CHAPTER 5

THE COUNTERFACTUAL

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INTRODUCTION

5.1 In its Draft Determination on the proposed Alliance between Qantas and Air New Zealand, the Commerce Commission ("Commission") discounted Qantas' view of its likely future if the Alliance were not to proceed. Qantas' view of its future in the absence of the Alliance with Air New Zealand remains unchanged. This document sets out further material for the Commission's consideration, which addresses each of the arguments made in the Draft Determination, demonstrating why Qantas' Counterfactual is the most likely future outcome if authorisation is not granted.

5.2 The Commission argued that the expansion of capacity by Qantas under the Counterfactual should be discounted based essentially on the following factors.

(a) First, few parties considered the "war of attrition" to be a likely Counterfactual because Qantas would not want to release planes from its Australian domestic fleet.

(b) Second, if capacity expansion were Qantas' optimal strategy, it might be expected that such behaviour would be evident now, but this does not appear to be the case.

(c) Third, the increase in capacity reflected in Qantas' Counterfactual would be inconsistent with commercially rational behaviour.

(d) Fourth, the Qantas capacity increase would be unlikely to succeed if the Air New Zealand shareholders were to demonstrate a willingness to resist such behaviour by committing to support the company through any war of attrition and because the exit of Air New Zealand, the assumed outcome of the war of attrition, would leave no other airline to exercise the country's bilateral air rights.

5.3 Instead, the Commission expressed the preliminary view that if authorisation were blocked, then Qantas' next most preferred option might be to enter into tacit collusion with Air New Zealand. However, despite this preliminary view, the Commission reached a preliminary conclusion that the likely Counterfactual would involve, in the short-run, a continuation of competition from Qantas on the Tasman and domestic New Zealand routes, but with capacity being expanded in line with market growth, not accelerated to produce a "war of attrition".

5.4 Before turning to the issues listed above, the Applicants raise three preliminary matters.

5.5 First, the Applicants note that the Commission failed to consider any further the implications of Qantas' statements regarding the likelihood of tacit collusion as a preferred outcome for Qantas. If the Commission considered this a likely outcome then clearly the detriments of the proposed Alliance would have been substantially lower than those presented in the Draft Determination, yet the Commission does not acknowledge this.

5.6 Second, the Applicants note that the Commission's preliminary conclusion regarding the Counterfactual is inconsistent with the advice received from the Commission's own financial experts, Taylor Duignan Barry Ltd. In a letter to the Commission dated 11 April[1] these experts provided the following advice in relation to the Commission's Counterfactual:

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1 This letter was forwarded to Bell Gully by email on the 14th of May by Janet Whiteside.

> "The one comment (which we have already made) in relation to this Counterfactual is that the discussion on Qantas is specified in terms of an outcome for Qantas (i.e. "Qantas grows in line with the market"), that as far as we are aware has not been demonstrated to be commercially viable or attractive as a business strategy. We suggest this aspect of the Counterfactual is vulnerable to a Qantas response that such an outcome is not a sustainable position for them. The Counterfactual may therefore lose credibility. An alternative for the Commission might be to say something like "competition in the domestic market continues as before", with the precise outcome left unspecified."

5.7 Third, the Applicants draw the Commission's attention to the use of the term "war of attrition". Qantas' proposed increase in capacity, including in domestic New Zealand, is consistent with commercially rational behaviour and not unrealistically intense competition. It is the outcome of this increase in capacity leads to a "war of attrition", not an overly aggressive attack on Air New Zealand's market share, but a steady and gradual wearing down due to competitive pressure.

5.8 The remainder of this document is set out as follows:

(a) Section 1 provides a break-down of Qantas' planned capacity increases in domestic New Zealand under the Counterfactual to demonstrate that this expansion rate is consistent with the relatively early stages of an entry strategy, which includes not only the increase of capacity on existing routes, but the extension of services to new routes.

(b) Section 2 explains why the timing of Qantas' expansion plans into domestic New Zealand is consistent with Qantas' views on its future in the absence of the Alliance with Air New Zealand, as claimed by the Commission.

(c) Section 3 explains Qantas' commitment to domestic New Zealand. This is important given that the extent of Qantas' commitment might not have been understood by third parties.

(d) Section 4 examines why Qantas' Counterfactual is consistent with commercially rational behaviour.

(e) Section 5 describes Qantas' code-share arrangement with Origin Pacific ("Origin"), and the likely impact of the Alliance, and the Counterfactual, on Origin.

(f) Section 6 describes the effect of the Counterfactual on Air New Zealand which is explained in more detail in Chapter 6 of this Submission.

(g) Section 7 compares the Commission's proposed Counterfactual to that modelled by its economic expert, Professor Gillen, and discusses the inconsistency in the approaches adopted.

5.9 Because Sections 1 to 5 involve matters confidential to Qantas, they are described from Qantas' point of view. Section 6 is from Air New Zealand's point of view. Section 7 is from the perspective of the Applicants collectively.

SECTION 1: BREAKDOWN OF QANTAS' CAPACITY INCREASES

Domestic New Zealand

5.10 The Commission's concerns regarding the plausibility of Qantas' planned expansion of capacity under the Counterfactual appear to focus predominantly on domestic New Zealand. In domestic New Zealand, Qantas' Counterfactual Schedules reflect an increase in Qantas operated capacity by a total of **[CONFIDENTIAL]** between 2002/03 and year 3 of the Counterfactual. This equates to an increase from 5 B737s to **[CONFIDENTIAL]** B737s.

5.11 While this may seem like a large expansion on an aggregate basis, it must be understood that Qantas is still in the relatively early stages of the establishment of its domestic New Zealand operations, and hence much of the planned additional capacity is for the operation of new city-pairs. The increase in frequencies on key routes makes Qantas significantly more attractive to high yield passengers. In addition, Qantas already operates some capacity on these routes via its block-space code share with Origin. As a result, some of the change in capacity is essentially replacement of capacity obtained through (or that otherwise might be obtained through) that block-space code share. The current codeshare arrangement with Origin is described further in Section 6 below.

Qantas is still in the early stages of the establishment of its domestic New Zealand operations.

5.12 Qantas' plans in the absence of the Alliance involve incrementally growing capacity on existing routes and extending operations to new routes in order to better access the local domestic market. Qantas currently operates on just 3 city-pairs in domestic New Zealand: Auckland-Wellington (AKL-WLG), Auckland-Christchurch (AKL-CHC) and Christchurch-Queenstown (CHC-ZQN). For each of the domestic New Zealand city-pairs, the capacity expansion planned by Qantas under the Counterfactual and the compounded annual growth rate (CAGR) are presented in Table 1 below.

Table 1: Qantas' Domestic New Zealand Capacity Expansion

(ASKs per week)

City-pair	Current	Year 1	Year 2	Year 3	**CAGR (current to year 3)**
[CONFIDENTIAL]					

5.13 As can be seen from Table 1:

- over **[CONFIDENTIAL]**% of the increase in Qantas operated capacity under the Counterfactual is on the new city-pairs or city-pairs where Qantas currently has a minimal presence; and
- of that, **[CONFIDENTIAL]**% of the increase is devoted to **[CONFIDENTIAL]**.

[CONFIDENTIAL] % of the increase is devoted to [CONFIDENTIAL].

5.14 The growth rates planned on Auckland-Wellington and Auckland-Christchurch, the two major city-pairs which have been the focus to date of Qantas' domestic New Zealand operations, are modest and declining. While the growth rates for these two major city-pairs marginally exceed the long-term natural rate of demand growth, they are substantially lower than the growth observed in the first year of Qantas' entry into domestic New Zealand. Even with these growth rates, Qantas will still be at a frequency disadvantage compared with Air New Zealand on the

[CONFIDENTIAL](assuming Air New Zealand does not increase its frequencies), but [CONFIDENTIAL]. The importance of frequency to revenue shares and hence profitability is discussed in Section 3 below.

5.15 The high Qantas growth rate on [CONFIDENTIAL] reflects Qantas' plan to operate by year 3 of the Counterfactual [CONFIDENTIAL]. Qantas believes this level of capacity is reasonable given that [CONFIDENTIAL]. The level of capacity is [CONFIDENTIAL].

5.16 [CONFIDENTIAL].

5.17 Overall, the compounded annual growth rate for Qantas operated capacity in domestic New Zealand between the base case and year 3 is [CONFIDENTIAL]% (excluding codeshare capacity), which is [CONFIDENTIAL]. This [CONFIDENTIAL] plans for Virgin Blue in Australia.[2] [CONFIDENTIAL].

The compounded annual growth rate between the base case and year 3 is [CONFIDENTIAL]

Modelling of Commission's growth assumptions

5.18 Qantas notes that even if the Commission's assumptions regarding the rate of capacity expansion on the two routes currently operated by Qantas were adopted, Qantas would still require [CONFIDENTIAL] aircraft to operate its domestic New Zealand schedule by year 3. [CONFIDENTIAL].

5.19 Qantas has examined a variation to the core Counterfactual to determine the implications of adopting the Commission's assumption that the rate of Qantas' capacity expansion would be in line with natural demand growth. Table 2 below sets out the results. The growth in capacity on the two major city-pairs - Auckland-Wellington and Auckland-Christchurch – have been reduced [CONFIDENTIAL] to an average annual growth rate between the base case and year 3 of approximately 3%. The frequencies on the new routes have been reduced to the minimum level considered viable for operation, given the importance of frequency to securing revenue share and to reflect the increments of capacity that need to be added with each additional aircraft and the efficient use of that aircraft once added. To operate the base case frequencies requires [CONFIDENTIAL]aircraft, 2003/04 frequencies require [CONFIDENTIAL]aircraft and the frequencies in 2004/05 and 2005/06 require [CONFIDENTIAL]aircraft. Hence, in terms of the Commission's cost savings estimate, even if this Counterfactual were adopted it would only reduce the cost savings estimated by NECG in respect of domestic New Zealand by [CONFIDENTIAL].

5.20 Therefore, in Qantas' view, even if the Commission's Counterfactual for domestic New Zealand were adopted it would have little impact on the cost savings estimated by NECG and would lower the welfare loss associated with the proposed Alliance.

Even if the Commission's assumptions regarding the rate of capacity expansion were adopted, Qantas would still require [CONFIDENTIAL] aircraft to operate by year 3.

Table 2: Qantas capacity expansion with Commerce Commission expansion assumption

[CONFIDENTIAL]

Tasman

5.21 For the Tasman routes, the only new city-pair that Qantas currently plans to operate under the Counterfactual Schedules that it was not operating in the base case (ie northern winter 2002/03) is [CONFIDENTIAL] and the addition of capacity in this case is [CONFIDENTIAL] and amounts to only [CONFIDENTIAL] for all years of the Counterfactual. Given that there is no significant increase in capacity associated

[2] Virgin Blue's growth is described in more detail in Chapter 3 of this Submission, in particular in Figure 12 of that Chapter which show Virgin Blue's rapid expansion domestic in Australia since 2001.

with the operation of new city-pairs on the Tasman, the growth in Tasman capacity under the Qantas Counterfactual can be examined at the aggregate level.

The growth rate for the Tasman over the Counterfactual period is consistent with historic trends.

5.22 Qantas' historic and Counterfactual capacity on the Tasman is presented in Figure 1 below in terms of ASKs. The CAGR rate over the historic period 1994/95 to 2002/03 is **[CONFIDENTIAL]**%. The CAGR over the Counterfactual period is **[CONFIDENTIAL]**% between 2002/03 and 2005/06. While the growth rate over the Counterfactual period exceeds the estimated natural rate of demand growth for the Tasman, it is consistent with historic trends.

5.23 In terms of steps in Qantas' capacity expansion plans on the Tasman, Annex 2 of the Air New Zealand/Qantas Response to Third Party Submissions filed on 14 March 2003 ("Applicants' Counterfactual Paper") explained the reasons for Qantas' capacity expansion by city-pair. These reasons can be summarised as follows:

(a) competitive pressures to maintain frequency;

(b) changes in the Tasman fleet, particularly the upgrade of existing B737 aircraft and the phase-in of A330 aircraft on the higher traffic routes;

(c) changes to Qantas' broader network, **[CONFIDENTIAL]** ; and

(d) the efficiencies associated with adding capacity in relatively large increments.

5.24 In its Draft Determination, the Commission has not challenged any of the detailed planning material provided by Qantas explaining its capacity expansion on the Tasman. Hence, it is difficult for Qantas to determine why the Commission has chosen to discount Qantas' Counterfactual for the Tasman, particularly since Qantas has provided evidence to the Commission to demonstrate that such a strategy is profitable.

Figure 1: Qantas Counterfactual Tasman capacity

[CONFIDENTIAL]

Other international routes

5.25 The only other international routes that would be operated by Qantas in the Counterfactual are **[CONFIDENTIAL]**. Again, the addition of capacity by Qantas on these routes is regarded as conservative. **[CONFIDENTIAL]**.

5.26 **[CONFIDENTIAL]**.

5.27 As the Commission has not raised specific issues regarding the reasonableness of the Qantas Counterfactual for these routes, Qantas assumes that the Commission accepts Qantas' Counterfactual as reasonable in this respect.

SECTION 2: QANTAS' DOMESTIC NEW ZEALAND EXPANSION

5.28 In its Draft Determination the Commission claimed that if capacity expansion were Qantas' optimal strategy to improve its profitability on the Tasman and domestic New Zealand routes, it might be expected that such behaviour would be evident now, although that does not appear to be the case.

5.29 Since the demise of Tasman Pacific in April 2001 Qantas has made significant progress in establishing a viable domestic New Zealand operation with an increasing number of aircraft and a low cost base from which it will be in a position to quickly and efficiently increase capacity in domestic New Zealand and on the Tasman. Qantas' expansion plans were somewhat delayed by events outside its control, however, the implementation of the Counterfactual capacity is now well advanced.

Qantas' expansion plans were delayed by events outside its control, however, the implementation of the Counterfactual capacity is now well advanced.

5.30 When Tasman Pacific was placed into receivership on 21 April 2001, Qantas faced the prospect of not having any presence in domestic New Zealand. As a result, within 24 hours of Tasman Pacific's receivership, Qantas had received an extension of its Australian Air Operator's Certificate ("AOC") to New Zealand, and had placed a B767 on the Auckland to Christchurch route, to maintain a presence while it considered its options.

5.31 In a Management Paper of 23 May 2001 ("23 May Paper") Qantas explained a number of options including:

[CONFIDENTIAL]

5.32 The paper notes that Qantas had chosen the final option and had announced that it would commence a four B733 operation on Auckland-Wellington and Auckland-Christchurch, with a full schedule to commence in July 2001.

5.33 The 23 May Paper also recommended **[CONFIDENTIAL]** Origin's **[CONFIDENTIAL]** operation left the **[CONFIDENTIAL]** route operating at **[CONFIDENTIAL]**% less than Tasman Pacific's schedule. Qantas aircraft would bring that to **[CONFIDENTIAL]**%.

5.34 **[CONFIDENTIAL]**, Qantas elected to operate on main trunk routes implemented the recommendations in light of the significant network benefits which its domestic New Zealand presence brings to its broader operations.

[CONFIDENTIAL], Qantas elected to operate on main trunk routes in light of the significant network benefits which its domestic New Zealand presence brings to its broader operations.

5.35 On 12 September 2001, Ansett Australia was put into voluntary administration. Two days later all flight operations were suspended. As a result, Qantas was required to add significant capacity to domestic Australia at very short notice. Under pressure from the Australian unions and Commonwealth Government, Qantas was not permitted to use foreign crew for any Australian domestic operations. Hence, it returned the aircraft operating in domestic New Zealand to Australia with the Australian pilots and crew.

5.36 To continue its domestic New Zealand operations, Qantas wet-leased sufficient aircraft and crew to service Qantas' domestic New Zealand operations and its additional requirements in domestic Australia. The first aircraft arrived in New Zealand in October 2001 and the fourth by January 2002. Hence, this interfered with the commencement of Qantas' expansion into domestic New Zealand.

5.37 Before Qantas could take further steps to establish its own domestic New Zealand operations, it faced another set-back as a result of flow-on effects from September 11. On 1 February 2002, Qantas was notified by the lessor that the wet-lease arrangements would not be continued beyond the contract expiry date of 31 March 2002.

5.38 As the date for termination of the wet-lease arrangements approached, a number of options for the future of Qantas services in New Zealand were discussed. In a paper dated 8 February 2002 ("8 February Paper"), Qantas considered options **[CONFIDENTIAL]**. Qantas noted:

Qantas noted that New Zealand was too important within Australasia for it not to have a significant share of the available business.

[CONFIDENTIAL]

5.39 **[CONFIDENTIAL]**.

5.40 Qantas concluded that the only practical option to provide continuity of its service in New Zealand to bridge the time gap was **[CONFIDENTIAL]**, with the intention of working towards establishing its own New Zealand-based operations with a reduced cost base.

5.41 Given these significant external events, Qantas' expansion plans into domestic New Zealand have been to some extent compromised. However, as discussed above, the implementation of the Counterfactual capacity is now well advanced, with the fifth aircraft operating since November 2002, and Qantas aims to have this fully implemented by 2005/06.

SECTION 3: QANTAS' COMMITMENT TO DOMESTIC NEW ZEALAND

5.42 The Commission's Draft Determination suggests that few parties considered Qantas' Counterfactual the likely Counterfactual. In support of this point the Commission noted that out of six of the former directors/senior managers of Air New Zealand that were interviewed by the Commission one of them thought that while the Qantas Counterfactual was possible, it would be delayed because Qantas would not want to release planes from its Australian domestic fleet. Three others either dismissed the possibility of the Qantas Counterfactual or downplayed its significance.

5.43 In addition, the Commission argued that Qantas stands to lose more from competing with Virgin Blue in Australia if it diverts resources from confronting it, than it can hope to gain from enlarging its market share in New Zealand.

5.44 First, Qantas considers that the views of the current directors and senior managers of Air New Zealand on Qantas' likely future strategy to be far more relevant than the views of people who have held these positions in the past. In this regard Qantas notes that the current board of Air New Zealand regard the Qantas Counterfactual not as "an economic theory" but as "commercial reality"[3].

5.45 Second, if the Commission is to give weight to the views of past Air New Zealand directors/managers then it should give equal weight to those who viewed Qantas' Counterfactual as likely. Of the three former directors/managers of Air New Zealand that dismissed the possibility of Qantas' Counterfactual, the Commission does not explain what it means by the term "downplayed its significance". The Applicants note that the Commission appears to have preferred the views of three former directors/managers, who no longer have access to current airline information, over those of the current new Board appointed by the New Zealand Government to improve the historical and operational issues which Air New Zealand appears to have suffered from in the past.

5.46 Third, the arguments put by the Commission appear to overlook the substantial commitment that Qantas has made to its domestic New Zealand operations and the plans already in place to devote resources to increasing capacity to the level planned in the Qantas Counterfactual.

Qantas has maintained a presence in domestic New Zealand for over a decade

5.47 Qantas has maintained a presence in domestic New Zealand for over a decade – this is set out in timeline form at Annex A. In the deregulated environment created by the Single Aviation Market, it was a natural progression for Qantas to enter and

[3] Ralph Norris Media Release 'No Retreat, No Concessions from Air New Zealand', 12 April, 2003

maintain a domestic New Zealand presence following the demise of Tasman Pacific in April 2001.

5.48 For example, in November 2001, Qantas assessed the benefits of having a strong domestic New Zealand presence, and it chose establishment of a New Zealand based operation and network expansion as its optimal strategy. In a Strategy Paper presented on 22 November 2001 ("22 November Paper"), in relation to its domestic New Zealand operations Qantas notes:**[CONFIDENTIAL]**

5.49 Qantas therefore considered its options, **[CONFIDENTIAL]**:

5.50 The outcome of this review and analysis was that Qantas chose **[CONFIDENTIAL]** to build its local arrangements. This led to the establishment of Jetconnect Limited ("Jetconnect"), a wholly owned subsidiary of Qantas, which now employs 186 New Zealand staff and is continuing to expand and add aircraft to its Air Operating Certificate ("AOC"). Annex B sets out the detail of Qantas' establishment of Jetconnect in domestic New Zealand.

Jetconnect, a wholly owned subsidiary of Qantas, now employs 186 New Zealand staff and is continuing to expand and add aircraft to its Air Operating Certificate

5.51 On 22 January 2002, Qantas issued a press release entitled "*Qantas Appoints Grant Lilly to Develop NZ Expansion Opportunities*". Mr Lilly had previously been employed by Air New Zealand, including as General Manager of Air New Zealand's International Airline, General Manager of the Domestic Airline Group and Regional General Manager for Asia and Japan. Mr Lilly was also appointed CEO of Jetconnect.

5.52 In early 2002, Mr Lilly **[CONFIDENTIAL]**. Jetconnect's fifth aircraft came on the NZ register on 28 October 2002 and was operational by 7 November 2002. The sixth aircraft came on the register on 10 April 2003 and was operational by 5 May 2003. **[CONFIDENTIAL]**.

5.53 The addition of further aircraft to Jetconnect's AOC is also consistent **[CONFIDENTIAL]**. In particular, Qantas plans to **[CONFIDENTIAL]** over the course of the next five years. Qantas has already **[CONFIDENTIAL]**.

5.54 Jetconnect's cost base is **[CONFIDENTIAL]**.

5.55 In summary, Qantas has made a substantial commitment to its domestic New Zealand operations and its plans for the addition of the Counterfactual capacity are well advanced. The claims that the Counterfactual expansion in capacity would be unlikely due to Qantas' reluctance to redeploy aircraft from its domestic Australia operations are unfounded. Decisions regarding deployment of aircraft are planned carefully and well in advance. Planning and steps for the implementation of the bulk of Qantas' Counterfactual have already been undertaken.

Jetconnect's cost base is [CONFIDENTIAL].

SECTION 4: COMMERCIAL RATIONALE FOR QANTAS' COUNTERFACTUAL

5.56 In its Draft Determination the Commission questioned whether the Qantas Counterfactual reflected commercially rational behaviour. In particular, the Commission argued that:

(a) an expansion in Qantas capacity might force Air New Zealand more quickly into an alliance with another airline and because Qantas would prefer to face a stand-alone Air New Zealand this could provide an incentive for Qantas not to compete over-aggressively;

(b) the Qantas capacity increase would be unlikely to succeed if the Air New Zealand shareholders were to demonstrate a willingness to resist such behaviour by committing to support the company through any war of attrition and because the exit of Air New Zealand, the assumed outcome of the war of attrition, would leave no other airline to exercise the country's bilateral air rights;

(c) the cost differential between Air New Zealand and Qantas implies that Qantas would incur a greater loss per passenger than Air New Zealand in the event of a price war;

(d) recoupment of any losses incurred through an expansion would seem unlikely if weight is given to the competitive threat posed by Virgin Blue;

(e) profitability is an important consideration for Qantas; and

(f) it would not necessarily be an advantageous strategy for Qantas to dominate Air New Zealand because labour and other factors would likely gain some of the rents from market power and push up costs on a system-wide basis. Also entry would be a threat and hence planes could not be redeployed, as they would continue to be needed as the basis for the strategic entry barrier.

5.57 Regarding the possibility of Air New Zealand entering an alternative alliance more quickly if Qantas increased its capacity to the levels in the Counterfactual, Qantas does not understand who this possible alliance partner would be, and in paragraphs 295 to 299 of the Draft Determination the Commission dismisses the possibility of an alliance with Singapore or any other Star Alliance members. The Commission does note the possibility of Virgin Blue as an alternative alliance partner. However, Qantas' profitability modelling does not depend on whether Air New Zealand is in an alternative alliance or not. Also, the Commission fails to explain why Air New Zealand would delay entering such an alliance on the basis of Qantas' capacity expansion in the Counterfactual world.

5.58 The Commission's own draft acknowledges the Government's intention to sell-down its stake in Air New Zealand if the opportunity arises. It is difficult to understand why the Government would wait until Qantas and Air New Zealand were in the midst of a war of attrition to take up this opportunity if one was available sooner.

5.59 Further, Qantas disagrees with the suggestion that it would not add the Counterfactual capacity because the Air New Zealand shareholders might demonstrate a willingness to resist such behaviour by committing to support the company through any "war of attrition" (because the exit of Air New Zealand would leave no other airline to exercise the country's bilateral air rights). While it cannot entirely discount the possibility that the New Zealand Government would provide assistance to Air New Zealand (it is an incentive to enter into the Alliance), such action would be inconsistent with all current government policy statements and representations in the media. As recently as late last month Finance Minister Michael Cullen addressed this point in an interview in Australia with journalist Helen McCombie. When asked about the possibility of future additional injections of equity into Air New Zealand by the New Zealand Government, Cullen replied :

> "…one of the things that our Commerce Commission said was that you could basically assume rather blindly mind you, that the Government would have deep pockets…I'm not sure I could take quite such a rosy view …in that respect…competition authorities should not proceed on the basis that we have

> bottomless pockets for injections of capital and…'soft touches' in that regard. I'm looking after a significant amount of money of New Zealand taxpayers at some point you have to say we'll we're not prepared to go further in that regard" [4].

5.60 Lastly, Qantas does not understand why the prospect of New Zealand Government support for Air New Zealand would deter Qantas from competing vigorously (including through the frequency of its services) in the Commission's Counterfactual, but would not have a similar deterring effect on entry – the Commission's view that Qantas will be deterred, but Virgin Blue not, seems inconsistent. Moreover, any steps by the New Zealand Government to restrict Qantas competing in domestic New Zealand or to hinder the most efficient use of the country's bilateral air rights, would be inconsistent with many broad policy initiatives of the New Zealand government, including the encouragement of open market competition, and Australian-New Zealand Closer Economic Relations and the Single Aviation Market.

The Commission claims that Air New Zealand is lower cost. **[CONFIDENTIAL].**

5.61 The Commission claims that Air New Zealand is lower cost than Qantas in domestic New Zealand and hence Qantas would have more to lose from any price or capacity war. **[CONFIDENTIAL]**. Moreover, Qantas believes its wider network overall would make it well placed to sustain strong price or capacity competition.

5.62 The remaining points made by the Commission go to the profitability of Qantas' operations, particularly in domestic New Zealand. The core of the Commission's argument appears to be that "capacity dumping" by Qantas would increase losses and hence the expansion of capacity planned by Qantas would be irrational unless recoupment was possible. Qantas strongly disagrees with this view. The Applicants have never characterised the Counterfactual as "capacity dumping". Qantas has analysed the Counterfactual found it to be profitable when all factors are properly taken into account, including network benefits and city-presence effects and for this reason Qantas is committed to its stated expansion plans in domestic New Zealand.

5.63 Qantas has undertaken further work to demonstrate to the Commission the value of the network benefits that Qantas derives from its domestic New Zealand presence and the importance of connectivity, city presence and capacity to Qantas' profitability.

Network benefits

5.64 In its Draft Determination, the Commission appears to draw conclusions about whether Qantas' Counterfactual is commercially rational based solely on route profitability, without any regard to Qantas' estimates of network benefits. For network airlines, which are structured to provide connecting service to a wide range of destinations, flights and routes are operated not only to participate in local markets but also to provide feed traffic to the network. For this reason network airlines consider the benefits of that feed when evaluating the performance of a route. For example, consider an Auckland-Sydney passenger who connects at Sydney to a Qantas flight to Hong Kong. Without service on the Auckland-Sydney flight segment, Qantas would be unlikely to attract this passenger. Instead, the passenger might travel on a Cathay Pacific non-stop flight from Auckland to Hong Kong or a Singapore Airlines routing from Auckland to Hong Kong via Singapore. The consequence would be that Qantas loses the revenues (and consequent contribution to profits) from this passenger on both the Auckland-Sydney and Sydney-Hong Kong flight segments. Put differently, the removal of a flight or route from the Qantas network will generally reduce overall network profit by more than

[4] 25 May 2003, Interview with Helen McCombie, www.nine.msn.com

the calculated profit of that flight or route unless some account is taken of the flight's beyond revenues.

5.65 Network airlines typically address this issue by calculating another performance measure called network benefit, network contribution or beyond contribution. Some airlines add this explicitly to their route profitability reports, while others evaluate it during the route planning process.

5.66 Network contribution is calculated in a variety of ways, but the general methodology consists of taking the upline/downline revenue from connecting passengers and then subtracting an appropriate measure of the costs associated with transporting those passengers. Such a calculation begins with the apportionment of each connecting passenger's fare among the various flight segments in his/her itinerary. There are standard industry procedures for this "prorating" of revenues. To return to the example given above, this would involve dividing the fare paid for the Auckland-Hong Kong trip between the Auckland-Sydney and Sydney-Hong Kong segments. Note that only the Auckland-Sydney portion of the fare would be included in a conventional route profitability report for Auckland-Sydney.

5.67 The next step takes the revenue apportioned to the Sydney-Hong Kong segment and subtracts an appropriate measure of the cost of transporting that passenger from Sydney to Hong Kong. Network airlines use various methodologies in an attempt to capture these costs. Some use rules-of-thumb such as subtracting a fixed percentage of revenue, while other airlines use more elaborate statistical models that attempt to predict the likelihood that a seat on the connecting flight would otherwise have been empty. While network airlines use somewhat different methodologies to measure this "network" or "beyond" contribution, they all recognise its importance in evaluating the performance of a route.

5.68 American Airlines, for example, calculates FAUDNC (fully-allocated earnings plus upline/downline contribution net of cost) and VAUDNC (variable earnings plus upline/downline contribution net of cost) for each of its routes. Other U.S. network carriers use similar performance measures. Air Canada calculates "beyond contribution" for each of its routes and uses the data in its route planning and scheduling activities.

5.69 Qantas is no exception and considers network benefits during its planning process, including its decisions regarding domestic New Zealand. For example, **[CONFIDENTIAL]**.

5.70 Qantas has also incorporated into its profitability modelling the network benefits that it would derive from its operations in domestic New Zealand under a number of different Counterfactual scenarios:

(a) The Qantas Counterfactual;

(b) The Qantas Counterfactual with VBA entry;

(c) The Commission's Counterfactual (as the Applicants have drawn from the Draft Determination and the Commission's modelling) with no VBA entry; and

(d) The Commission's Counterfactual with VBA entry.

5.71 The methodology used to calculate the network benefits is the same as set out in the Applicants' Counterfactual Paper.

5.72 The results of this analysis are summarised in Table 3 below in terms of profit before tax (PBT). The results demonstrate that if authorisation is not granted then the next best strategy for Qantas is to expand capacity in domestic New Zealand to the levels set out in Qantas' Counterfactual. The Commission's low growth Counterfactual is less profitable for Qantas. This is the case whether or not VBA entry occurs.

If network benefits are not taken into account, the Counterfactual advanced by the Commission cannot possibly be said to be a rational profit maximising strategy for Qantas.

5.73 In addition, if the network benefits are not taken into account, the Counterfactual advanced by the Commission cannot possibly be said by the Commission to be a rational profit maximising strategy for Qantas. This is because absent network benefits, the Commission's Counterfactual results in a loss to Qantas when its domestic New Zealand operations are considered on a stand alone basis. This result is illustrated by Table 3 under the headings "Commission Counterfactual" (both with and without VBA entry) and by the numbers corresponding under the heading "PBT with no network benefits". If this approach were taken (and contrary to accepted airline practice network benefits were not able to be taken into account), then the profit maximising response by Qantas would be to withdraw from domestic New Zealand altogether. If this were to occur, then clearly any detriments associated with the Alliance would be significantly reduced.

Table 3: Qantas PBT for domestic New Zealand with and without network benefits (NZ$ million)

[CONFIDENTIAL]

Note (1): "Qantas PBT" is first provided on a stand-alone fully allocated cost basis, before network benefits are included.
Note (2): VBA entry in the Qantas Counterfactual is modelled in accordance with assumptions used by the Commission in its modelling of the Counterfactual with VBA entry, ie it enters with 2 aircraft in domestic New Zealand in year 2 and adds a further aircraft in year 3.
Note (3): VBA entry in the Commission's Counterfactual is modelled to occur in Year 2 with 3 aircraft and to add a further aircraft in Year 3. The VBA entry profile in that Counterfactual is different to that of the Qantas Counterfactual as it is assumed that the comparatively lower Qantas capacity in the NZCC Counterfactual would induce a higher level of VBA entry.
Note (4): Updated modelling since first submitting the Applicants' Counterfactual Paper, has resulted in minor changes to Qantas PBT outcomes.

5.74 Finally, it should also be noted that the network benefit measures likely understate the total contribution that an individual route makes to the overall profitability of the network. This is because such measures do not capture all the system benefits to the airline of operating particular routes and flights, some of which are in addition to the upline/downline contribution from connecting passengers. They arise from the fact that serving certain routes can provide enhanced regional presence or city presence to an airline's route network, thereby making its entire system more attractive to travellers. Such system benefits are not captured in the performance measures for individual routes and flights because these benefits accrue on other routes and flights. The fact that network airlines have not developed a standard, consistent way to quantify these system benefits does not mean that they do not exist. The consequence is that performance measures tend to understate the true contributions of individual routes and flights to the overall profitability of a network airline.

City presence benefits

5.75 Further important considerations underlying Qantas' expansion in domestic New Zealand, relate to the benefits which Qantas recognises it will derive from increasing its city presence in key cities in domestic New Zealand. While the earlier analysis of network benefits shows Qantas' continuing profitability with the addition of the Counterfactual capacity, this section provides further support for the rationality of Qantas' intended expansion in domestic New Zealand.

5.76 It is recognised in the airline industry that "city presence" benefits, in the form of a carrier achieving a greater revenue share than its capacity share, accrue to the largest carrier out of a city. In particular, higher yield passengers tend to travel disproportionately with the carrier perceived to be the largest in the city. As noted in the Applicant's Counterfactual Paper, Qantas believes that it currently suffers a revenue share gap disadvantage, ie it is not achieving the share of available domestic revenue equivalent to its capacity/frequency share. It therefore needs to increase capacity/frequencies in order to narrow this revenue share gap.

Qantas believes that it currently suffers a revenue share gap disadvantage, ie it is not achieving the share of available domestic revenue equivalent to its capacity/ frequency share.

5.77 Analysis conducted by APG,[5] using extensive US Department of Transport Origin and Destination (O&D) data[6] supports the importance of city presence and hence frequency and capacity to narrowing the revenue share gap.[7] The APG analysis compares the actual share of revenue that an airline obtains with the "fair share" it

[5] APG are described more fully in Chapter 3 of this Submission. For more information, refer to www.apgnet.com.

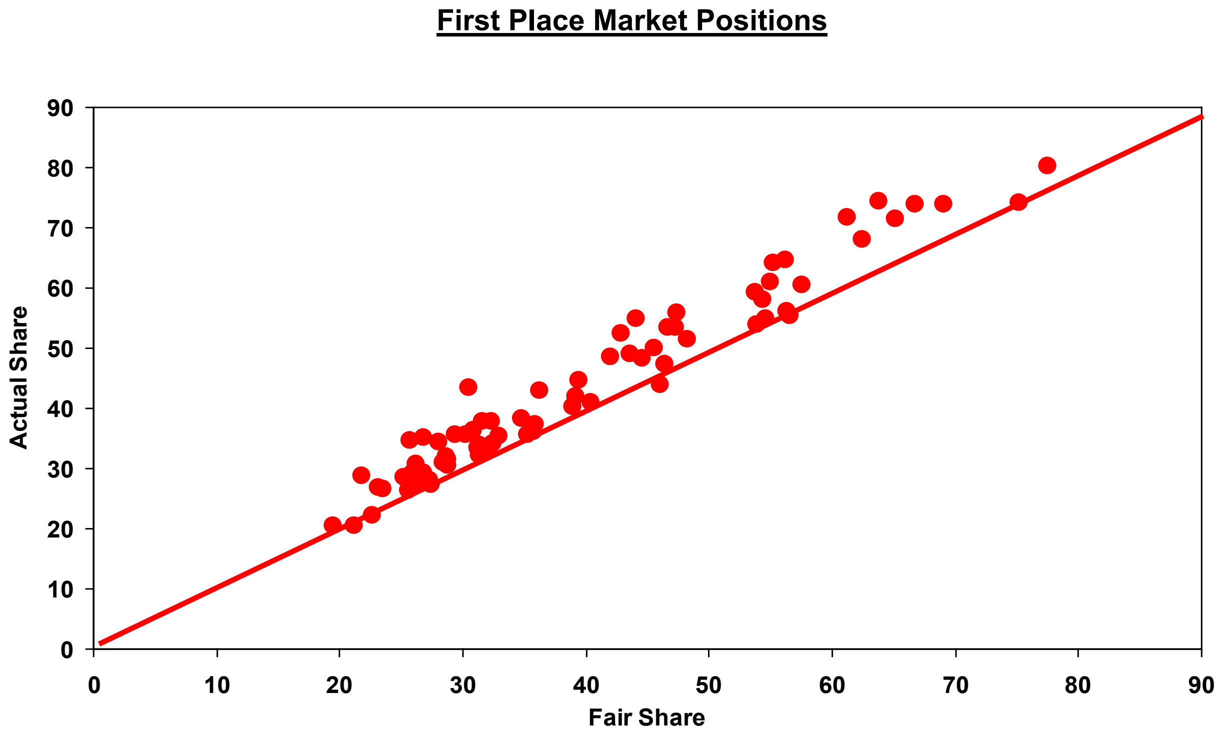
[6] All US DOT data used in the APG analysis is for US domestic O&Ds.

[7] US data was used for the analysis given the limited NZ data available, and the fact that the much larger sample size means that the data is inherently more reliable.

would be expected to obtain using a QSI methodology. APG's QSI methodology forecasts the expected "fair share" of total revenues available in a given city, by adjusting the airline's share of total capacity in a market, to take into account the quality of service provided by the airlines. The quality factors taken into account in this analysis include the type of service provided (ie non-stop, codeshare, online connection or interline connection), time of day, the number and type of destinations (short-haul or long-haul) served by that carrier from a given city, and size and specifications of aircraft employed by the carrier.

5.78 The APG analysis demonstrates that airlines with the highest level of capacity into and out of a city, weighted by QSI, (which will be referred to as its "capacity fair share"), achieve a share of revenue which exceeds their fair share (see Figure 2 below). In other words, the airline which ranks first place in terms of QSI weighted capacity to and from a given city achieves a positive revenue share gap, or a "city presence" benefit over and above its competitors.

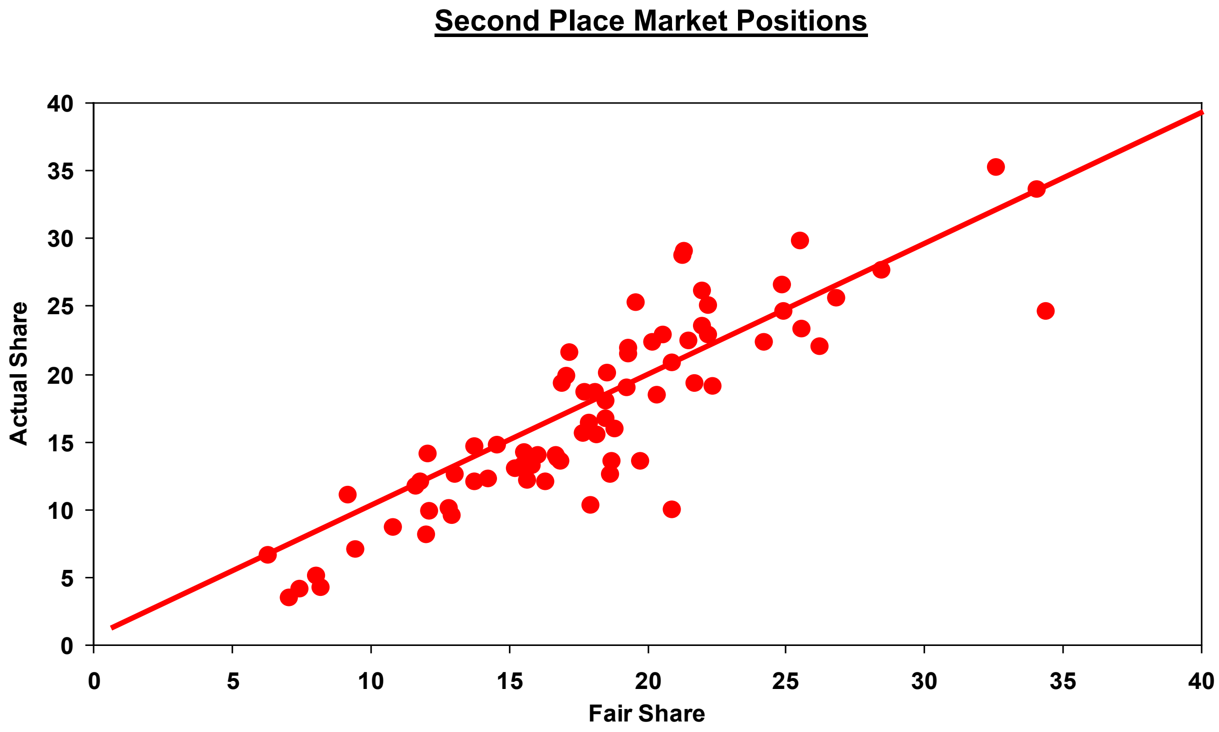
Figure 2: Actual revenue share versus capacity fair share for airlines with highest level of city presence



APG analysis demonstrates that the airline which ranks first place achieves a positive revenue share gap, or a "city presence" benefit over and above its competitors.

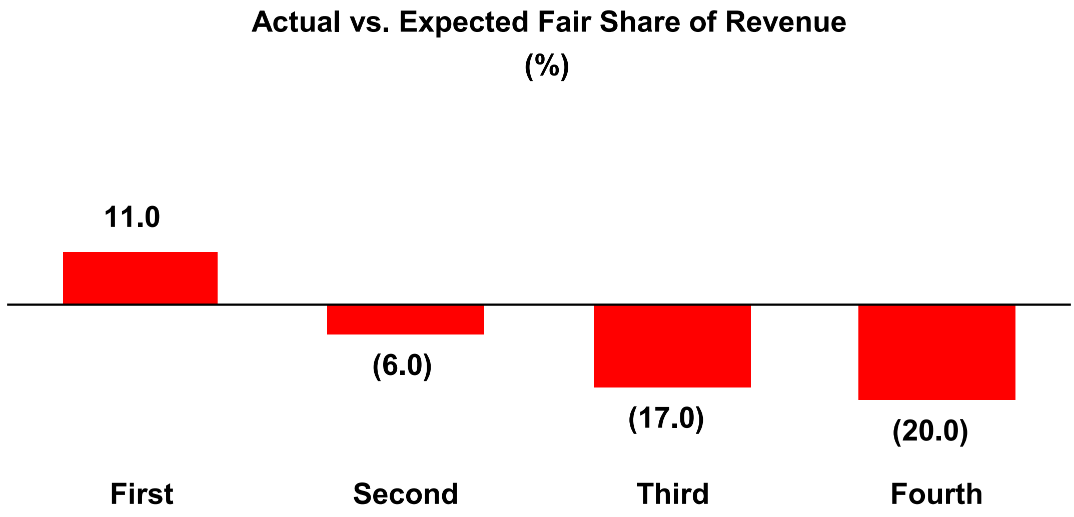
5.79 As Figure 3 below shows, APG finds that where cities are served by three or more airlines (as is the case for each of Auckland, Wellington and Christchurch), airlines that rank second in a city in terms of capacity often suffer a revenue share disadvantage, particularly when their capacity fair share is low. This revenue share gap can, however, be reduced when capacity is added by the second ranked carrier so that its overall city presence approaches that of the first ranked carrier. In that instance, the second ranked carrier will be able to narrow the negative revenue share gap *before* it actually alters its city ranking from "second" to "first equal", or "first". This is illustrated by Figure 3 below.

Figure 3: Actual revenue share versus capacity fair share for airlines with ranking second in terms of city presence



5.80 APG analysis of this data reveals that, on average, the first ranked carrier usually achieves a positive revenue share gap of approximately 11%. That is, the first ranked carrier achieves 11% more revenue of the total available city revenues out of that city than its capacity fair share would suggest it should achieve. The APG analysis shows the second ranked carrier on average receives a revenue share gap of -6%, with the revenue share gap for the third ranked carrier being larger, at approximately –17%. Figure 4 shows these revenue share gap differentials.

Figure 4 : Revenue share gap for first, second and third ranked carriers



5.81 Finally, APG find that the relationship between city presence and revenue share on a city pair depends on having sufficient ranking or city presence on at least one end of the city pair. Specifically, an airline may command its fair share of city pair revenues if it has a strong position at one end of a city pair, even though another airline has the first rank city presence at the city pair's other end.

City presence analysis of Qantas Counterfactual

5.82 Based on these findings, APG estimates both the improvement in revenue share that Qantas could achieve by adding the Counterfactual capacity and the potential revenues that Qantas could secure if it were to close the revenue share gap between itself and Air New Zealand (ie by becoming the airline with the highest, or near highest, level of capacity to and from a city).

5.83 Figure 5 below shows that once the Counterfactual capacity is added, Qantas **[CONFIDENTIAL]**.

Figure 5: Qantas' expected capacity fair share pre and post addition of Counterfactual capacity

[CONFIDENTIAL]

5.84 Figure 5 also shows that when Qantas implements the Counterfactual capacity, its expected capacity fair share increases proportionately. However, as described above, this does not immediately translate into the equivalent increase in revenue, without taking into account the city presence which Qantas will achieve by adding that capacity. The significance of the addition of the Counterfactual capacity is that it gives Qantas the required level of city presence **[CONFIDENTIAL]**. This in turn provides the potential for it to narrow the revenue share gap and thus to achieve fair share of total city revenues out of those cities. Figure 7 shows APG's calculation of Qantas' actual revenues in Auckland, Wellington and Christchurch, if it were able to close the revenue share gap in each of those cities. APG calculates this by taking Air New Zealand's estimates of the total revenue out of each of these cities, calculating Qantas' capacity fair share of those revenues **[CONFIDENTIAL]** then applying the negative share gap which Qantas presently suffers in each of those cities. Qantas estimates its current revenue share gap is likely to approximate **[CONFIDENTIAL]**(illustrated in Figure 4 above), which is consistent with Qantas' early stage of entry in domestic New Zealand.

The Counterfactual capacity gives Qantas [CONFIDENTIAL], which provides the potential for it to narrow the revenue share gap and achieve fair share of total city revenues out of those cities.

Figure 6: [CONFIDENTIAL].

5.85 As Figure 6 shows, when Qantas achieves its "capacity fair share" by **[CONFIDENTIAL]**, APG estimates it will increase its revenues, not only by the incremental capacity increase, but also by an additional $**[CONFIDENTIAL]** annually (which is the amount APG estimates it is currently not receiving from those cities due to its negative revenue share gap). **[CONFIDENTIAL]** However, it should achieve a greater share of total available city revenues because it will be the first ranked carrier on the other end of many city-pairs served from Auckland. While it would be rational for Air New Zealand to respond to protect those revenues, as explained above, Qantas believes that Air New Zealand's financial constraints will restrain it from doing so.

5.86 The APG analysis further confirms that it is rational for Qantas to increase its capacity in domestic New Zealand in line with the Counterfactual Schedules, as this would also allow Qantas to reduce its current, significantly negative, revenue share gap and achieve a share of domestic New Zealand revenues which more closely resembles its capacity fair share. It also reveals that the Qantas Counterfactual is conservative. If Qantas were to increase its capacity at an even greater rate than is currently proposed, then it would have a greater opportunity to become the first ranked carrier in the domestic main trunk cities and thereby achieve a disproportionately greater share of available city revenues. Indeed, if Virgin Blue were to enter the Tasman and domestic New Zealand under the Counterfactual, it would be irrational for Qantas to leave "easy pickings" for Virgin Blue and itself adopt a kindly approach to Air New Zealand.

5.87 APG's findings are consistent with the type of considerations that Qantas has historically taken into account when expanding capacity in domestic New Zealand. For example, **[CONFIDENTIAL]**:

5.88 Therefore, when both the network benefits and the higher revenue shares associated with expanding capacity are considered, Qantas' Counterfactual is the most profitable strategy for Qantas in the event that authorisation is not granted.

SECTION 5: ORIGIN PACIFIC

5.89 Before it entered into a code-share arrangement with Qantas, Origin was an established airline with plans for development in New Zealand. As the Commission noted in its Draft Determination, Robert Inglis, co-owner of Origin, has already established and developed one successful airline, Nelson Air, which he sold to Air New Zealand. At the time Origin entered into the code-share arrangement with Qantas, Qantas understands that **[CONFIDENTIAL]**.

5.90 The original relationship with Origin entered into in June 2001 **[CONFIDENTIAL]**. This was in order to preserve the independence of both airlines and their ability to make other alliances, as each saw fit.

5.91 The relationship has been modified and developed over time. By early 2003, Origin provided **[CONFIDENTIAL]** services to Qantas:

[CONFIDENTIAL]

5.92 The relationship was most recently updated in **[CONFIDENTIAL]** and continues to provide for **[CONFIDENTIAL]**. The new arrangement will expire on **[CONFIDENTIAL]**, unless the parties otherwise agree. Up until **[CONFIDENTIAL]**, Qantas may **[CONFIDENTIAL]**.

5.93 Qantas' seat factor on code-share seats provided by Origin is approximately **[CONFIDENTIAL]**% with the blocks provided to Qantas representing less than **[CONFIDENTIAL]**% of their operations. Qantas thus estimates it is providing just **[CONFIDENTIAL]**% of their business.

5.94 **[CONFIDENTIAL]**.

5.95 Under the Counterfactual, Origin might choose to continue a reduced form of code-share with Qantas. It would however equally be open for it to consider an alliance with another carrier, including with Virgin Blue.

Under the Counterfactual it would equally be open for Origin to consider an alliance with Virgin Blue.

5.96 Origin's position would not be significantly different under the Alliance, if anything, a greater range of opportunities might be available to it. For example:

(a) As expanded on in Chapter 3, the Alliance increases the likelihood that Virgin Blue would seek to enter and expand to establish a significant presence in domestic New Zealand. This would enhance Origin's opportunity to form an alliance with Virgin Blue under the Factual as compared with the Counterfactual.

This must be a very real prospect for Origin given that on 10 June 2003 Virgin Blue has announced that it has entered into an alliance with an Australian regional airline, Regional Express (http://au.news.yahoo.com/021125/2/UPW4.html). In relation to that alliance, Virgin Blue's CEO, Brett Godfrey, stated:

> "There are many cities where Virgin Blue would love to fly but can't land a 737 aircraft so we are excited to be forging a relationship with Rex to benefit those people who want easy access to Virgin Blue destinations and fares throughout the country."

This would equally apply to Origin in New Zealand.

(b) Similarly, the opportunity for Origin to enter into an alliance with, and obtain feed from, fifth freedom airlines operating on the Tasman is likely to be enhanced by the Alliance. For example, on 9 June 2003 Emirates announced that it would enter the Tasman from 1 August 2003. Indeed, if the Alliance were to result in Air New Zealand exiting the Star Alliance, this might present additional expansion opportunities for Origin into the future.

SECTION 6: EFFECT OF COUNTERFACTUAL ON AIR NEW ZEALAND

5.97 As noted in the Applicants' Counterfactual Paper, the Air New Zealand view of the Counterfactual assumes that **[CONFIDENTIAL]**:

Air New Zealand reached these conclusions based on information gained from public statements by Qantas and other market intelligence.

5.98 In each case, Air New Zealand formed the view that the anticipated additional capacity likely to be applied by Qantas was rational from that company's perspective on longer-term profitability.

5.99 Air New Zealand is not currently, and is unlikely to be, in a position to thwart Qantas' expansion plan by substantially increasing the size of its fleet, beyond its current A320 program. The Air New Zealand increase in total jet fleet size from **[CONFIDENTIAL]**aircraft results in **[CONFIDENTIAL]**.

5.100 The position is exacerbated by the fact that it has become clear that Virgin Blue will in the near term commence services on the Tasman and in domestic New Zealand.

5.101 The presence of these two substantial and well-resourced competitors with broad-based Australian operations will inevitably create a "squeeze" on Air New Zealand leading to declining overall profitability.

SECTION 7: COMMISSION MODELLING OF QANTAS' COUNTERFACTUAL

5.102 Finally, the Applicants query the inconsistency between the Counterfactual that is outlined in the text of the Draft Determination and the Counterfactual that Professor Gillen states that he uses in his welfare analysis.

5.103 Professor Gillen's most recently revised counterfactual for domestic New Zealand is set out in Table 1 of his note titled "Revised Notes to Respond to Questions and Issues Raised by NECG in Meeting of May 15-16, 2003" dated 5 June 2003. The level of Qantas capacity reported in this table for domestic New Zealand is **[CONFIDENTIAL]**seats per year or **[CONFIDENTIAL]**seats per week. This capacity is identical to the Qantas Counterfactual capacity (see Table 1 above). Professor Gillen's most recently revised counterfactual for the Tasman is set out in Table 2 NEW June 5 of the same note and is reported as **[CONFIDENTIAL]**seats per year or **[CONFIDENTIAL]**seats per week.

5.104 Based on the methodology used by Professor Gillen (which according to the Commission's Draft Determination is based on Professor Hazledine's modelling) a higher level of capacity will result in a lower price in the Counterfactual. This is because Professor Hazledine's approach is to determine the level of competition in the Counterfactual by finding the conjectural variation parameter that will achieve a target load factor. Professor Gillen appears to use a target load factor of 75%. Hence, the higher the level of capacity assumed in the Counterfactual the more competitive one must assume the Counterfactual world is to achieve the target load factor. This is because the level of competition determines the solution price, which in turn determines the quantity demanded and the load factor. The upshot of this is that the higher the level of capacity assumed in the Counterfactual, the lower the Counterfactual solution price will be.

5.105 Therefore, the inconsistency in the Commission's approach – which involves determining cost-savings on the basis of a low growth counterfactual for domestic New Zealand, but determining welfare losses on the basis of the Applicants' Counterfactual capacity - results in an underestimate of the cost savings and an overestimate of the detriments associated with the Alliance. In the Applicants' view, such an inconsistency is illogical and indefensible.

ANNEX A: TIMELINE OF QANTAS' DOMESTIC NEW ZEALAND PRESENCE

Timeline

- 1990 — Qantas commenced a preferred selling arrangement with Ansett New Zealand.
- March 2000 — Ansett New Zealand sold to Tasman Pacific. In June 2000, Qantas announced that its presence in New Zealand would be maintained through a franchise agreement under which Tasman Pacific operated "Qantas New Zealand". Services commenced September 2000.
- 3 August 2000 — Virgin Blue commenced operations in domestic Australia.
- 21 April 2001 — Tasman Pacific placed into receivership and franchise agreement terminated. Operations ceased immediately.
- May 2001 — Qantas commenced operations in New Zealand in its own right with Qantas aircraft, operating under its Australian AOC.
- 11 June 2001 — Jetconnect incorporated in New Zealand as a wholly owned subsidiary of Qantas, for the purpose of employing New Zealand based cabin crew.
- 12 September 2001 — Ansett Australia placed into voluntary administration. All flight operations suspended on 14 September 2001. To service a dramatic increase in demand, Qantas aircraft in domestic New Zealand were recalled to Australia.
- late September 2001 — Qantas entered into an agreement with a wet-leasing company, under which it wet/damp leased four aircraft for domestic New Zealand use (and two aircraft for domestic Australia), operated under that company's Australian AOC. Jetconnect provided the cabin crew for the New Zealand operations.
- 1 February 2002 — The wet-leasing company notified Qantas that the wetlease arrangements would not be extended beyond the initial term, ending on 31 March 2002.
- 28 April 2002 — Qantas acquired the wet-leasing operation, and with it the crew and facilities and Australian AOC, extended for use in domestic New Zealand.
- 15 October 2002 — Jetconnect received its New Zealand AOC. All four aircraft were immediately registered on this AOC. A fifth B737 from Qantas' domestic fleet (ZK-JNE) was added on 7 November 2002 three

weeks later.

- 5 May 2003 The sixth B737 was registered against Jetconnect's AOC (ZK-JNG).
- 1 June 2003 Jetconnect commenced recruiting crew for its new Wellington-based operations.
- **[CONFIDENTIAL]** **[CONFIDENTIAL]**

ANNEX B: DESCRIPTION OF ESTABLISHMENT OF JETCONNECT

Introduction

[CONFIDENTIAL]

Jetconnect

[CONFIDENTIAL]

Introduction of aircraft to the NZ register

[CONFIDENTIAL]