second, please. I just want to get a sense from you; how important is it the number of directors in terms of influence? And I guess the question that I have in the back of my mind really goes to this; it seems to me that one of the major motivations for Air New Zealand in going into this strategic alliance is to get access to much needed capital, and it also seems to me that Air New Zealand will be at the mercy of Qantas with respect to accessing that capital.

Given that Air New Zealand doesn't -- in its management and board doesn't directly have the means to support its own business decisions without the support of Qantas, it seems to me that Qantas, at least at this point in time, has a very significant control over everything that Air New Zealand management and board might want to do, particularly given the information this Commission has been given about the capital requirements of the company.

So, I'd just like to get your response to that, if I can, Mr Norris.

MR NORRIS: In regard to decisions of the board, the Board will obviously make decisions based on best information and recommendations of management and will obviously test those views.

Certainly, Qantas will have two directors out of 10, so that gives them 20% of the vote on the board. As far as capital is concerned, being a 22.5% shareholder and capital requirements for the company going forward, there would be an issue as to whether or not Qantas would support various development proposals for Air New Zealand from the point of view if there were additional capital calls and the shape of those.

Our belief is, in our discussions to date, that Qantas very much sees the world going forward in a similar manner as we do. We see the opportunity for us going forward to make much more effective use of the Qantas network offshore from the point of view of the fact that they will obviously be buying larger aircraft and the like that may not be appropriate for Air New Zealand to purchase, and from a cost perspective it would make sense for both entities to have an ability to share those costs and reduce the cost base that would need to be supported by customers going forward.

CHAIR: I understand the point about some alignment in some areas. My question really is, how do any decisions of the Air New Zealand board and management really get made? Almost anything would require investment of some sort, and it seems to me as soon as you're in that realm, you're highly dependent on Qantas, and even if they have -- even if there are benefits that both of you had from the alliance, it still seems to me that your decisions, whatever they may be, are still conditional, and they're conditional on your gaining the support of the Qantas board, and in that sense what I'm putting to you is that, the independence of the New Zealand board management is really quite constrained.

MR NORRIS: Well, the capital injection that goes into the business with the -- with Qantas coming in as a shareholder does place Air New Zealand's capitalisation at one of the better levels, if not in the top tier of airlines going forward, so we do end up in a situation vis-a-vis the size of the company, with a capital base which is probably amongst the best positions the company has had. It is then in a position to enter into aircraft leases and replace existing aircraft leases in a way that there would be the ability to do a reasonably significant refresh of the fleet.

CHAIR: If that capital injection puts you in the top tier, how would you describe your current position, vis-a-vis other companies and other airlines in the world?

MR NORRIS: Our current position has improved, there is no doubt about that, with our better performance over the last 12 months in a benign position. I would suggest at the moment we are in the -- would be well and truly in the top half of full service airlines in regard to our equity position.

CHAIR: Right. Thank you for that.

MR NORRIS: 9.3. If I can summarise the position; without the alliance, Air New Zealand would be at best competitively marginalised or at worst, lost to New Zealand. With the alliance, Air New Zealand will be able to link with Qantas as a single FSA constrained on short haul routes by the presence of a potential entry of the VBA Virgin Blue. It will be able to achieve efficiencies which not only benefit Air New Zealand and Qantas but will also benefit New Zealanders.

The alliance can cease what is commonly known as wingtip flying, where both airlines compete on flights departing at exactly the same time. As a result, passengers will have a greater spread of flights throughout the day, both domestically and internationally. We will be able to achieve greater efficiencies by using a larger aircraft rather than two smaller aircraft on some routes.

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

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

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

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

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

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

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

MR PJN TAYLOR: Can I just clarify then, Mr Norris, the point that's being made here is that it's Air New Zealand's position that there is no other alternative potential suitor?

MR NORRIS: Correct.

From a national perspective, the alliance provides substantial supportable net benefits to the New Zealand economy.

A. While difficult to quantify, it provides the means to provide a New Zealand owned and controlled flag carrier having all the necessary incentives, capability, and willingness to encourage tourism growth for New Zealand.

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

C. It allows for improved scheduling, including more direct flights.

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

E. It enables Air New Zealand Holidays to cheaply access the Qantas Holidays intellectual property and its vast network.

F. It provides a basis for Air New Zealand's first class engineering services to secure greater portions of Qantas' engineering and maintenance requirements, and additionally creates leverage in servicing other third parties.

G. It provides increased freight opportunities for New Zealand's export industries at a time when otherwise the new A320 aircraft will reduce available freight space.

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

CHAIR: Can I stop you there for a second, Commissioner Bates has a question.

MS BATES QC: Mr Norris, you will recall I asked you a question about the profitability of the domestic business compared with the international business and your answer I think was that the international business was at present unprofitable;

am I correct in...?

MR NORRIS: This year we will make a small profit, but --

MR WARBRICK: Generally the international business is about break-even. Most of our profits are sourced from the domestic business.

MS BATES QC: So there's been an improvement, has there, in that area?

MR NORRIS: There has been an improvement and that's been due to issues that have resolved around the Iraq War, issues that have evolved around SARS, which have given us possibly a better outcome than a lot of other international airlines because of the fact that we were seen as a safer destination.

MS BATES QC: So how significant has the improvement been?

MR NORRIS: It's been a reasonably significant turn around from where we were the previous year, but then we had the problems of 911 which exacerbated 2002's result. So, 2003 has been, relatively speaking, a good year, but still in profitability terms, I mean, we're talking about a return of probably something in the order of 1 to 2% return on capital employed.

MS BATES QC: Thank you. Now, is that the same for Qantas? What's its profitability on its international routes compared to --

MR NORRIS: I suggest that you ask Mr Dixon.

MS BATES QC: Do you have no idea? Come on.

MR NORRIS: I haven't seen their latest results.

MS BATES QC: Are they in the position same as you?

MR NORRIS: Generally speaking I think that Qantas' international routes have been more profitable than Air New Zealand's.

MS BATES QC: Now, how do you think that merging with -- not merging with, but the proposed alliance will help Air New Zealand on the international -- with the international parts of its business? How will it work? I'm just quite interested in that.

MR NORRIS: I think the issue for us is, it gives us the ability to access Qantas' broader network, from the point of view of being able to provide better connections to other parts of the world going forward. I think that from our perspective the ability to manage freight more effectively is a significant benefit.

We've talked about the issues of wingtipped flying; we have the same situation between here and Los Angeles, and so, generally speaking there's an opportunity to have a more efficient use of aircraft and different size of aircraft as well.

MS BATES QC: I'll just put this up to you; is it one possible scenario that Air New Zealand concentrates on the Tasman and the New Zealand domestic, and Qantas has a freer hand with the international business?

MR NORRIS: The situation currently is that a lot of the bilaterals are based around country to country agreements and based around designated flag carriers, and certainly we do not have internationally at this stage a single aviation market worldwide. So, there are some restrictions that would prevent Qantas from doing that.

MS BATES QC: So you say it's not a possible scenario?

MR NORRIS: Not currently, under the current -- could be; things change.

MS BATES QC: Could be an efficient way of managing the business for the future?

MR NORRIS: I think the issue here for us comes back down to, again, the promotion of New Zealand as a tourism destination, and certainly the fact of the matter is that there are some markets where the Air New Zealand brand does do very well.

MS BATES QC: So, say the -- just theoretically speaking, say Air New Zealand cut back on its long haul operations; do you think that Qantas would promote New Zealand tourism in the same way that Air New Zealand does?

MR NORRIS: I think the issue -- whether or not they do that -- I think the issue here is this whole issue of the network capability and requirement that comes out of FSAs. Our belief is that the best way to get the best of both the Qantas brand, the Air New Zealand brand, is to operate in alliance to the world markets internationally.

MR P TAYLOR: Could I intervene and ask one question of Mr Norris, just clarifying a point. Mr Norris, could you just clarify the nature of the bilaterals; are they in any way within the airline's control?

CHAIR: I think the Commission can direct the questions to your client. I think that's probably the appropriate means.

MR NORRIS: I think that the situation at the moment is one that we are getting into the area of hypothesis and speculation. The issue is --

MS BATES QC: I'll tell you what the concern is, if you want to put it absolutely, so that there's no misunderstanding.

In the future we wouldn't have the advantage of New Zealand tourism being promoted in other than the Tasman and domestically; that there would be a decrease in that?

MR NORRIS: If Air New Zealand disappeared from the marketplace and those markets, that's --

MS BATES QC: What if Air New Zealand goes along with this arrangement and it's decided that it's better for Qantas to do all the long haul stuff?

MR NORRIS: The issue -- the situation is one where this alliance has been set up on the basis that Air New Zealand is going to manage the Qantas operation, commercial operations to, from and within New Zealand. There's no way that the board of Air New Zealand is going to sanction a situation which is going to see -- is going to be to the disadvantage of Air New Zealand, and we have made the point very strongly that the advantages that Air New Zealand does accrue to New Zealand tourism is significant.

MS BATES QC: But I mean, if that was the only way that you could get the capital that you needed, what would you do?

MR NORRIS: I think as I've said a little earlier, the injection of capital that comes from Qantas and the work that we are doing inside the business to make it obviously more efficient, we believe that the capitalisation of Air New Zealand with the injection that comes from the capital provided by Qantas as part of this alliance, does put Air New Zealand into the top tier of airlines from a capital perspective, which gives the company a lot more financial flexibility.

MS BATES QC: Thank you.

MR NORRIS: All of the above benefits have been the subject of intensive economic examination and quantification by NECG, supported by some of the world's leading economists. I do not attempt to summarise here the outcomes of their deliberations, they will do so directly to the Commission over the course of the next few days.

What I can say is that I have read the papers they have prepared and filed with the Commission. In particular, I have read and noted the papers from Professor Willig in which he provides a damning view of the modelling work carried out for the Commission by its external expert, Professor Gillen and equally damning view of the modelling work carried out by Professor Hazledine which will be tabled in the evidence to be given by Professor Willig.

I have yet to see any expert economist with an industry understanding examine the NECG model on which our benefits are based and discredit in any material way the model, the methodology, the implementation or the theory upon which NECG have based their report.

Of course, there are available criticisms of the NECG report but none of them go to the overall veracity of the model -- a model which I am informed is utilised widely in the other jurisdictions for assessment of airline mergers and alliances.

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

CHAIR: Can I just stop you there for a minute, please. Having read Professor Willig's submission, I'm not at all clear that he's been given access to the NECG model. From what you've just said I take it he has had access to it and has reviewed it.

MR NORRIS: I've been advised that that's the case.

CHAIR: Thank you.

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

CHAIR: Can I just stop you there, I would like to go back to the comment you made earlier, Mr Norris, about -- and I'm sorry to do this, to go back so far into your presentation, but you talked a little bit about, when the Board considered an alliance with Virgin Blue it was considered to be at best temporary. I just want to get a sense of why it would be temporary and what did you mean by "temporary"?

MR NORRIS: Well, there are a number of issues that fall into this. I mean, there are the ownership issues of Virgin Blue where there are -- there's Patrick Corporation and there is the Branson Group. There is not, from our understanding, absolute unanimity between the shareholders, and I think there's been some coverage of some of that in various newspapers.

So, the issue from our perspective is, what parties are you dealing with, what is the organisation going to look like going forward.

Secondly, the VBA model is one that is predicated on growth, and a company that had the intention to list, wanting to put itself in a position going forward that it did have significant growth opportunities, which is the premise behind the growth or the business model of a VBA.

So when we looked at the fact that our business is a network business; their business is a point-to-point business, we felt that while there may be some temporary benefits, we couldn't see that going forward that that option provided Air New Zealand with a satisfactory alliance partner going forward. The differences in the business models, the undoubted significant benefits that could accrue from a Qantas alliance from our perspective was significantly more beneficial to Air New Zealand than an alliance with Virgin Blue.

CHAIR: Will the strategic alliance with Qantas, if it goes ahead, limit Air New Zealand's ability to reposition itself more towards certain sort of offerings that look similar to what value based airlines offer?

MR NORRIS: I think it's probably pretty -- Madam Chair, Air New Zealand is concentrating on making itself what could be regarded as a low cost network airline. We are looking at all of the facets that make up our business and asking ourselves the question, does this add value to our business? Does it add value to the customer? If it doesn't, then why are we doing it? And that has been the premise about what we have done in regard to Domestic Express and Tasman Express.

I don't believe we're convinced that there won't be any deviation from that strategy. We are a company that, if we are going to survive, then I think all full service airlines are going to have to take a similar review of the way that they operate. There are differences in the models between a VBA and an FSA, and there will always be so, but the fact of the matter is that there's no doubt that there have been efficiencies in the way that the full service airline model has developed over time.

CHAIR: I just want to follow-up one other point on this earlier submission. You indicated that -- in the written submission that you provided us with, and that you've just spoken to -- that one of the issues for Virgin Blue is that in Australia there's only limited growth available and that the Tasman and New Zealand domestic markets are two of the more material and stable sources of growth for it, and that in my reading of that part of your submission you were suggesting that that was one of the reasons why any sort of arrangement with Virgin Blue would be temporary. You indicate in that that Virgin Blue would have to enter New Zealand eventually in order to realise the growth that was available.

What I don't understand is, why that same factor doesn't affect Qantas.

MR NORRIS: The issue for us is with Qantas we are operating on a similar business model --

CHAIR: Sorry for interrupting, but I understand from your perspective. What I'm asking is from Qantas, why is Qantas' view on this different from Virgin Blue, that this is a market where the growth opportunities are more material and stable compared to Australia, and why does Qantas approach this market differently than Virgin Blue, in terms of not wanting to realise that for itself and not share it with a partner such as Air New Zealand?

MR NORRIS: I would suggest that that question is one that should be posed to Qantas.

CHAIR: Well, I'm interested in your views. Why would that be? Air New Zealand, who's put forward this proposition about Virgin Blue's behaviour, so you've speculated on Virgin Blue's behaviour and motivation. I want to know why that motivation doesn't, in your view, apply to Qantas?

MR NORRIS: Well, the advantage is that we have the Chief Executive of Qantas is sitting right to --

CHAIR: I know, but I'm interested in your view. I might pose the same question to him later.

MR NORRIS: I think the situation is that Qantas does see that an arrangement with Air New Zealand acts -- it is beneficial to them. Air New Zealand does have the ability to provide significant benefits to Qantas. We have very strong engineering capabilities which we are already carrying out significant work for Qantas on a third party basis, as we do for a number of airlines around the world, including Virgin Blue. I think that it would be, from their perspective, a strong Air New Zealand continues to provide them with access to those sorts of facilities, and so that would be one reason.

I think that Qantas respects Air New Zealand's operational capabilities in being able to access some of those. We appreciate Qantas' capabilities as well. There's been a shared history between the two companies over many many years where the companies have been able to co-operate operationally, and that happens here in the domestic New Zealand market where we act for them on ground handling and they act for us in Australia; so, there are a lot of linkages and a lot of benefits that each company has provided to the other over time.

CHAIR: Sure, and those benefits were accrued with or without the arrangement?

MR NORRIS: But in a completely different competitive environment.

CHAIR: Okay, thank you. Please proceed.

MR NORRIS: In the event that the Commission considers that it should gain additional comfort by imposing conditions on the grant of the application authorising the alliance, we have advanced a number of suggestions for conditions which might be considered appropriate and these were set out in our submission to the Commission of 20 June 2003.

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

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

To avoid any doubt, the offer made by Air New Zealand to Virgin Blue in the above letter, relative to domestic counters at Auckland Airport, will be included as a condition of authorisation.

A variation of the conditions previously provided to the Commission revise to specify the terms of the offer of Auckland domestic counters to Virgin Blue is now offered to the Commission.

The second concern expressed by Virgin Blue is dealt with by my earlier evidence when I discussed the advantage of VBA has over a full service airline due to its significantly lower cost base. This issue is also covered by the evidence of Dr Tretheway and that of Mr Andrew Miller. I have earlier refuted the issue that Freedom can become an effective fighting brand that will rule out entry by Virgin Blue.

Again, if the Commission requires more comfort, we have advanced two very simple conditions restricting Freedom's ability to be used strategically; it will not be used on New Zealand domestic routes or to fly Trans-Tasman between Auckland, Christchurch and Wellington, and any of Sydney, Melbourne and Brisbane for 3 years from when the alliance comes into force.

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

CHAIR: I'd just like to stop you there. I'm always troubled by conditions that are meant to deal with difficulties in the competitive environment that impose more difficulties of a different nature; in other words, limiting capacity. I mean -- and I always wonder, well where do you end up after all of that? Do we fix a competition problem by allowing another competition restraint to be put in place, and I ask myself, well, what are you left with in the end, and it starts to feel very third best to me.

So, I'd just like to hear your views really on how well does that really correct for any market problems that this arrangement might create, and would we really know what the impact will be?

MR NORRIS: I mean, that obviously is a very valid view. The issue for us is, how do you address a situation which does have a significant element of anti-competitiveness in it in the basic alliance itself? And the mitigating factor is creating a situation where competitive entry can be facilitated into the market, and so we're in a situation where Virgin quite rightly turns around and makes the point that Air New Zealand and Qantas working together have the ability to predate. And so it's very important from our perspective to provide an environment which does facilitate competitive entry, but does also provide a period of time where the new entrant has the ability to get a degree of entrenchment in the market.

CHAIR: I think there are a range of issues relating to conditions, including some legal issues that we want to work through with the Applicants but I think we'll leave it to a later time, if that's acceptable. Thank you.

MR NORRIS: So, some conclusions that can be drawn. The alliance provides a platform to create a viable future for Air New Zealand. This is an opportunity that is unlikely to be available to Air New Zealand in the future. If the applications for authorisation are declined, the risks to Air New Zealand's survival as a full service airline within an international network are grave.

The arguments put forward by us are robust. We said in December 2002, when we filed the original applications, that Virgin Blue would enter the Tasman and New Zealand domestic markets in a constraining way well within the Commission's two year timeframe. 8 months later we're giving evidence at a hearing where that outcome is assured in only a few months.

In its Draft Determination issued on 10 April this year, the Commission found that constraining entry was not likely to occur within such a timeframe. I believe the Draft Determination was severely tainted by that view. Far from prices increasing to the levels modelled by the Commission, I believe entry by VBA will ensure that prices are actually lower than those modelled by ours in our counterfactual. To the extent that any concerns remain, these are more than met by the simple conditions we have proposed.

Thank you.

CHAIR: Thank you for that, Mr Norris. I just want to ask the Applicants, is Mr Dixon going to also present?

MR P TAYLOR: Yes.

CHAIR: How much time do we think we'll need for that?

MR PETERSON: 20 minutes.

CHAIR: I'll just see if there are further questions before we go to Mr Dixon.

MR CURTIN: Just a couple of questions, really just to try and flesh out my background understanding of the industry, and one is, with the benefit of hindsight looking back at your time as the director at the time of Ansett struggling to get out of its hole; in retrospect what do you feel Ansett might or might not have done to compete in the situation it found itself?

MR NORRIS: I think in regard to my time on the board, we were half pregnant when I arrived; the company had a 50% shareholding in Ansett. It needed to get to 100% in order to enable it to put in place the programmes that needed to make Ansett more efficient.

A perfect storm effectively occurred at that time, when you had a situation that the New Zealand and Australian dollars depreciated some 20% against the US dollar. You had a situation where fuel prices tripled, and you had a -- on the back of what had been the Asian issues and things of that nature, there were a lot of things that came together.

On top of that you had the entry into the market of Virgin Blue and Impulse, and at the same time you had the two groundings of the Ansett 767s; all of those things together brought together a confluence of events that created a situation which was very difficult to come back from.

There were also conditions that were applied by the Foreign Investment Review Board in Australia in regard to the company's ability to make staff redundant during a certain time period. So, there were a number of -- on top of that, some pretty intransigent union issues as well. So, all of those things together brought about the demise of Ansett.

So, like many things that occur, it's not a single event in itself; it's usually the confluence of multiple events as it was in this case.

MR CURTIN: My second question is, from when you arrived at Air New Zealand either as director or as CEO, and you observe a company with 75% of its business barely washing its face and the other 25% is apparently where all the money is. Does that strike you as a typical situation for a business to be in, or what sort of management or board strategy might that lead you to consider?

MR NORRIS: I think the situation had not always been the same. If you go back to the early part of the 90s in particular, and rolling forward into early-mid-90s, Air New Zealand had been very successful with its long haul services and the bulk of the income was being made from long haul. In fact, its domestic operations were in pretty poor shape, and my colleague on my left here did a lot of work during the latter part of the 90s to reshape the domestic operations of Air New Zealand which have created a significantly profitable domestic operation.

So, you had a situation with additional competition and changes that took place with over-capacity internationally and trends in the international long haul business which have had a significant impact on the deterioration of yield.

MR CURTIN: Thank you.

MS BATES QC: I just want to just follow that up because it's an area I'm interested in as well. You say that in the early part of the 90s Air New Zealand was successful with the long haul operations?

MR NORRIS: Yes.

MS BATES QC: Unless I missed it, and I'm sorry if I did; why did that situation change?

MR NORRIS: I think it was a combination of factors; excess capacity coming into the market internationally, some fairly aggressive moves by some of the Asian carriers as they moved into routes in this part of the world, and it's also fair to say that Air New Zealand didn't do enough in investing in its -- reinvesting in its long haul product, and so it became less competitive from a product perspective, and I think it's also fair to say that management of Air New Zealand became probably more focused on the issues at Ansett.

MS BATES QC: So, since those times there hasn't been really the focus put into the international area?

MR NORRIS: Very much so, but I think the international business has significant issues.

MS BATES QC: So they're long-term longstanding problems?

MR NORRIS: Well, they're becoming longer term problems now, yeah.

MS BATES QC: Thank you.

CHAIR: Any further questions from Commission staff or experts?

PROF GILLEN: Mr Norris, I need to understand, in your statements you said that you expect that the increase in capacity that Qantas is going to offer is going to be through Jet Connect; is that correct?

MR NORRIS: Correct.

PROF GILLEN: You also made the statement that you would expect that, with the increase in capacity that Qantas is offering, you'd expect that there is going to be more on-line passengers moving from Qantas to Air New Zealand. Is that correct?

MR NORRIS: We expect that they will get a bigger share. If you put additional capacity into the market, we will believe that they will achieve a bigger share than they currently have; that market share does tend to detract capacity share.

PROF GILLEN: And, would you agree or not that New Zealand Express and Jet Connect offer fairly comparable services?

MR NORRIS: Currently, as far as the product to the customer is concerned, there's a difference in the product set. Air New Zealand offers a single class operation with its Express class, whereas Qantas offers a two class operation with full meal and beverage services to Jet Connect.

PROF GILLEN: Thank you.

CHAIR: Before we go on, I want to come back to an issue that arose earlier, Mr Norris, and that is the review by Professor Willig of the NECG model. I am aware that the

Commission has not been supplied with that and if such a review has been done, we request that that be done today, please. It would appear to me that it will be new evidence that has not been submitted up till this point, so I would ask that that be provided today at the earliest possible time.

Now, I'm aware of the time and I would like to ask the Applicants if it's their preference for Mr Dixon to proceed now? If it is Mr Dixon's preference I'm prepared to carry on longer this morning.

MR DIXON: Madam Chair, whatever suits you. We could come back at 2 o'clock your time if that suits you.

CHAIR: I think, if that's not a big inconvenience for you Mr Dixon, we will adjourn until 2 o'clock when we will resume the session with you.

MR DIXON: No. Okay, we'll see you then.

CHAIR: Thank you very much. We will start promptly at 2 o'clock if everyone could please be ready at that time. Thank you.

Adjournment taken from 12.58 pm to 2.00 pm

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