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PUBLIC VERSION

Commerce Commission
Draft Determinations

Determinations pursuant to the Commerce Act 1986 in the matter of an application for authorisation of a business acquisition and in the matter of an application for authorisation of certain restrictive business practices and involving:

QANTAS AIRWAYS LIMITED

and

AIR NEW ZEALAND LIMITED

The Commission:	**MJ Belgrave** **PR Rebstock** **PJ Taylor** **DF Curtin** **D Bates QC**
Summary of Applications:	The subscription by Qantas Airways Limited of up to 22.5% of the voting equity in Air New Zealand Limited pursuant to a Subscription Agreement between Air New Zealand Limited and Qantas Airways Limited (the proposed Acquisition); and The implementation by Air New Zealand Limited and Qantas Airways Limited of the terms of a Strategic Alliance arrangement which creates a Joint Airline Operation network (the proposed Arrangement)
Draft Determinations:	The Commission's draft determination, on the basis of the information provided to date, is that it would be likely to decline an authorisation for the proposed Acquisition pursuant to s 67(3)(c) of the Act. The Commission's draft determination, on the basis of the information provided to date, is that it would be likely to decline an authorisation for the proposed Arrangement pursuant to s 61(1)(b) of the Act.
Date	10 April 2003

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EXECUTIVE SUMMARY

Proposed Alliance

1. On 9 December 2002 the Commerce Commission (the Commission) received two interrelated applications from Qantas Airways Limited (Qantas) and Air New Zealand (Air NZ) (together, the Applicants).

2. The first application relates to a proposed acquisition of 22.5% of the voting equity in Air NZ. The second application relates to a strategic alliance agreement between Air NZ and Qantas. This would involve the two airlines coordinating their pricing, schedules and capacity, and profit-sharing, on all flights operated by Air NZ, and all Qantas-operated flights within, to and from New Zealand. The second application also envisages that coordination may be extended beyond these markets.

3. The two applications are interrelated in that the Applicants state that neither would proceed without the other. Together they may be referred to as the "proposed Alliance". In these circumstances, the Commission, in exercising its discretion, is of the view that it is appropriate to analyse the combined impact of the two applications.

Framework for Consideration

4. The Commission is responsible for deciding whether to authorise the applications under the relevant provisions of the Commerce Act 1986 (the Act).

5. In brief, the Commission must determine whether the proposed Alliance would result in a substantial lessening of competition in any of the markets affected and, if so, whether the detriments flowing from this lessening of competition are outweighed by the public benefits claimed to flow from the Alliance. The Commission considers that a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. If the Commission is satisfied that the public benefits outweigh the detriment, it may authorise the proposed Alliance.

Commission Process

6. In preparing this draft determination, the Commission has fully considered and given weight to information and analysis from a wide range of sources. It has:

   - reviewed the substantial amount of information and analysis in the Applications, including the economic model submitted by the Applicants' economic experts;

   - sought further information and clarification from the Applicants on a range of points;

- considered submissions from interested parties;
- interviewed the Applicants and numerous other parties;
- sought advice from its own external legal and economic experts; and
- conducted its own analysis and modelling.

7. Below is a summary of the Commission's key preliminary conclusions.

The Factual and Counterfactual

8. The factual is what would happen if the proposed Alliance proceeds. In order to assess the competition effects, as well as the detriments and benefits, the Commission compares the factual to the counterfactual, or what would likely happen in the absence of the proposed Alliance. A counterfactual will not necessarily be a continuation of the status quo, but rather encapsulates a pragmatic and commercial assessment of what is likely to happen in the absence of the factual.

9. The factual and counterfactual give rise to different states of competition in each of the relevant markets. A comparison between them allows a judgment to be made as to whether competition in the factual is likely to be substantially lessened relative to the counterfactual.

The Factual

10. The factual, involving an acquisition of 22.5% of the equity of Air NZ combined with the proposed arrangement, will essentially result in Air NZ and Qantas coordinating their schedules and prices for all of their flights within, to and from New Zealand. The two would essentially operate as one head in the relevant markets.

The Counterfactual

11. The Applicants considered six alternative counterfactuals, but their preferred counterfactual involved aggressive capacity competition by Qantas and Air NZ, a so-called "war of attrition".

12. The Commission, after considering a range of factors—the external environment, Air NZ's ability to attract investor funding, its profitability and financial projections, the likely strategic behaviour of Qantas, the prospect of new airline entry, and scope for an alternative alliance—reached the preliminary conclusion that the counterfactual would have the following characteristics:

    - a gradual recovery in the financial position of Air NZ and ongoing financial viability;

- a continuation of the present support by the Government for Air NZ, but with a question mark over whether sufficient capital in addition to retained earnings, would, if necessary, be forthcoming to pursue its preferred network strategy;

- 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";

- Air NZ standing alone in the short term, while seeking, and perhaps in the medium term gaining, an alternative alliance with another airline; and

- incremental entry by Virgin Blue being likely on the Tasman, with possible expansion onto the New Zealand main trunk.

13. In short, the Commission envisages a less aggressive form of competition between Air NZ and Qantas, and less entry, compared to the counterfactual put forward by the Applicants.

Market Definition and Competition Analysis

14. The Applicants have acknowledged that the proposed Alliance would be likely to give rise to some lessening of competition in the New Zealand main trunk, Tasman and New Zealand United States markets, but that the lessening would be small as the result of competition from both existing and new entrant airlines (the barriers to entry and expansion being low). A lessening of competition on some routes has been substantiated by the results from the Applicants' economic model.

15. The Commission has reached the preliminary conclusion that the proposed Alliance would be likely to result in a substantial lessening of competition in a number of markets:

- the following passenger air service markets:
    - New Zealand main trunk and provincial markets,
    - Tasman market,
    - New Zealand / Pacific market,
    - New Zealand / Asia market,
    - New Zealand / USA market.

- the following freight markets:
    - Tasman belly hold air freight services market,
    - international air freight services market,
    - the domestic air freight services market,

- the national wholesale travel distribution services market.

16. In broad terms, the lessening of competition would arise from the difference between:

- the factual, where competition between Air NZ and Qantas would be lost, other competitors would generally offer limited competition, and there would be no significant value based airline (VBA) entry; and

- the counterfactual, where competition between Air NZ and Qantas would be preserved, and may be augmented on Tasman markets by the entry of a VBA.

Detriment

17. The Commission compares the difference between the factual and the counterfactual and, to the extent possible, quantifies the economic efficiency detriments arising from the loss of competition.

18. The view of the Applicants is that detriments would be limited largely to a loss of allocative efficiency. They have calculated this to be about $10.3 million at year 3. Prospective losses of productive and dynamic efficiencies are almost completely discounted.

19. In the Commission's view, detriments arise from the substantial lessening of competition in various markets, and the ensuing poorer performance in the factual relative to the counterfactual. These detriments stem from the losses of:

    - allocative efficiency: the deadweight losses and transfer effects caused by the higher prices in some markets;

    - productive efficiency: reduced competition through the erosion of competitive incentives to keep costs down; and

    - dynamic efficiency: the impact the proposed Alliance would have both in deterring VBA entry, with the subsequent loss of innovative, lower cost, services, and the potential losses from global alliance competition should Air NZ switch from the Star Alliance to the oneworld Alliance.

20. The Commission's preliminary view is that the detriment to the public of New Zealand would be likely to fall within the range of $202m - $432m per annum.

Benefits

21. The benefits are any gain to the public of New Zealand that arise directly from the implementation of the proposed Alliance.

22. In the Applicants' view, the detriments arising from the proposed Alliance would be easily outweighed by the benefits to New Zealand from the Alliance.

23. The Applicants argued that benefits arise from:

- cost savings;
- new direct flights;
- better scheduling of flights;
- increased inbound tourism;
- maintenance of existing levels of NZ based engineering and maintenance contracts; and
- increased capacity in the freight markets.

24. The Applicants estimate that the benefits arising from the proposed Alliance over a five year period would be $236.3 million at year 3. The Applicants mention, but do not attempt to quantify, certain other benefits.

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

    - Cost savings of $32.4 million. The Commission adopted a counterfactual that does not involve wasteful capacity expansion, and a model that generates higher fare increases from those assumed by the Applicants.

    - Tourism benefits of between -$2.6 million to $13.5 million. The Commission has used a measure of the economic effects of tourism that expresses the welfare gain as the gross tourist expenditure less the opportunity cost of the resources employed to provide tourism services. In addition, the Commission expects that the higher prices resulting from the proposed Alliance could result in fewer tourists than anticipated by the Applicants, to the extent that current tourist numbers could be reduced.

    - Other benefits of $0.36m. The Commission found few additional benefits that would accrue only as a consequence of the proposed Alliance.

26. The Commission's estimates suggest that the public benefits attributable to the proposed Alliance are likely to be in the range of $30.2 million to $46.3 million per annum.

Net Effect

27. In the Commission's preliminary view, the overall detriment expected to result from the proposed Alliance would clearly outweigh the expected benefits. On a provisional basis, the detriments are estimated to fall in the range of $202 million to $432 million, and the benefits in the range of $30.2 million to $46.3 million.

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

	Applicants	Commission
Detriments	-10.3	-202m to -432
Benefits	236.3	30.2m to 46.3
Net Benefits	226	-155.7 to -401.8

Conditions

28. The Commission is able to accept divestment undertakings and/or impose conditions on an authorisation and is seeking submissions on whether such undertakings or conditions would result in a benefit to the public such that the proposed Alliance might be authorised.

29. The Applicants have provided the Commission with suggested undertakings that might eventually be considered by the Commission as conditions to be included in any authorisation. At this stage, the Commission has not completed a full analysis of potential conditions as it is necessary to first identify the impact of the proposed Alliance.

Draft Determination

30. The Commission has concluded, in this Draft Determination, that on the basis of the information currently available, it cannot be satisfied that the public benefits that would result from the proposed Alliance would outweigh the detriment. The Commission would therefore be likely to decline to authorise the Applications if its preliminary conclusions were confirmed by its subsequent processes that lead to its final Determination.

Next Steps

31. The Commission is now seeking submissions from interested parties in respect of the preliminary conclusions it has reached in the Draft Determination. The deadline for submissions to be received by the Commission is 9 May 2003.

32. The Commission proposes to hold a four-day conference in Wellington over the period 20-23 May 2003. The purpose of the conference is to enable the Commission to ask questions of interested parties in relation to their submissions on the Draft Determination.

33. The Commission intends to release its final Determination on the Applications by the end of June 2003.

THE PROPOSALS

1. On 9 December 2002 the Commission received two interconditional applications from Qantas Airways Limited ("Qantas") and Air New Zealand ("Air NZ") ("the Applications"), one from Qantas relating to a proposed acquisition (the s 67 Application) and one from both Qantas and Air NZ ("the Applicants") relating to a proposed Arrangement (the s 58 Application) (both together the proposed Alliance).

Proposed Acquisition

2. Qantas filed a notice with the Commission seeking authorisation under s 67(1) of the Commerce Act 1986 ("the Act") for the subscription by Qantas Limited of up to 22.5% of the voting equity in Air NZ pursuant to a Subscription Agreement between Air NZ and Qantas ("the proposed Acquisition").

Proposed Arrangement

3. Pursuant to s 58 of the Act, Air NZ and Qantas also filed a notice with the Commission seeking authorisation under s 61 of the Act to implement the terms of a Strategic Alliance Agreement (the proposed Arrangement). The proposed Arrangement creates a Joint Airline Operation network ("the JAO Networks") which, once fully implemented, would be commercially managed by Air NZ. All Air NZ flights would be part of the JAO Networks, together with all Qantas flights into, within and departing from New Zealand. The day to day flying operations would remain the responsibility of each airline. There are also extensive reciprocal rights for codesharing on each other's services. By way of example, this would enable Air NZ to obtain feeder traffic from codesharing on connecting flights on Qantas' Australian domestic and international networks.

4. In respect of the JAO Networks, the parties would co-ordinate pricing, capacity and all other aspects of the normal business operations of an airline. The two airlines also agree, as part of the proposed Arrangement, that where it is effective and efficient for them to do so, they would also co-ordinate on their non-JAO networks.

5. Air NZ's management of the JAO Networks would be supported by a Strategic Alliance Advisory Group ("SAAG") that comprises three representatives appointed by each airline. The decisions of that group are required to be unanimous. A recommendation of the SAAG would only result in a change in management direction when both Air NZ and Qantas agree that such a change should take place.

6. After taking into account the capacity of Air NZ and Qantas, each airline's net financial performance for the JAO Networks would be compared to allow for the equitable allocation of benefits.

COMMISSION PROCEDURES

7. The proposed Alliance is conditional (inter alia) on being granted authorisation by the Commission and the Australian Competition and Consumer Commission ("ACCC").

8. The Applicants have advised the Commission that the Applications are inter-conditional and stated they must be considered together.[1] The proposed Acquisition will not occur without the proposed Arrangement and vice versa. As two separate Applications have been made under two different sections of the Act, the Commission is required to make two separate determinations. In doing so, the Commission must take account of the factual matrix that it considers would exist in the event the proposed Alliance were to proceed. Thus, the Commission must take account of the proposed Arrangement when considering authorisation of the proposed Acquisition, and vice versa when considering authorisation of the proposed Arrangement. Consequently, although the Commission makes two draft determinations in this document, it has treated the proposed Alliance as one total package, as the Applicants requested.

Question 1

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

9. In preparing this draft determination, the Commission has fully considered and given weight to information and analysis from a wide range of sources. It has:

   - reviewed the substantial amount of information and analysis in the Applications, including the economic model submitted by the Applicants' economic experts;
   - sought further information and clarification from the Applicants on a range of points;
   - considered submissions from interested parties;
   - interviewed the Applicants and numerous other parties;
   - sought advice from its own external legal and economic experts; and
   - conducted its own analysis and modelling.

10. The Act requires the Commission to follow similar procedures in respect of each of the two Applications, although there are some differences in respect of the Commission's ability to accept undertakings or impose conditions on any

[1] Section 67 Application, para 3; section 58 Application p.6, and paragraphs 4 and 14(c).

authorisation granted. The Act requires the Commission to issue a draft determination and receive submissions from interested parties. This document constitutes the draft determinations in respect of the Applications. The closing date for submissions is 9 May 2003.

11. The Act also provides, in respect of the Applications, that the Commission may determine to hold a conference prior to making a final determination (s 69B for the proposed Acquisition and s 62 (6) for the proposed Arrangement). The Commission proposes to hold a four day public conference in Wellington on 20 – 23 May 2003. The conference is to enable the Commission to ask questions of interested parties in relation to their oral presentations based on their submissions on the draft determination and for the interested parties to make presentations to the Commission.

THE PARTIES

Air NZ

12. Air NZ comprises a group of companies. Its total revenue for the year ended 30 June 2002 was $3.6 billion and it has total assets of $3.9 billion

13. Air NZ operates domestic trunk and regional air transport services throughout New Zealand, carrying around 3.5 million passengers domestically per annum. Its domestic operations comprise 20% of its total airline (passenger and cargo) business. Air New Zealand National operates eleven B737 aircraft between the main centres of Auckland, Wellington and Christchurch and significant regional centres such as Hamilton and Queenstown. Air NZ Link (which includes Eagle Aviation Ltd, Air Nelson Ltd and Mount Cook Airline Ltd) operates regional services. In November 2001, Air NZ rebranded its domestic operations as "*Air NZ Express*", which offers only economy class and provides no food service.

14. Air NZ operates international services to and from Auckland, Wellington and Christchurch airports, carrying around 3 million passengers internationally per annum. Air NZ's international operations represent 80% of its total airline business. Air NZ International operates a fleet of 747, 767 and 737 aircraft on routes to Australia, the Pacific, Asia-Japan, and the Atlantic.

15. Freedom Air is a wholly owned subsidiary of Air NZ. It operates low-cost Tasman services.

16. Air NZ domestically and internationally operates 83 aircraft and serves 48 destinations in 16 countries. It is the 33rd largest airline internationally on the basis of revenue passenger kilometres ("RPK"s).

17. As well as operating its own international air services, Air NZ provides ground handling, loading and engineering line maintenance services on the ground at international airports in New Zealand to overseas airlines that require it.

18. In addition to its Star Alliance involvement, Air NZ has alliance or code-sharing agreements directly with the following airlines: Singapore Airlines, United, Air Canada, Lufthansa, British Midland, Mexicana, JAL, Aircalin and EVA Air.[2]

Qantas

19. Qantas comprises a group of companies. Its total revenue for the year ended 30 June 2002 was $11.4 billion and its total assets are $14.8 billion.

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[2] Schedule 4 to the Applicant's s 58 Application provides a more detailed summary of the agreements.

20. Qantas is the leading Australian provider of international and domestic air transport services to, from and within Australia. Qantas is the world's 15th largest airline measured by RPKs. The airline services 142 destinations in 32 countries worldwide with 194 aircraft, carrying almost 20 million passengers per annum.

21. In addition to its oneworld involvement, Qantas has alliance or code-sharing agreements directly with the following airlines: British Airways, JAL, Aircalin, Fin Air, South African Airways, Asiana Airlines, Vietnam Airlines, Air Vanuatu, Air Niugini, Air Pacific, Polynesian Airlines, Air Tahiti, Norfolk Jet, Alaska Airlines, American Airlines, Lan Chile and EVA Air.[3]

22. Qantas holds 46.32% of the shares in Air Pacific. Air Pacific is also a party to the proposed Acquisition.

23. British Airways ("BA") holds 18.93% of the shares in Qantas. It is unclear whether Qantas and BA are associated parties but as there is unlikely to be any competition impact from the association in this particular instance the Commission does not consider this issue any further.

24. After the collapse of Qantas NZ in April 2001, Qantas itself began operating domestic services in New Zealand (via a New Zealand subsidiary Jetconnect) between the major centres. Qantas currently operates code-sharing with Origin Pacific Airways ("Origin Pacific") to provide services to the regional centres. Jetconnect is currently in the process of expanding its operations in New Zealand.

OTHER RELEVANT PARTIES

Virgin Blue Airlines (Virgin Blue)

25. Virgin Blue is a low-cost Australian domestic airline and part of the worldwide Virgin Group owned 49% by Patrick Corporation, 49% by the Virgin Group and 2% by other shareholders. It is the only solely low-cost airline operating domestically in Australia (and the number two airline to Qantas). It operates a fleet of Boeing 737 aircraft to key domestic locations in Australia. Virgin Blue has expressed interest in operating on the Tasman, to Asia-Pacific destinations, and domestically in New Zealand.

Origin Pacific

26. Origin Pacific is a regional airline operating from Nelson and is 100% New Zealand owned. It was established by Robert Inglis who also founded Air Nelson (which was subsequently sold to Air NZ). Origin Pacific was initially launched in 1997 as an air charter service, but now operates scheduled services between major cities and regional centres. Origin Pacific expanded significantly after the collapse of Ansett

[3] *Ibid.*

NZ and Qantas NZ, acquiring a number of aircraft previously operated by those airlines on regional routes. As noted, currently Origin Pacific has code-share arrangements with Qantas.

Other Provincial Operators

27. There is a range of very small operators such as Soundsair and Wairarapa Airlines.

Asian Carriers

28. The following Asian based carriers operate on the same international routes as Air NZ. These routes are set out in Appendix 1.

Cathay Pacific

29. Cathay Pacific is Hong Kong's international airline serving over 80 destinations worldwide. It has over 60 aircraft in service, and carries over 12 million passengers per annum. Cathay Pacific competes with Air NZ and Qantas on passenger flights between New Zealand and Hong Kong

Singapore Airlines

30. Singapore operates air services from both Christchurch and Auckland airports. It is one of the world's leading passenger and cargo carriers, operating a fleet of over 90 aircraft in 90 cities in 40 countries. The Singapore Government owns part of the airline. The airline carries over 12 million passengers per annum worldwide. Singapore Airlines competes with Air NZ and Qantas on flights between New Zealand and Singapore.

Thai Airways

31. Thai Airways is Thailand's designated flag carrier, carrying 18 million passengers per annum using over 80 aircraft. The Thai Government owns the majority of the airline. It operates services from Auckland, via Australia, to Bangkok daily. Air NZ does not operate on this route, but Qantas does.

Malaysia Airlines

32. Malaysia Airlines flies to 110 cities across six continents annually. It operates services to Kuala Lumpur from Auckland (some via Australia). Neither Qantas or Air NZ operate services on this route. The Malaysian Government owns part of the airline.

Garuda Indonesia ("Garuda")

33. Garuda carries 6 million passengers per annum. It operates from Auckland, via Sydney, to Bali. Qantas operates extensive services into a number of points in Indonesia from Australia.

Korean Air

34. Korean Air operates services to Incheon. Neither Qantas nor Air NZ operate services on this route. It also operates flights between new Zealand and Fiji. Internationally, Korean Air operates 119 aircraft and carries 22 million passengers per annum.

Asiana Airlines ("Asiana")

35. Asiana is another Korean carrier and a recent addition to the Star Alliance. It does not operate services to and from New Zealand, but does operate to and from Australia. Asiana operates 66 aircraft worldwide.

EVA Air

36. EVA Air (a Chinese airline) operates services to Taipei. Air NZ also operates services to Taipei and code-shares on some services with EVA Air.

Pacific Islands Carriers

37. The following Pacific Island-based carriers operate on the same routes as Air NZ. These routes are set out in Appendix 1.

Polynesian Airlines

38. Polynesian Airlines is Samoa's national airline. It operates return services daily to varying island destinations from Auckland and Sydney. Qantas code-shares on some of its flights. It competes with Air NZ and Air Tahiti on services to Tahiti, and Royal Tongan Airlines on services to Tonga.

Air Tahiti

39. Air Tahiti code-shares on Qantas on the Tasman and operates weekly return services from Auckland to Papeete (on which Qantas code-shares). It competes with Air NZ and Polynesian Airlines.

Royal Tongan Airlines

40. Tonga's airline flies daily return services Auckland to Tonga, competing with Polynesian Airlines.

Air Pacific

41. Air Pacific is 46.32% owned by Qantas and 53.68% by the Fijian Government, and is Fiji's national airline. It operates return services to Nadi and Suva from Auckland and Australia daily. Competition is provided on services to Nadi by Air NZ and Korean Air.

Air Vanuatu

42. Air Vanuatu operates return services to Vanuatu. Neither Qantas nor Air NZ operates services on this route.

Air Caledonie International ("Aircalin")

43. Aircalin flies between Auckland and Noumea. Neither Qantas nor Air NZ operates services on this route.

Other Carriers

Aerolineas Argentinas

44. Aerolineas Argentinasoperates return air services from Sydney, via Auckland, to Buenos Aires. Air NZ does not operate on this route, but Qantas does.

Lan Chile

45. Lan Chile operates daily from Sydney, via Auckland, to Santiago. Neither Qantas nr Air NZ operate services to Chile themselves, but Qantas code-shares on Lan Chile.

United Airlines

46. United Airlines until recently operated on the New Zealand–Los Angeles route. Although it is currently in Chapter 11 bankruptcy, it continues to operate internationally.

APPLICATION OF THE COMMERCE ACT

Proposed Acquisition

47. Section 47 of the Act states:

> *(1)* A person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.
> (2) For the purposes of this section, a reference to a person includes 2 or more persons that are interconnected or associated.
> (3) For the purposes of this section, a person is associated with another person if that person is able, whether directly or indirectly, to exert a substantial degree of influence over the activities of the other.
> (4) A person is not able to exert a substantial degree of influence over the activities of another person for the purposes of subsection (3) by reason only of the fact that—
> (a) those persons are in competition in the same market; or
> (b) 1 of them supplies goods or services to the other.

48. Any person who proposes to acquire assets of a business or shares and considers that the acquisition may breach s 47, can make an Application for an authorisation under s 67 of the Act, the relevant provisions of which provide:

> *(1)* A person who proposes to acquire assets of a business or shares may give the Commission a notice seeking an authorisation for the acquisition.
> (2) Subsections (1), (2)(a) and (b), (4), and (5) of section 60 of this Act shall apply in respect of every notice given under subsection (1) of this section as if the notice was an application under section 58 of this Act.
> (3) Within 60 working days after the date of registration of the notice, or such longer period as the Commission and the person who gave the notice agree, the Commission shall—
> (a) If it is satisfied that the acquisition will not have, or would be likely to have, the effect of substantially lessening competition in a market, by notice in writing to the person by or on whose behalf the notice was given, give a clearance for the acquisition; or
> (b) If it is satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted, by notice in writing to the person by or on whose behalf the notice was given, grant an authorisation for the acquisition; or
> (c) If it is not satisfied as to the matters referred to in paragraph (a) or paragraph (b) of this subsection, by notice in writing to the person by or on whose behalf the notice was given, decline to give a clearance or grant an authorisation for the acquisition.
> (4) If the period specified in subsection (3) of this section expires without the Commission having given a clearance or having granted an authorisation

or having declined to do so, the Commission shall be deemed to have declined to give a clearance or grant an authorisation.

(5) The Commission shall state in writing its reasons for a determination made by it under subsection (3) of this section.

(6) A clearance given or an authorisation granted under subsection (3) of this section expires—

(a) Twelve months after the date on which it was given or granted; or

(b) In the event of an appeal being made against the determination of the Commission giving the clearance or granting the authorisation, and the determination of the Commission being confirmed by the Court, 12 months after the date on which the determination is confirmed.

49. Section 67(3)(a) of the Act, when read in conjunction with s 47 of the Act, requires the Commission to give clearance for a proposed acquisition if it is satisfied that the proposed acquisition would not have, and would not be likely to have, the effect of substantially lessening competition in a market or markets.

50. If the Commission is not so satisfied, it may grant an authorisation under s 67(3)(b) of the Act, if the Commission is satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted. If the Commission is not satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted, it must decline an authorisation under s 67(3)(c).

51. Section 67(3) of the Act requires the Commission to issue a decision within 60 working days after the date of registration of the notice, or such other longer period agreed to by the Commission and the Applicants. There is no statutory deadline associated with the authorisation of RTPs under s 60.The Applicants and the Commission have agreed to an extension to 30 June 2003. The Commission intends to deliver its final determination on the s 67Application by the end of June 2003.

Proposed Arrangement

52. Section 27 of the Act provides:

(1) No person shall enter into a contract or arrangement, or arrive at an understanding, containing a provision that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market.

(2) No person shall give effect to a provision of a contract, arrangement, or understanding that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market.

(3) Subsection (2) of this section applies in respect of a contract or arrangement entered into, or an understanding arrived at, whether before or after the commencement of this Act.

(4) No provision of a contract, whether made before or after the commencement of this Act, that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market is enforceable.

53. Section 30 of the Act provides:

> (1) Without limiting the generality of section 27 of this Act, a provision of a contract, arrangement, or understanding shall be deemed for the purposes of that section to have the purpose, or to have or to be likely to have the effect, of substantially lessening competition in a market if the provision has the purpose, or has or is likely to have the effect of fixing, controlling, or maintaining, or providing for the fixing, controlling, or maintaining, of the price for goods or services, or any discount, allowance, rebate, or credit in relation to goods or services, that are—
>
> (a) Supplied or acquired by the parties to the contract, arrangement, or understanding, or by any of them, or by any bodies corporate that are interconnected with any of them, in competition with each other; or
>
> (b) Resupplied by persons to whom the goods are supplied by the parties to the contract, arrangement, or understanding, or by any of them, or by any bodies corporate that are interconnected with any of them in competition with each other.
>
> (2) The reference in subsection (1)(a) of this section to the supply or acquisition of goods or services by persons in competition with each other includes a reference to the supply or acquisition of goods or services by persons who, but for a provision of any contract, arrangement, or understanding would be, or would be likely to be, in competition with each other in relation to the supply or acquisition of the goods or services.

54. Under s 58 of the Act, a person may apply for an authorisation for contracts arrangements or understandings that breach ss 27, 28, 29, 37 or 38. Section 58 provides:

> 58 Commission may grant authorisation for restrictive trade practices
>
> (1) A person who wishes to enter into a contract or arrangement, or arrive at an understanding, to which that person considers section 27 of this Act would apply, or might apply, may apply to the Commission for an authorisation to do so and the Commission may grant an authorisation for that person to enter into the contract or arrangement, or arrive at the understanding.
>
> (2) A person who wishes to give effect to a provision of a contract or arrangement or understanding to which that person considers section 27 of this Act would apply, or might apply, may apply to the Commission for an authorisation to do so, and the Commission may grant an authorisation for that person to give effect to the provision of the contract or arrangement or understanding.
>
> (3) A person who wishes to require the giving of, or to give, a covenant to which that person considers section 28 of this Act would apply, or might apply, may apply to the Commission for an authorisation to do so, and the Commission may grant an authorisation for that person to require the giving of, or to give, the covenant.
>
> (4) A person who wishes to carry out or enforce a covenant to which that person considers section 28 of this Act would apply, or might apply, may apply to the Commission for an authorisation to do so, and the Commission may grant an authorisation for that person to carry out or enforce the covenant.
>
> (5) A person who wishes to enter into a contract or arrangement, or arrive at an understanding to which that person considers section 29 of this Act would apply, or might apply, may apply to the Commission for an authorisation for that person to enter into the contract or arrangement or arrive at the understanding.
>
> (6) A person who wishes to give effect to an exclusionary provision of a contract or arrangement or understanding to which that person considers section 29 of this Act would apply, or might apply, may apply to the Commission to do so, and the Commission may

grant an authorisation for that person to give effect to the exclusionary provision of the contract or arrangement or understanding.

(7) A person who wishes to engage in the practice of resale price maintenance to which that person considers section 37 of this Act would apply, or might apply, may apply to the Commission for an authorisation to do so, and the Commission may grant an authorisation for that person to engage in the practice.

(8) A person who wishes to do an act to which that person considers section 38 of this Act would apply, or might apply, may apply to the Commission for an authorisation to do so, and the Commission may grant an authorisation for that person to do that act.

55. Section 61 of the Act provides:

(1) The Commission shall, in respect of an application for an authorisation under section 58 of this Act, make a determination in writing—
   (a) Granting such authorisation as it considers appropriate:
   (b) Declining the application.

(2) Any authorisation granted pursuant to section 58 of this Act may be granted subject to such conditions not inconsistent with this Act and for such period as the Commission thinks fit.

(3) The Commission shall take into account any submissions in relation to the application made to it by the applicant or by any other person.

(4) The Commission shall state in writing its reasons for a determination made by it.

(5) Before making a determination in respect of an application for an authorisation, the Commission shall comply with the requirements of section 62 of this Act.

(6) The Commission shall not make a determination granting an authorisation pursuant to an application under section 58(1) to (4) of this Act unless it is satisfied that—
   (a) The entering into of the contract or arrangement or the arriving at the understanding; or
   (b) The giving effect to the provision of the contract, arrangement or understanding; or
   (c) The giving or the requiring of the giving of the covenant; or
   (d) The carrying out or enforcing of the terms of the covenant—

   as the case may be, to which the application relates, will in all the circumstances result, or be likely to result, in a benefit to the public which would outweigh the lessening in competition that would result, or would be likely to result or is deemed to result therefrom.

(6A) For the purposes of subsection (6) of this section, a lessening in competition includes a lessening in competition that is not substantial.

(7) The Commission shall not make a determination granting an authorisation pursuant to an application under section 58(5) or (6) of this Act unless it is satisfied that—
   (a) The entering into of the contract or arrangement or the arriving at the understanding; or
   (b) The giving effect to the exclusionary provision of the contract, or arrangement or understanding—

   as the case may be, to which the application relates, will in all the circumstances result, or be likely to result, in such a benefit to the public that—
   (c) The contract or arrangement or understanding should be permitted to be entered into or arrived at; or
   (d) The exclusionary provision should be permitted to be given effect to.

(8) The Commission shall not make a determination granting an authorisation pursuant to an application under section 58(7) or (8) of this Act unless it is satisfied that—
(a) The engaging in the practice of resale price maintenance to which the application relates; or
(b) The act or conduct to which the application relates—

as the case may be, will in all the circumstances result, or be likely to result, in such a benefit to the public that—

(c) The engaging in the practice should be permitted; or

(d) The act or conduct should be permitted.

COMPETITION FRAMEWORK

56. The proposed Alliance is comprised of two parts: the proposed Acquisition and the proposed Arrangement which the applicants have advised are interdependent and one will not occur without the other. The effect of the two Applications being conditional upon each other in this way effectively equates the proposed Alliance to one head in the market with the proposed Arrangement being cemented into place by the proposed Acquisition. On that basis, the competition analysis is conducted from the position of Qantas and Air NZ acting as one person in the market.

57. For the Commission to have jurisdiction to authorise the proposed Alliance, the Commission must be satisfied as to three separate competition thresholds:

- Section 47 of the Act prohibits mergers and acquisitions which would have, or would be likely to have, the effect of substantially lessening competition in a market;
- Section 27 of the Act prohibits arrangements that have the purpose, or have or are likely to have, the effect of substantially lessening of competition, (although s 61(6A) provides that for the purpose of an authorisation, the Commission need not find that any lessening of competition is substantial); and
- Section 30 provides that any arrangement that has the purpose, or has or is likely to have, the effect of fixing, controlling or maintaining prices, is deemed to substantially lessen competition.

58. Given the similarity of the shareholders, the Commission has analysed the impact of the proposed Alliance to determine if it would have, or would be likely to have, the effect of substantially lessening competition in a market. This threshold, if breached would provide the Commission with the jurisdiction to consider authorisation of the Applications.

59. In order that the Commission can consider authorisation of the proposed Alliance, it considers the following issues:

- Industry background: The background to the industry provides a necessary factual matrix to assist the competition analysis.
- Market definition: The Commission is required to identify those markets where the aggregation of the activities of the applicants will likely have a competitive effect in light of the proposed Alliance;
- The factual: The Commission must assess how the factual (the proposed Alliance) is likely to operate in practice;
- The counterfactual: In order to assess the competitive impact of the proposed Alliance on the identified markets, the Commission must identify the counterfactual situation that would likely exist in the absence of the proposed Alliance;

- Comparison of the counterfactual and factual: A comparison of these two situations will allow the Commission to identify the competitive impact of the proposed Alliance in each of the identified markets and whether the proposed Alliance would substantially lessen competition;
- Detriments: If a substantial lessening of competition is found to result in any of the identified markets, the Commission must consider the extent of the detriment that results from the proposed Alliance; and
- Public benefits: The Commission may authorise the proposed Alliance if the public benefit arising directly from it outweighs the detriment.

60. The following analysis considers each of these issues in turn.

INDUSTRY BACKGROUND

Introduction

61. The purpose of this section is to provide an overview of the international aviation industry, and of the industry in Australasia, in light of the regulatory environment in which it operates.

Regulatory Background

Introduction

62. Since 1983, New Zealand domestic aviation markets have been open to foreign-owned airlines provided they meet safety regulations. Any airline (domestic or foreign-owned) can start up and fly domestically; no air licence is needed from the Ministry of Transport (‘MOT’). The only requirement is for an air operator certificate from the Civil Aviation Authority. The provision of international air services is restricted as a result of the regulation of international freedom (air) rights and foreign ownership restrictions.

International Obligations

63. The primary international means of regulating the aviation industry are twofold: the directives of the International Civil Aviation Organisation (‘ICAO’), and the agreement and enforcement of bilateral Air Service Agreements. New Zealand is required to comply with the directives of ICAO, and is also party to a number of Air Service Agreements (‘ASAs’). Both of these forms of regulation have some impact on the operation of civil aviation in New Zealand.

ICAO

64. ICAO, an inter-government organisation, was established in 1947 following the introduction of the “Convention on International Civil Aviation” (‘the Chicago Convention’).[4] The Chicago Convention has been ratified by 185 countries, including New Zealand. It imposes obligations regarding many aspects of air transport operation on signatories.

65. Although the Chicago Convention provides for ICAO to play a part in the economic regulation of international air transport, the organisation has traditionally not focused on that area, preferring instead to concentrate its efforts on matters affecting aviation

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[4] The Chicago Convention is in 4 parts and has 96 Articles. Part 1 deals with Air Navigation, Part 2 establishes ICAO, Part 3 covers International Air Transport, and Part 4 details further administrative matters. The convention also has 18 Annexes, which contain more detailed recommendations and standards.

safety and security. ICAO's main priorities are to ensure safety and security in the operation of international civil air transport by policies, which take three forms: binding obligations in the Chicago Convention; Statements to Contracting States; and Advisory Manuals[5].

66. ICAO's main purpose is to develop international standards and recommended practices for the safe and efficient conduct of international air transport. It is the responsibility of each member country to ensure that the minimum standards are applied. However, Air Services Agreements usually recognise this responsibility in both of the bilateral partners, who agree to accept the certification and licensing of the carriers registered in each country.

67. The Convention and its articles include the following:

- Article 1 (Sovereignty), which recognises that every State has complete and exclusive sovereignty over the airspace above its territory.

- Article 6, which provides that no scheduled international air service may be operated over or into, the territory of a contracting State, except with the special permission or other authorisation of that State.

- Article 7 (Cabotage, which is the right of one country to carry traffic between two points within the territory of another country). The Article provides that each contracting State has the right to refuse cabotage rights to aircraft of other contracting States. Should permission be granted, it cannot be limited to only one other State.

- Article 10, which provides that, where regulations of a State require it, aircraft which enter the territory of that State must land in that State (and not just cross it). Aircraft which land in the territory of a contracting State are required to land only at an airport designated by that State for the purposes of customs and other examination. Similarly, on departure from that State's territory the aircraft must also depart from an appropriately designated airport.

- Article 68, which provides that each contracting State may designate the airports, and air routes, that any international air service may use within its territory.

Bilateral System—Air Service Agreements

68. Article 1 of the Chicago Convention provides for complete and absolute sovereignty to each nation over the air space above its territory, and consequently, confirms the legal authority for states to grant and exchange "Aviation Rights of Passage" (commonly known as freedoms) to other states. Such rights are exchanged through

[5] See www.icao.org

inter-governmental agreements, known as ASAs. ASAs are negotiated bilaterally and generally comprise an Air Service Agreement, a Memorandum of Understanding ("MOU") and/or an exchange of letters. They are sometimes accompanied by other less formal and less transparent understandings.

69. The fundamental principle of the bilateral system is that of bilateral reciprocity, whereby countries exchange rights on the basis of 'equality of opportunity'. This essentially means that two countries agree to exchange equal rights of access for their own carrier in the other's market. The precise form of any bilateral agreement depends on the negotiations between the two party countries.

70. ASAs cover matters such as the routes that may be flown, the freedoms granted, the capacity (frequency and aircraft types) that may be offered by airlines, how many airlines may operate, and how tariffs (prices) may be regulated. They also include a series of 'doing business' rules such as rights for airlines to repatriate funds, be exempt from customs and excise duties, and gain access to terminals and ground handling services. These provisions generally facilitate the operation of international air services between countries by seeking to minimise the potential for anti-competitive practices.

71. Under the bilateral system, international air transport between two countries does not take place unless it is expressly permitted by an ASA, in contrast with most other products, where trade does take place unless specifically restricted. Although it provides a mechanism to facilitate trade in air services, the system limits competition in, and the growth and development of, international air services by having provisions in ASAs that restrict the services provided by international carriers between sets of countries.

72. Restrictions, imposed bilaterally within the international framework of ASAs, mean that the international airline industry is highly regulated:

> The bilateral system restricted where airlines fly, the number and frequency of flights they operate, their ownership and access to equity, what types of aircraft they use, and how much they charge. It influences the nature of competition between airlines by controlling market entry and the quantity and variety of rights allocated to particular airlines.
>
> . . .
>
> Regulation of entry, frequency, capacity, routes and prices keeps fares up and impedes the development of new travel products. Relaxing of such restrictions would lead to greater competition, reduced fares, new routes and destinations, and improved quality of service.[6]

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[6] Productivity Commission, *International Air Services Inquiry*, Melbourne: Productivity Commission, 1998, pp. xxvi-xxvii.

73. Air rights are needed by an airline, regardless of whether it is operating a service itself or by code-sharing[7] with another airline. Air rights are traffic rights (rights to uplift passengers and cargo, not airline rights).

74. Non-scheduled services (including charters) generally fall outside the bilateral system, although some ASAs contain provisions relating to them.

Freedoms of the Air[8]

75. The bilateral system allows a country to grant various "freedoms of the air" to the carrier of another country, in exchange for similar rights for its own carrier (principle of "equality of opportunity"). These freedoms include the airlines of the two countries being able to fly to, from, between and beyond each country. There are nine distinct 'freedoms' that states can confer. These freedoms provide the backbone for negotiating capacity rights between countries under each ASA and are detailed below.

76. The first freedom is the right of an airline of one country to fly over the territory of another country without landing. For example:

77. The second freedom is the right of an airline of one country to land in another country for non-traffic purposes such as refuelling or maintenance, while en route to another country. For example:

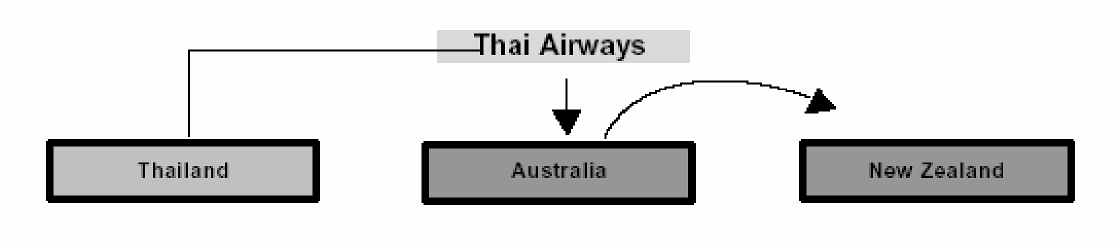
78. The third freedom is the right of an airline of one country to carry traffic (passengers, cargo or mail) from its country to another country. For example:

---

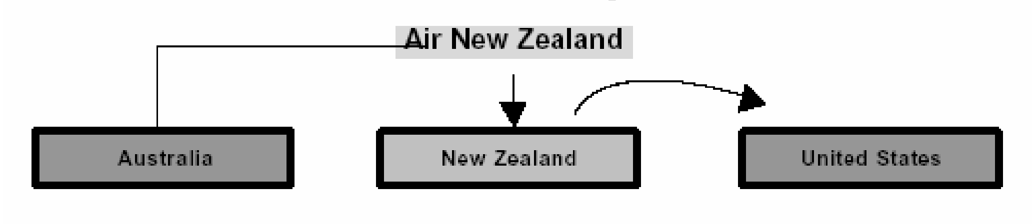
[7] Codesharing involves an airline assigning its own code to (selling seats on) a flight operated by another airline.
[8] Schedule 3(a) to the Applicant's section 58 Application provides a detailed summary of the various freedoms of the air, including examples.
[10] Separate criteria apply to SAM airlines operating only within and between New Zealand and Australia. These airlines are not "designated".

79. The fourth freedom is the right of an airline of one country to carry traffic from another country to its own country. For example:

80. The fifth freedom is the right of an airline of one country to land in a foreign country, pick up and deliver traffic, and then fly to a second foreign (intermediate) country. Fifth Freedom rights are confined to flights that originate or terminate in the airline's home country. For example:

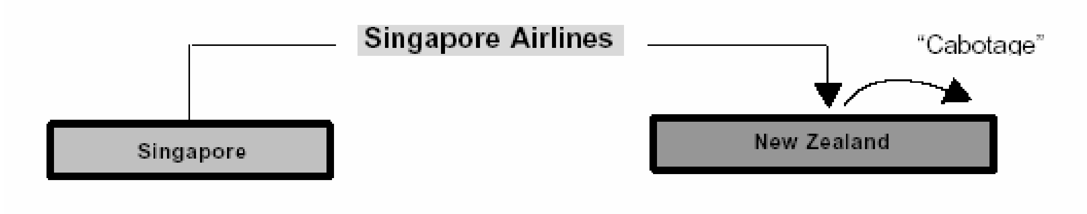


81. The sixth freedom is the right of an airline of one country to carry traffic between two other countries via its own country. A sixth freedom is effectively a combination of two sets of third and fourth freedoms. For example:

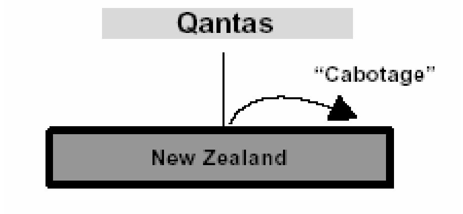


82. The seventh freedom is the right of an airline of one country to operate flights between two other countries without the flight originating or terminating in its own country. For example:

83. The eighth freedom (also known as cabotage) is the right of an airline of one country to carry traffic from one point in another country to another point in the foreign country on a flight originating in the airline's home country. For example:



84. The ninth freedom is the right for an airline of one country to carry traffic from one point in another country to another point in the same foreign country without a requirement that the flight originates in an airline's home country. For example:



<u>Substantially Owned and Effectively Controlled</u>

85. The bilateral system assumes that each country has its own "substantially owned and effectively controlled" designated national flag carrier. Only designated airlines can exercise a country's air rights under ASAs. There is no internationally accepted definition of what constitutes 'substantial ownership and effective control' but in New Zealand and Australia it is defined as being where foreign ownership is not more than 49 per cent, a single foreign airline owns not more than 25 per cent, and all foreign carriers own not more than 35 per cent. As a matter of policy, New Zealand will not designate as a New Zealand airline an airline that is not substantially owned and effectively controlled by New Zealand nationals.

86. Currently, the only New Zealand designated airline is Air NZ, and the only Australian designated airline is Qantas.

87. Different ASAs contain different criteria for designation of an airline. Some are more liberal than others. Criteria included are of four types: place of incorporation ("POI"), principal place of business ("PPB"), substantial ownership ("SO") and

effective control ("EC"). Table 1 (provided by MOT) summarises criteria included in each of New Zealand's ASAs.

Table 2
Criteria of New Zealand's ASAs

POI, PPB & EC (19)	**POI & PPB** (2)	**SO & EC** (25)
Australia,[10] Austria, Belgium, Brunei, Chile, Cook Islands, Denmark, Hong Kong,[11] Ireland, Malaysia,[12] Mexico, Norway, Peru, Samoa, Singapore, Spain, Sweden, Tonga, United States	Macau, Taiwan	Argentina, Brazil, Canada, China, Fiji, France, Germany, India, Indonesia, Italy, Japan, Korea, Luxembourg, Nauru, Netherlands, Niue, Papua New Guinea, Russia, Solomon Islands, South Africa, Switzerland, Thailand, United Arab Emirates,[13] United Kingdom, Vanuatu

88. To date, the restrictions on the ownership of international airlines contained in the bilateral system have effectively prevented airlines from merging across national boundaries, and so competitive pressures encouraging them to offer comprehensive, worldwide networks of routes have found expression in the formation of alliances between them.

<u>New Zealand's ASAs</u>

89. New Zealand currently has ASAs with a total of 46 countries, amongst which are our top 25 export markets. ASAs are negotiated in New Zealand by the MOT, which also allocates air rights to airlines. The MOT desires agreements to be as liberal as possible, as agreements open markets for trade and tourism. The 1985 International Aviation Policy of the New Zealand Government (still current) is intended to foster growth in tourism, trade, aviation industry. When negotiating ASAs, the MOT considers what can be delivered for New Zealand, and not just what rights might provide for airlines. Many ASAs have been negotiated because of the wider benefits to the economy. Any origin-destination traffic between two countries is considered to be primarily the rights of the airlines in those two countries. When negotiating ASAs, the MOT considers what reciprocal advantages or benefits can be obtained from intermediary countries.

90. New Zealand, unlike most other countries, does not start negotiations from the most restrictive position, from which concessions are negotiated (which generally reflects a desire to protect the country's flag carrying airline), but rather starts from an "open skies" position and introduces restrictions only when compelled to do so by the other side (which reflects a desire to do what is best for the country's economy). New Zealand has also been prepared to negotiate on cabotage, although cabotage in this country is not attractive to foreign airlines.

[11] The designating government is to be in position to exercise regulatory control over designated airlines.
[12] The 1997 MOU states that it is current policy not to designate an airline that is not SO and EC.
[13] It is understood that the SO requirement would not be applied in respect of New Zealand airlines.

91. There are no restrictions imposed from the New Zealand side of ASA negotiations on which airports may be serviced; its approach is to leave the choice to the foreign airline's commercial assessment, although sometimes the foreign government specifies the airport to be used. ASAs thus generally do not impinge upon either Air NZ's or a foreign airline's ability to substitute between New Zealand airports.

Open Skies Agreements

92. In negotiating ASAs, New Zealand has a preference for open skies agreements. Such agreements aim to remove most of the traffic and market access constraints and reduce the extent of government involvement in the aviation industry. They generally permit unrestricted services by the airlines of the countries involved to, from and beyond the other's territories, without prescribing where carriers fly, the number of flights they operate and the prices they charge. As stated by the Applicants in Schedule 3(b) to their section 58 Application:

> Although there is no uniform definition of Open Skies and the precise provisions of Open Skies vary from arrangement to arrangement, it generally involves the removal of restrictions and access to each country's markets, including unlimited rights to intermediate and beyond points. Restrictions on capacity and frequency, ability to code-share and routes (including points of access) are also removed. However, restrictions often remain on foreign ownership and control of designated airlines, ability to operate domestic flights in the other country (cabotage) and, in some cases, the ability to fly from the other country to a third country (Fifth Freedom).

93. New Zealand currently has negotiated 12 "open skies" agreements, the most important being with the US. The other open skies agreements that New Zealand has entered into are based on the United States model, but include more liberal terms such as the inclusion of passenger and cargo seventh freedom and cabotage rights. Open skies agreements also exist with Australia, Brunei, Chile, the Cook Islands, Luxembourg, Malaysia, Peru, Samoa, Singapore, Tonga, and the United Arab Emirates. These open skies agreements have removed most of the barriers with regard to routes and capacity.

Multilateral Agreement for Liberalisation of Air Transportation

94. A number of countries (Brunei, Chile, Peru, Samoa, Singapore, and the United States) have signed a multilateral open skies agreement with New Zealand, known as the Multilateral Agreement for Liberalisation of Air Transportation ("MALIAT") which came into force on 21 December 2001. The MALIAT means that any airline owned and controlled in any of the countries party to the agreement can fly to and from countries party to the agreement without constraint, and also within a country in the case of those that have signed a protocol to that effect (namely New Zealand, Singapore, Brunei and Chile).

Australasian Single Aviation Market

95. The current ASA between Australia and New Zealand was signed in 1961, with a further MOU being negotiated in 1992. The MOU was the first step towards a Single Aviation Market ("SAM"), and was undertaken as part of the existing Closer Economic Relations Agreement. The Australia/NZ ASA and MOU remain in force today, along with additional understandings provided in SAM arrangements agreed on 1 November 1996.

96. SAM arrangements define the requirements for an airline to be authorised as a SAM airline - basically that an airline is substantially owned and controlled, and operated, in Australasia. Specifically, there must be no more than 49% foreign control, the head office and operational base must be in Australia or New Zealand, the chairperson of the board must be a citizen of either country, and the board of directors must controlled by citizens of either country.

97. The 1996 SAM arrangements created, for Australasian (SAM) airlines, a single market between Australia and New Zealand. In practical terms, this means that travel between the two countries is like travel within one country. Any New Zealand or Australian-owned, controlled and operated airline can operate within and between New Zealand and Australia without restriction. SAM airlines (which must also be controlled in New Zealand or Australia) can also fly to and from New Zealand and Australia internationally using existing air rights (in addition to the Tasman). The SAM arrangements also permit cabotage, thereby allowing Air NZ to fly routes domestically between city pairs within Australia, for example.

98. The only designated SAM airlines at present are Qantas, Air NZ and Asian Express (a freight operator). Although Virgin Blue meets the owned and operated criteria for SAM status, the issue as to whether it is controlled within Australia/New Zealand remains in doubt given the involvement of Sir Richard Branson as chairman. The indications are that the New Zealand Government would waive any requirement of control if Virgin Blue were to commit to entering.

99. While the SAM arrangements liberalise domestic and Tasman services, other international services are still governed by the bilateral agreements between the two countries and foreign counterparts. Even though Australia and New Zealand are a SAM within their borders, looking from the outside they are still two separate countries. For example, for Qantas to be able to fly internationally out of New Zealand to Los Angeles, it must have the necessary air rights under the Australia-New Zealand ASA. Seventh freedom rights are not covered in the SAM arrangements. Similarly, Air NZ cannot base an operation in Australia to fly to third countries, but can fly from New Zealand through Australia to third countries (the same applies to

Qantas). Fifth freedom beyond rights beyond both countries are also limited to the equivalent of 12 B747 flights per week (as established in the MOU).[14]

International Air Service Licences

100. To ensure that scheduled aviation services to and from New Zealand are operated in accord with bilateral arrangements, airline companies must hold an international air service licence issued under New Zealand's International Air Services Licensing Act 1947. The licence is issued by the Minister of Transport for New Zealand airlines or, in the case of foreign airlines, the Secretary of Transport. The licence prescribes the routes and capacity that may be operated by the airline concerned. This requirement is additional to a safety certification required by the CAA.[15] To operate services only between New Zealand and countries party to open skies agreements, an airline only requires an open aviation market licence.

101. Where there are quantitative capacity constraints under an ASA, rights are applied for by airlines. These are allocated by the International Air Services Commission ("IASC") in Australia, and by the MOT in New Zealand. Rights under ASAs are allocated for an unlimited time period, but operate on a "use it or lose" it principle. If there are no prospects of another airline operating, then the MOT takes the approach of allocating all rights to the airline that seeks them (rather than the rights not being used). Where there are open skies, rights are unlimited.

102. The exercise of air rights takes into account multi-country rights allocation. For example, if there is an open skies agreement between A and B and between A and C, then an airline can fly between B and C under open skies. All countries that have open skies agreements with New Zealand can fly on the Tasman routes in theory. Any constraints that remain are due to any Australian ASA with that country.

103. If an airline's New Zealand domestic operation is part of the international air services network of a foreign airline, then the airline needs cabotage rights to undertake the domestic operations (requiring MOT approval). Only Singapore and Brunei have these rights at present.

Competition Implications of Bilateral System

104. Although growth in demand has been strong for passenger services, airlines internationally have been hampered in meeting this growth by the bilateral system of regulation. In particular, it often prevents them from operating efficient networks through the following: capacity and route constraints (preventing spreading of route development and fixed costs); lack of beyond rights (which leads to an inability to hub out of foreign airports); break of gauge restrictions (inability to change plane size

[14] Beyond rights are the right of an airline to fly to another country then beyond to a third country picking up passengers in the second country (a form of Fifth Freedom rights).
[15] More details are provided in: Commerce Commission, *Decision No. 278: Air New Zealand Ltd/Ansett Holdings Ltd*, Wellington: Commerce Commission, 3 April 1996, pp. 10-14.

for beyond leg); inability to merge; and limits on foreign investment. Airlines have been forming alliances and using code sharing as a partial means of breaking free from these constraints. The aim is to provide a "seamless" service via a comprehensive network of routes to all parts of the globe.

105.ASAs generally include provisions aimed at promoting competition or reducing the potential for anticompetitive practices in the airline industry. Australia's ASAs generally include a fair competition clause and/or a commercial opportunities clause which seek to remove potential impediments to market access and improve the effectiveness and/or profitability of international air services. These provisions often refer to commercial and related activities such as ground handling, currency conversion and remittance of earnings, employment of non-national personnel, sale and marketing of international air transport and computer reservation systems. However, ASAs do not generally include provisions dealing specifically with the application of competition law.

Domestic Safety and Security Regulation in New Zealand

Civil Aviation Act 1990

106.The primary legislation in New Zealand for dealing with civil aviation safety and security is the Civil Aviation Act 1990 ("the CA Act").[16] The purpose of the CA Act is to promote aviation safety through establishing rules of operation and divisions of responsibility, and to ensure that New Zealand's obligations under international aviation agreements are implemented.

107.The Civil Aviation Authority ("CAA"), an independent Crown entity, was established by the Civil Aviation Amendment Act 1992. The principal function of the CAA is to undertake activities which promote safety in civil aviation at a reasonable cost, It is headed by a five-member authority and reports directly to the Minister of Transport.

108.The CAA establishes and monitors compliance with safety and security standards, and issues certificates to those intending to engage in aviation-related activities. Aviation operators are required to achieve a set standard before they can be certified to operate. The CAA undertakes regular reviews of the civil aviation system to promote the improvement and development of safety and security.

109.The CAA also provides the following services: advice to the Minister of Transport; promotes safety and security in civil aviation through providing information, advice and education programmes; provides search and rescue services; and acts on behalf of the Crown in respect of ICAO.

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[16] This Act replaced the *Civil Aviation Act 1964*.

Air Operator Certificate

110.An airline requires an Air Operator Certificate ("AOC") as a condition of entry. The CAA requirements relate to safety and operational matters. An operator must be able to demonstrate to the CAA that it can satisfactorily service and operate the aircraft, with sufficient infrastructure, i.e. with manuals, skills, training, staff and management. The CAA's test is whether the operator of an aircraft who is providing the domestic air transport services in New Zealand would be safe and competent.

111.There are two types of AOC: Part 119 New Zealand AOC, and Part 129 Foreign AOC. Airlines operating domestically in New Zealand should have a Part 119 AOC, as should New Zealand airlines that operate internationally to and from New Zealand. This varies but should take between two and nine months. Foreign airlines that fly internationally to and from New Zealand need only a Part 129 AOC (where recognised by the CAA). The process for getting a New Zealand AOC. The Part 129 AOC process only involves the CAA checking the overseas safety approvals already obtained by the airline.

112.While an airline strictly requires a New Zealand AOC to operate regular domestic operations, an anomaly in the wording of Part 129 allows an airline with a Part 129 foreign AOC to operate to/from and within NZ. The wording was intended to provide for a flight domestically between two cities tying into international legs and not full/regular domestic operations (cabotage operations). In practice, the CAA will allow an airline with a Part 129 AOC to operate domestically for 6 months before they are required to have a New Zealand (Part 119) AOC. Qantas operated for one year on its Part 129 AOC before having its New Zealand domestic subsidiary Jetconnect obtain a Part 119 AOC.

113.Negotiations have been taking place between New Zealand (CAA) and Australia (Civil Aviation Safety Authority) for an arrangement (aimed to take effect in December 2003) between the safety bodies that will mean that any SAM airline operating domestically in New Zealand or Australia (certified by either country's safety body) can operate in the other country domestically without needing to be certified there. For example, Virgin Blue would be able to operate domestically in New Zealand without need for approval from the CAA. However, this agreement will not provide for full mutual recognition, as aircraft will have to be managed and controlled in the country in which they are registered.

Section 88 CA Act

114.Section 88(2) of the CA Act provides that the Minister of Transport has the discretion to authorise arrangements (for example code-sharing) involving the carriage by air of persons, cargo and mail:

- between New Zealand and any place outside New Zealand; and

- between places outside New Zealand if that carriage is purchased, sold or arranged in New Zealand.

115.Section 88(4) of the CA Act details the competition law concerns that the Minister of Transport is directed to consider in determining whether or not to exercise his discretion to grant an authorisation. The Minister of Transport may not authorise any provision of any contract, arrangement, or understanding, that has any of the following purposes or effects:

- provides that any party to it may directly or indirectly enforce it through any form of action by way of fines or market pressures against any person, whether or not that person is a party to the contract, arrangement, or understanding;

- has the purpose or effect of breaching the terms of a commission regime issued under section 89 of the CA Act;

- unjustifiably discriminates between consumers of international air services and the access they have to competitive tariffs;

- so far as it relates to tariffs, has the effect of excluding any supplier of international carriage by air from participating in the market to which it relates;

- has the purpose or effect of preventing any party from seeking approval, in terms of section 90 of the CA Act, or the purpose of selling international carriage by air at any other tariff so approved; or

- prevents any party from withdrawing without penalty on reasonable notice from the contract, arrangement, or understanding.

116.However, the Minister of Transport must not decline to make an authorisation if such an action would have an undesirable effect on international comity between New Zealand and another state.

Section 91(1) CA Act

117.Section 91(1) of the CA Act provides that sections 27 to 29 of the Act do not apply to negotiating and concluding tariff or capacity-fixing arrangements under section 88 of the CA Act. Section 91(2) provides that Ministerial Authorisations under section 88 of the CA Act are specific authorisations for the purposes of section 43 of the Act. Section 43 of the Act provides that nothing in Part II of the Act relating to restrictive trade practices applies to any matter that is specifically authorised by any other enactment.

118.Section 88 of the CA Act is not being used in the case of the proposed Alliance from Air NZ and Qantas.

Civil Aviation Rules

119.The Minister of Transport, pursuant to section 28 of the CA Act, has introduced Civil Aviation Rules which set out the safety and security regulatory framework within which civil aviation in New Zealand is to operate. The rules deal with areas including regulation of aircraft, personnel, airspace, and aerodromes. The Rules generally follow the standards and recommended practices established internationally by ICAO, subject to some limited modifications to meet local conditions.

Industry Overview

International Air Transport Association ("IATA")

120.IATA is an international trade association representing the interests of over 230 airlines offering scheduled services. IATA provides a forum for determining various technical, operational and commercial standards. This allows carriers to coordinate scheduling of flights and to interline. It also operates a clearing house for inter-airline debts arising from interline traffic.

121.Traditionally, air fares and cargo rates were negotiated and agreed at IATA traffic conferences, and subsequently approved by governments under Air Services Agreements. The focus of the IATA tariff conferences is now on 'reference fares', mainly to facilitate interlining (connecting passengers between two airlines on the same ticket) and to determine how money from the sale of an interline ticket should be divided between the airlines operating the services. As a result, the fares negotiated and agreed at IATA tariff conferences usually do not reflect the final fares paid by consumers.

122.Participation in fare coordination is optional, with approximately 100 of IATA's 230 members participating.

Alliances

123.The formation of international alliances between airlines has been a feature of the last decade. An airline's alliance with global or regional partners (sometimes involving equity) can enable it to interface networks to provide seamless travel, or to share facilities or services, yielding synergies. An alliance can be an easier way for an airline to gain economies of scope and scale than by creating its own networks abroad or becoming a 'mega-carrier' through mergers and acquisitions (which are often prevented by the bilateral system of air rights regulation).

124.There are demand-side forces driving alliance formation, an important one of which is seamless travel. Consumers favour airlines serving a large number of cities with high frequencies and integrated schedules and operations. In order to attract more passengers in the increasingly competitive environment, a major airline needs to offer convenient services to almost every destination in the world. As alliance partners link up their networks and provide seamless services, they are able to expand their service network beyond their own territories. In addition, through alliances, the partners can obtain access to attractive airports, and provide services on thin markets by pooling traffic when a single carrier alone cannot provide services profitably. Another motivation for alliance formation is to obtain feed traffic. A successful linkage of alliance partners' networks would allow them to feed traffic to each other, and thus increase the load factor on their flights. Each partner may be able to increase flight frequency it can offer to its customers without actually increasing its own flight frequency.

125.Alliances can also potentially reduce unit costs by allowing the partners to take advantage of operational or cost economies, increased traffic density and economies of scope. Economies of density can be achieved if an alliance partner is able to serve the same amount of traffic at a lower cost, with its network size held constant. Joint use of airport facilities and ground staff, joint advertising and promotion, joint purchase of fuel and other items, joint development of systems and software, and joint handling of baggage transfer, etc. will result in economies of density. Network expansion and mutual traffic feeding allow alliance partners to achieve cost savings through utilization economies. This will allow partners to operate higher frequency and/or to use larger aircraft, which in turn, reduce unit cost. Economies of scope can be achieved if alliance partners link up their existing networks so that they can provide efficient connecting services for new origin-destination markets.

126.Other demand side reasons for alliances are improved service quality and broader choice of itinerary. Frequency, schedule convenience and convenience of on-line connections are major dimensions of an airline's service quality. A properly executed alliance will improve service quality by increasing flight frequencies available to customers, offering more convenient flight schedules, and by increasing the proportion of on-line connections. The partners also coordinate flight schedules to minimize waiting time for connecting passengers, and ease inconvenience associated with making connections by locating arrival and departure gates close by each other. An alliance carrier can also offer more variety of itinerary and routing choices to its passengers than non-aligned carriers of similar size can.

127.A particularly important market power advantage can arise from alliance formation through the control of capacity. In an alliance involving two parallel routes or networks an increase in market share and market power potentially enhances the ability to charge higher prices.

128.At present, there are four major international air alliances, with members as follows:

- *Star Alliance* established May 1997 – Air Canada, Air NZ, All Nippon Airways, Austrian Airlines, British Midland, Lufthansa, Mexicana, Scandinavian Airlines (SAS), Singapore Airlines, Thai Airways, United Airlines, Varig, Asiana Airlines, Lauda Air and Tyrolean Airways.

- *oneworld* established September 1998 – Aer Lingus, American Airlines, British Airways, Cathay Pacific, Finnair, Iberia, Lan Chile, and Qantas,

- *SkyTeam* established June 1999 – AeroMexico, Air France, CSA Czech Airlines, Delta Air Lines, Korean Airlines and Alitalia.

- *Wings—KLM/Northwest* established 1989 – KLM, Malaysia Airlines, Northwest Airlines, Japan Air Systems, Martinair, Kenya Airways and Surinam Airways.

129.Together these four alliances carry 69% of the global international passenger traffic and control 43% of international passenger flights worldwide.[17]

130.There was a fifth alliance called *Qualiflyer* but this was dissolved in 2001 after the collapse of two members, Swissair and Sabena. Other Qualiflyer members included Air Littoral, AOM/Air Liberte, Crossair, LOT Polish Airlines, Portugalia, TAP Air Portugal, Turkish Airlines and Volare Group.

Code-Sharing

131.Code-sharing is a practice where an airline, by agreement, purchases blocks of seats on another airline's flight, and sells those seats to passengers under its own brand name. The net effect is that a passenger buying a ticket from airline A can end up flying a sector on airline B, along with airline B's passengers. Both airlines' official designation codes apply to the flight. An airline might also sell blocks of seats without putting its brand on the ticket.

132.The benefit to an airline of a code-sharing arrangement is that it is an economical way to make a flight available to passengers, without bearing all the costs of running an aircraft. An airline will use code-sharing to provide better frequency of flights on a route, which is important for it to gain market share, and to create demand.

133.Code-sharing can be used on routes that are 'thin', i.e. where there is insufficient passenger demand to sustain two airlines' operations. Two separate flights on a 'thin' route might suffer lower load factors (more empty seats) and hence reduced profit yield, whereas one code-shared flight, with fewer seats for each airline to fill, could have higher load factors, and hence better profits. The net result is the ability to maintain frequency of service without the cost of unused capacity. In addition, the cost of running a second flight will be eliminated.

[17] Credit Suisse First Boston, *Global Airlines,* May 2002, page 3.

134.Alternatively, code-sharing can be used where capacity on a route between two countries is artificially limited by agreement. An airline can increase the frequency of available flights through a code-sharing arrangement with another airline, without having to exceed its quota.

Airline Service Models

135.The demand for air transportation is a derived demand. People want to get from A to B for business, family and vacation reasons. The demand in the markets is influenced by a variety of factors: fare levels, service quality, convenience and seamlessness of routes, the overall health of the economy, and the competitive environment for air services. The rapid growth in air travel over the last few decades reflects general economic growth, declining real air fares, changes in the rules governing trade, such as under the World Trade Organization and the liberalisation of markets, both domestic and internationally. Another factor has been the shifts in the structure of economies from manufacturing to service economies as service industries are more aviation intensive than manufacturing.

136.The financial fortunes of airlines depend on their business/service model and how they have organised themselves in their networks. The business model will drive their product, process and internal organisation. Full service carriers ("FSAs") have a complex product aimed at attracting high yield business passengers. They offer flight meals, beverages and entertainment, executive lounges, priority checkin, frequent flyer programmes, business class and first class. This results in complex and costly processes and a costly hub-and-spoke network.

137.Other carriers, niche and value based airlines ("VBAs") such as Virgin Blue, Southwest, Westjet and Ryanair have a simpler product and thus simpler processes and organizations. VBAs utilise their lower cost base to drive low fares and maximise profits. The low fares offered also stimulate demand for VBA services, which are offered on short-haul, point-to-point routes. No two VBAs are the same, but elements included in their business models typically include the following:[18]

(a) no 'frills' (no "free" on-board meals or beverages, executive lounges, priority checkin, frequent flyer programmes etc.);

(b) a single aircraft type (many VBAs have a young fleet);

(c) concentration on short-haul, point-to-point travel, (although new generation aircraft are extending the range serviced by VBAs);

(d) a high proportion of direct ticket sales (which ensures VBAs are not necessarily reliant on, or captive to, third-party distributors and the associated higher distribution costs);

(e) higher aircraft and staff utilisation, achieved via a range of the following:

[18] Section 58 Application, pages 27-28.

(i) single class of seats, which increases the number of seats per plane;

(ii) no heated food, which means the aircraft does not require a galley, allowing more seats, fewer cabin staff, and weight and cost reductions;

(iii) faster turnaround time, by virtue of a combination of all or some of:

- no interlining or codesharing – aircraft do not have to wait for connecting inbound services;
- utilising uncongested, secondary airports, which reduces the risk of delays and taxi time;
- not carrying freight (which takes time to load and unload);
- not offering on-board catering facilities, which take time to load; and
- not having a seating allocation, which encourages a faster check-in;

(f) a positive corporate culture;

(g) the opportunistic use of secondary airports, which generally have lower landing and other charges, and will give priority to the VBA operations;

(h) relatively flexible working practice by industry standards; and

(i) a high level of outsourcing of maintenance and other operations.

138. Different business models will lead to different cost levels due to both complexity of product and the incentives to keep costs under control. A key cost driver is the choice of network. For FSAs, hub-and-spoke networks are considered to add value on both the demand and cost side. On the demand side, passengers value broad geographic and service coverage, with multiple frequencies to a large number of points and better connections. On the cost side, any increase in the number of passengers on a network reduces unit costs.

139. FSAs have adopted a business model that is costly, complex, subject to cyclical swings and highly risky, due to its dependence on higher yield business traffic. In addition many of these firms have not been able to control their costs, not simply because their product is more complex but also because they have not had sufficient cost pressures.

140. In contrast, VBAs concentrate on having limited networks with the main focus on point-to-point (or origin-destination (“OD”)) routes of no more than four to five hours flying time. The profitability of each route is assessed on a stand-alone basis, without regard to possible feed traffic. While the success of VBAs derives in part because their low fares attract new customers into the market, it often comes at the expense of weaker FSAs. In smaller markets, where the amount of high-yield traffic is insufficient to sustain more than one full service network carrier, VBAs have (in recent times) contributed to the demise of weaker FSAs, which are forced from the market by high costs and a shrinking revenue as they price to compete with the VBA.

State of International Airline Industry

141. The industry in terms of FSAs, particularly in North America, is under severe financial stress because it expanded significantly in the mid-to-late 1990s in response both to increasing trade, and to the huge growth in the high technology sector. The product in their business plan is highly cyclical, and when the technology sector declined, demand for air travel fell just as dramatically. Demand had further to fall than in previous economic downturns and this was coupled with the events of September 11, 2001.

142. Currently, some airlines in the USA are under severe financial stress, while others are succeeding in spite of the current environment in North America. In Europe and Asia, the markets are recovering quite differently than in North America, and are in a stronger position. South American markets were also less affected than others. Business still requires aviation as a business tool and there is still high yield traffic in the market. However, markets have changed, with business travel having become more fare and time elastic. The value this traffic places on very high frequency and minimum connect times at hubs has diminished. There is also the reality that VBAs are not a transitory phenomenon, but are here to stay and are sustainable.

143. Table 2 below provides a high level summary of international airline operations according to major routes to/from New Zealand and air alliances (including code-share).

Table 3
Airlines within Route Groupings

Route(s)	Star Alliance & Close Commercial Partners	Oneworld & Close Commercial Partners	Other
Tasman	Air NZ, Freedom Air, Thai Airways, Lufthansa (code-share), United Airlines (code-share)	Qantas, British Airways (code-share), American Airlines (code-share), Air Tahiti, Lan Chile	Klm (code-share), Garuda Indonesia, Polynesian Airlines, Malaysia Airlines, Asian Express, Royal Tongan Airlines
Pacific Islands	Air NZ, United Airlines (code-share)	Qantas, Polynesian Airlines, Air Tahiti, Air Pacific	Air Vanuatu, Royal Tongan Airlines, Aircalin, Korean Air
Asia	Air NZ, Singapore Airlines, Lufthansa (code-share), Thai Airways, Asiana Airlines, JAL (code-share)	Qantas(ex Australia), Cathay Pacific, British Airways (code-share)	Garuda Indonesia, Malaysia Airlines, Korean Air, EVA Air, Cargolux
Atlantic	Air NZ	Qantas, British Airways (code-share)	Klm (code-share), Cargolux

Route(s)	Star Alliance & Close Commercial Partners	Oneworld & Close Commercial Partners	Other
America	Air NZ, Air Canada (code-share), United Airlines, Mexicana (code-share), Lufthansa (code-share)	Qantas, American Airlines (code-share), Lan Chile, British Airways (code-share)	Aerolineas Argentina

MARKET DEFINITION

Introduction

144.The Act defines a **market** as:

> *. . . a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.*

145.For the purpose of competition analysis, a relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, could impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the 'ssnip test'). For the purpose of determining relevant markets, the Commission will generally consider a ssnip to involve a five percent increase in price for a period of one year.

146.It is substitutability at competitive market prices which is relevant in defining markets. Where the Commission considers that prices in a given market are significantly different from competitive levels, it may be necessary for it to assess the effect of a ssnip imposed upon competitive price levels, rather than upon actual prices, in order to detect relevant substitutes.

147.The Commission defines relevant markets in terms of four characteristics or dimensions:

- the goods or services supplied and purchased (the product dimension);
- the level in the production or distribution chain (the functional level);
- the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic extent); and
- the temporal dimension of the market, if relevant (the timeframe).

148.The Commission defines relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration. A relevant market will ultimately be determined, in the words of the Act, as a matter of fact and commercial common sense.

The Applicants' View

149.The Applicants stated that from a commercial perspective, they treat the whole of the Australasian market as the natural base for their operations. However, the Applicants submitted that, having regard to previous regulatory determinations in New Zealand and Australia, other overseas precedent and the analysis set out in the NECG Report, for the purposes of the Applications, the relevant markets are:

(a) the markets for the provision of passenger air services:

(i) on New Zealand main trunk routes (routes between Auckland, Wellington and Christchurch) (the New Zealand Main Trunk Market); and

(ii) on New Zealand provincial routes[19] (the New Zealand Provincial Market),

(collectively the New Zealand Domestic Markets);

(iii) on routes between New Zealand and Australia (the Tasman Market);

(iv) between New Zealand and the Pacific Island and South East Asia holiday destinations - this includes Fiji, Samoa, Kingdom of Tonga, Cook Islands, Tahiti, Vanuatu, Noumea, Norfolk Island, Honolulu (Hawaii Islands), Bali, and destinations within Malaysia and Thailand (the Asia/Pacific Destinations Market);

(v) between New Zealand and the United States (the USA Market); and

(vi) a number of other international markets,

(collectively, (i) to (vi) above are referred to as the Passenger Air Services Markets);

(b) the markets for the provision of:

(i) time critical air freight services between points in New Zealand (the New Zealand same-day Freight Market); and

(ii) international air freight services to or from New Zealand (the International Air Freight Market),

(collectively the Freight Markets); and

(c) associated markets, including the markets for:

(i) the provision of travel distribution services in New Zealand (the Travel Distribution Services Market);

(ii) the provision of engineering and maintenance services in New Zealand (the Engineering Services Market);

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[19] Qantas indirectly competes with Air NZ on certain provincial routes by way of a code-share with Origin Pacific.

(iii) the provision of Computer Reservation Systems (CRS) and Global Distribution Systems in New Zealand (the CRS Market); and

(iv) the provision of terminal and ground handling services in New Zealand (the Terminal Services Market),

(collectively, the Associated Markets).

150.The Commission will consider the services and products provided by the Applicants in the following product dimensions and then analyse the geographic dimensions of each of these; passenger air services; airfreight services; travel distribution services; engineering and maintenance services; and ground handling services.

Passenger Air Services

Product Dimension

151.Both demand-side and supply-side factors are generally considered in defining market boundaries. Broadly speaking, a market includes products that are close substitutes in buyers' eyes on the demand-side, and suppliers who produce, or are able easily to substitute to produce, those products on the supply-side.

152.The Commission takes the view that the appropriate time period for assessing substitution possibilities is the longer term, but within the foreseeable future.[20] The Commission considers this to be a period of one year, which is the period customarily used internationally in applying the 'ssnip' test to determine market boundaries. The Commission will take into account recent, and likely future, changes in products, relative prices and production technology in the process of market definition.

Demand-Side Substitution

153.Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so by a small change in their relative prices.

154.Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. Unequivocal substitutes are combined. For each initial market so defined, the Commission will examine whether the imposition of a ssnip would be likely to be profitable for the hypothetical monopolist. If it were, then all of the relevant substitutes must be incorporated in the market. If not, then the next most likely substitute good or service will be added to the initial market definition and the test repeated.

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[20] In *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [   ] 2 NZLR 351 Smellie J approvingly quoted an earlier decision of the Commerce Commission in *Edmonds Food Ind Ltd v W F Tucker & Co Ltd* (Decision 21, June 1984) where the Commission had stated that: "A market has been defined as a field of actual or potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive".

155. This process continues until a combination of products is found which defines the product dimension of a relevant market, namely, the smallest combination of goods or services for which a ssnip would be profitable.

156. On the demand-side, the technical viability of one good or service as a substitute for another must be assessed. However, even where another product may technically be suitable as an alternative for the product in question, its price may be so much higher that it may be a poor substitute in an economic sense, at least for the great majority of buyers. In judging economic substitutability between products, the Commission will have regard to relative prices, quality and performance when assessing whether they are, in fact, close substitutes in the eyes of buyers.

157. The Applicants stated that the proposed Alliance is based on a single product market for passenger air services. They claimed that there is no relevant distinction between business and leisure passengers or economy and business/first class passengers. They pointed out that the Commission in *Bodas*[21] stated at paragraph 125:

> "The Commission does not believe that the domestic air services markets should be separated into categories for business and VFR *[   ]* travellers. Rather than each passenger type constituting separate markets, the Commission believes that they are different segments of the same markets".

158. The Applicants also referred to the ACCC's view in the Tripartite determination[22] that "different passenger types (business/leisure) represent different segments of the passenger services market" rather than representing different markets. They claimed that the labels given to types of passengers including leisure and business merely reflect a passenger's reason for travel and not the entirety or the most important of the demand characteristics of the customer.

159. The Applicants stated that passengers demonstrate a range of demand characteristics, relating to time sensitivity, flexibility in regard to conditions, complexity of itinerary, and product quality, that airlines offer an array of fare types to meet those demand characteristics, and that demand characteristics are not uniform among business and leisure travellers.

160. The NECG analysis demonstrated that, even if there are some customers who are not willing to substitute fare types, the cross-section of customers who are willing to substitute is significant enough to prevent a price increase by a hypothetical monopolist. The Applicants claimed that accordingly, the existence of some passengers who are not willing to substitute between fare types does not support a conclusion that these passenger types are in separate markets, or that there are separate markets for different fare types.

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[21] Commerce Commission Decision No. 278, *Air New Zealand/Ansett Holdings/Bodas Pty Ltd*, 3 April 1996

[22] Air Alliance Determination page 50

161. In *Bodas*, as pointed out by the Applicants, the Commission stated that the domestic air services markets should be separated into categories for business and visiting friends and relatives (“VFR”) and that rather than each passenger type constituting separate markets, they are different segments of the same markets. For the purposes of this analysis VFR passengers and leisure passengers (tourists) will be considered as one.

162. Several parties interviewed, including other airlines, travel agents and consumers stated that the demand-side characteristics of business and VFR/leisure passengers are quite different.

- Business
  - time sensitive
  - need to travel at beginning and end of the day
  - want direct routes
  - do not want weekend stops
  - less concerned about price – inelastic demand
  - more concerned about air-points, comfort, service etc.

- VFR/Leisure
  - not time sensitive
  - like stopovers, particularly backpackers
  - price is primary factor in choice of airline – elastic demand
  - not so concerned with air-points, full service, etc.

163. There does not therefore appear to be a high degree of demand-side substitutability between business and VFR/leisure passengers. Most VFR/leisure passengers are unlikely to be able to contemplate business class travel. Conversely, business passengers are unlikely to be satisfied with economy service levels where they are not compatible with business needs.

164. It would appear that from a demand-side view business and VFR/leisure passengers fall in different markets. For the purposes of the Draft Determination, VFR/leisure will be referred to as “VFR”.

Supply-Side Dimension

165. Close substitute products on the supply-side are those between which suppliers can easily shift production, using largely unchanged production facilities and little or no additional investment in sunk costs, when they are given a profit incentive to do so by a small change in their relative prices.

166. The Applicants, in support of including all types of passenger in one market, pointed out:

- the supply side complementarities in servicing the full range of customers, which makes it artificial to regard different passenger types as falling within distinct markets;

- the relatively small size of the Domestic New Zealand and Tasman Markets, which necessitates the targeting of a broad range of customers;

- the ease with which airlines can substitute to targeting different customer types;

- substitution between customer groups (i.e. revenue management); and

- the "chain of substitution" that links all fares such that an attempt to exercise a *ssnip* over only one segment of that continuum will be defeated by substitution.

167. In its determination on the application for authorisation of joint services between Qantas and British Airways (May 2000), the ACCC found evidence of separate economy and business class markets. The ACCC found competition in the economy section to be focused on price, whereas competition in the premium cabins is predominantly based on quality of service. The ACCC found it would be difficult to argue a high degree of substitutability between economy and premium class air transport.

168. The considerable price discrimination between the different classes of passenger indicates differentiation between them. The high proportion of business passengers travelling under corporate contracts and within loyalty programmes also tends to operate against supply-side substitutability.

<u>Conclusion on Product Dimension</u>

169. The Commission is of the view that there is differentiation between business and VFR/leisure passenger air services products, but that it is appropriate to consider them as belonging to one market for the purposes of considering the Applications. The differential impacts of the proposed Alliance on business and VFR/leisure products will be taken into account in the analysis of the impacts on competition and benefits and detriments.

Geographic Dimension

170. The Applicants stated that consistent with Commission, other regulatory bodies and judicial precedent, the Applications are based on the following geographic markets for passenger air services:

- New Zealand Main Trunk (Auckland, Wellington and Christchurch);

- New Zealand Provincial (includes all other domestic routes);
- Tasman;
- New Zealand – Asia/Pacific Destinations;
- New Zealand – USA; and
- Certain other international markets.

171. There is authority to support the idea of city pair routes as being the correct geographic markets. However, the Commission considers that for the purposes of competition analysis in this case, it is more appropriate to aggregate the city pairs into geographic groups, consisting of groups of city pairs that will be impacted similarly by the proposed Alliance. These geographic groups are discussed below.

New Zealand Domestic Markets

172. In *Bodas*, the Commission adopted three domestic passenger air services markets:

- main trunk routes (between Auckland, Wellington and Christchurch);
- provincial routes (between provincial airports serving cities such as Dunedin and Hamilton through to smaller communities); and
- tourist routes (to and from tourist destinations such as Rotorua and Queenstown).

173. Virgin Blue in its submission stated that there is a single domestic New Zealand air services market. Virgin Blue considered whether main trunk and provincial air services within New Zealand are separate markets, but on balance does not think that a separate market distinction is necessary to the analysis, provided that the different effects on main trunk as against provincial routes are taken into account in the competition analysis.

174. As stated by the Commission in *Bodas*, the distinction between main trunk and provincial routes is readily apparent, with each having different characteristics in terms of the number of passengers carried and the size and type of aircraft used to maintain sufficient service frequency. The main trunk routes represent about 80% of the total domestic passenger numbers carried by airlines in New Zealand. Passengers on the main trunk routes are usually carried on jet aircraft whereas smaller turbo-prop aircraft are often used on the provincial routes.

175. The Commission concluded in *Bodas* that tourist routes have a different customer base than main trunk and provincial routes and that Airlines appeared to differentiate tourist routes from provincial routes by the existence of direct flights between centres.

176. The Applicants considered tourist and provincial routes now comprise one market as there have been some changes which make the distinction between these markets less apparent. They said that there is nothing material to be gained by further segmentation of the market.

177. Information gathered by the Commission from airline, travel and tourism industry participants indicates that changes which make the distinction between the tourist and provincial routes as less apparent, as referred to by the Commission in *Bodas* have grown to the extent that there is now no real distinction between the two types of routes.

Conclusion on New Zealand Domestic Markets

178. The Commission concludes that there are two New Zealand domestic geographic markets:

- Main trunk market; and
- Provincial.

International Air Service Markets

New Zealand - Australia Market

179. The Applicants submitted that having regard to the SAM and the Open Skies arrangement and the ease with which suppliers can substitute (or shift supply) to alternative city pairs, a Tasman Market is the narrowest market which might reasonably be considered.

180. In *Bodas* and Decision 229A[23], the Commission concluded that the Tasman market can be distinguished from other international routes by differing market participants and regulatory conditions and that it was appropriate to identify the Tasman market as a separate market.

181. A further differentiating factor is the smaller aircraft used in the Tasman market as compared with long haul routes.

Other International Markets

182. In *Bodas*, the Commission concluded that other international passenger air services could be included within one market, and there was no need to define various regional destinations.

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[23] Qantas and Others/Air NZ

183.The Applicants submitted that there is an Asia/Pacific Destinations market due largely to the high degree of demand-side substitutability. They claim that consumers can, and do, choose from a variety of sun seeking holiday destinations which have broadly comparable prices. They state that there is a high level of supply-side substitutability due to the ability of many carriers to increase/shift capacity in the region.

184.The Applicants stated that travel packages typically consolidate airfares, transfers, and accommodation into a package retailed for a single, all inclusive price. Brochure pricing for packages to Pacific Island destinations closely correlate with brochure pricing for travel packages to Honolulu (Hawaii Islands), Denpasar (Bali) and other South East Asian holiday destinations.

185.Gullivers Pacific in its submission stated that the high degree of demand substitutability between Pacific and Asian destinations claimed by the Applicants is not supported by an analysis of New Zealand outbound travel statistics and wholesale travel statistics. Substitutability is limited to between the Islands of the South West Pacific such as Fiji, Vanuatu and the Cook Islands and Queensland.

186.Virgin Blue, in its submission, stated that there is an Asia-Pacific market or markets and potentially a South Pacific market.

187.Because of the different, non substitutable nature of the destinations, the Commission is of the view that New Zealand-Pacific Islands and New Zealand–Asia are two different markets.

188.The Applicants also submitted that there is a New Zealand-USA market and that this is supported by the Brierley/Air NZ decision,[24] the United States of America Department of Transport (US DOT) and the MOT.[25] They state that there have been no changes in this market to warrant the adoption of a different market definition.

189.The Commission is of the view that because the Applicants are currently the only airlines flying on the New Zealand-USA route for the foreseeable future, the competition issues affecting the route are different from those affecting other international routes and that it should be a separate market for competition analysis purposes.

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24 *Brierley Investments/Air New Zealand*

25 *United Airlines Inc, and Air New Zealand* Order to Show Cause – USA Department of Transportation 2 March 2001 Docket OST-1999-6680-7. The Final Order of 3 April 2001 (Docket OST-1999-6680-8) upheld the tentative decision in the Order to Show Cause to grant authorisation for the alliance between Air NZ and United Air Lines; and report from the Ministry of Transport to the Minister of Transport: *Air New Zealand application for authorisation of alliance between Air New Zealand Limited and United Airlines Limited* 28 February 2002

190. The Applicants submitted that other international destinations should be described in terms of regional markets. In its RJSA determination[26], the ACCC defined the relevant markets as: Australia – South East Asia; Australia – Europe; Australia – New Zealand/Oceania; Australia – North Asia; Australia and India/Middle East; and Australia – North/South America. The ACCC took account of the extent of indirect travel, with passengers having the option of travelling directly to a destination or via a number of other countries. The ACCC also noted the common practice of common rating fares to points within a region, for example, a passenger pays the same price for a ticket to virtually any point in Europe with a given airline.[27]

191. The relevant routes for the current Applications are from New Zealand to London via Los Angeles, from Los Angeles to other European destinations (on which Air NZ code-shares) and from Asia to European destinations including London (on which Air NZ also code-shares).

192. The Commission is of the view that for the purposes of competition analysis it is appropriate to consider the other international routes as belonging to one market while taking into account any differences that might exist between different destinations within the analysis.

Conclusion on International Markets

193. The Commission concludes that the relevant international geographic markets are:

- New Zealand – Australia;
- New Zealand – Asia;
- New Zealand - Pacific Islands;
- New Zealand – USA; and
- Certain other international markets.

Conclusion on Passenger Air Services

194. The Commission concludes that the relevant passenger air services markets are:

- New Zealand main trunk;
- New Zealand provincial;

[26] Restated JSA (Joint Services Agreement between Qantas Airways Limited and British Airways Plc (2000) ATPR (Com) 50-280); 53,498.
[27] The ACCC commented that a regional approach to market definition should not necessarily be assumed in the future, particularly where a high proportion of passengers travelled on direct services.

- New Zealand – Australia;
- New Zealand - Asia
- New Zealand – Pacific Islands;
- New Zealand – USA; and
- Certain other international markets.

Air Freight Services

Product Dimension

195. The Applicants agreed with the Commission's comment in *Bodas* that, in respect of New Zealand domestic routes, "the provision of deferred and overnight delivery is equally contested by air and land transport, and is part of a wider domestic freight market."[28] They pointed out that having regard to the large number of competing transport modes (including train, road and sea) and the large number of constraining participants in the market, the Commission concluded that the "acquisition does not raise any competition issues in that market".[29]

196. In respect of other air freight markets, the Applicants accepted that lesser constraint is imposed by other transport modes and therefore the correct product market is restricted to air freight services.

197. They stated that because the majority of freight in the relevant markets is carried in the belly hold of aircraft operating scheduled passenger services, the assessment of the various passenger air services markets will also illuminate the competitive dynamic in the relevant freight markets.

198. The Commission notes that there are significant differences between the cargo services offered by passenger airlines and cargo airlines. In particular, freight rates are much lower for freight carried in belly holds of passenger aircraft. The availability of belly hold depends on route structures and flight frequency generated by the economics of the passenger market. With the exception of Asian Express which flies across the Tasman, scheduled dedicated cargo airlines tend to serve New Zealand as one inbound and one outbound sector on a longer international route that may take a week to complete.

199. The operating costs of providing dedicated freight services are much higher than the costs of providing belly hold. Belly hold is available at a lower marginal cost because most costs on passenger flights can be attributed to serving passengers. Dedicated freighters' operating costs can only be recouped by selling cargo space.

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[28] *Bodas* para 149

[29] *Bodas* para 149

Consequently, a passenger airlines' cargo services may be profitable even when its capacity is under-utilised. Dedicated freight airlines, on the other hand, need to fill their cargo space in the same way passenger airlines need to fill seats.

200.Industry participants have told the Commission that dedicated freight services are not substitutable for passenger service belly hold for various reasons including difference in price, route network, and frequency of flights. Consequently, the type of cargo and customer base tends to be different between the two types of services. Dedicated freight airlines have told the Commission that they do not attempt to provide a substitute for passenger airlines' cargo services. Rather, they discover and develop niche markets where demand can be met by either infrequent scheduled flights or by chartered flights.

201.The economics of belly hold cargo services and dedicated cargo services mean that substitutability is weak on both the supply and demand sides. The Commission will therefore consider the cargo services supplied on passenger flights to serve a market distinct from that supplied by dedicated freight airlines. There is no aggregation in the dedicated freighter markets as the applicants do not currently provide services in this market. The competition analysis will therefore be restricted to the belly hold freight markets.

Geographic Dimension

202.In *Bodas* the Commission concluded that there were national and international air freight markets. It commented that there was nothing to be gained, in competition analysis terms, by further differentiating international freight services with separate Tasman and other international markets.

203.The Commission notes, however, that the Tasman market is differentiated from other international markets because of route density and possible backhauling. These factors are particularly relevant to the current Applications and the Commission therefore considers it is appropriate for competition analysis purposes in this instance to consider the Tasman and international freight markets separately.

204.The Commission is of the view that the geographic dimensions of air freight service markets are:

- National;
- Tasman; and
- International

Conclusion on Air Freight Services Markets

205.The relevant air freight markets are for:

- Domestic air freight services;
- Tasman belly hold freight services; and
- International belly hold freight services.

Travel Distribution Services

206. This is the market for the retailing of passenger air travel both to and from New Zealand, and within New Zealand. The Applicants submitted that the geographical extent of the market is national.

207. In broad terms, airline tickets are sold by:

- airlines directly to the public, via the internet, telephone, to businesses direct, via airline owned tour package wholesalers and airline owned retail travel centres;
- airlines to ”consolidators” who purchase tickets (frequently constructing multi-hop itineraries) and on-sell to travel distributors, who then on-sell in their own right to the public;
- airlines to ”wholesalers” who purchase tickets and package with other products, e.g. accommodation who then on-sell to travel distributors, who then sell in their own right to the public; and
- airlines to the public via travel agents, interline airline partners and internet travel portals.

208. As the Commission commented in *Bodas*, travel agencies act as agents for suppliers of travel services, in terms of the sale of transportation, accommodation and activities to tourists and other travellers. Providers of travel services promote their services both directly, and through intermediaries, or travel wholesalers. Travel wholesalers aggregate the various services available from several service providers and on-supply to retail travel agencies.

209. The Travel Distribution Services market has changed markedly since the *Bodas* decision due to the wide spread use of the internet and telephone call centres. The internet has been adopted by airlines selling directly to the public and airlines have now become much more active and competitive participants in the market for the retailing of airline tickets. NZ Express reports that around 29% (on average) of its bookings are made through the internet. Similarly, the ACCC recently reported that in Australia around half of all domestic air ticket sales are through the airlines, either through call centres or through the internet. Already in New Zealand, the role of travel agents in respect of domestic New Zealand is changing, with an increasing

focus on “value added” services, e.g. House of Travel’s “Searchflight” service, which searches across airlines’ websites and constructs the cheapest itinerary.

210. In *Bodas* the Commission commented that “there is nothing material to be gained by separating functional levels of wholesale and retail distribution into separate markets”. The ACCC has adopted a similar approach, determining that the relevant functional market includes all stages in the distribution chain.[30] This view was confirmed in the ACCC’s recent IATA Passenger Agency Programme Determination.[31] The Applicants agreed with this approach.

211. The Commission is of the view, however, that the proposed Alliance would affect the wholesale distribution of travel services to a considerably greater degree then the retail of travel services (as discussed in the competition analysis section). It therefore concludes that for the purposes of the current Applications, there is a separate functional market for wholesale travel distribution services and that it is this market that requires analysis.

Conclusion on Travel Distribution Market

212. The Commission is of the view that the relevant market is the national wholesale travel distribution services market.

Computer Reservation System Market

213. Two types of computerised information and reservation systems are relevant to this draft determination:

- Computer Reservation Systems (“CRS”s) are used by airlines for booking, pricing and ticketing functions, inventory management, and departure control functions. Some airlines host other airlines on their CRS.

- Global Distribution Systems (“GDS”s) are used by travel agents, including many “e-agents”, and encompass booking, pricing and ticketing functions, where ticketing occurs on neutral (not airline specific) ticket stock. Products booked are predominantly air travel, but may also include hotels, cars, and tours.

214. Air NZ and Qantas operate their own internal CRSs – Air NZ uses “Carina” and Qantas uses “Amadeus”. However, with the exception of Polynesian Airlines which is “hosted” on Amadeus by Qantas and Royal Tongan, Air Rarotonga and Air Chatham which are “hosted” by Air NZ on Carina, neither party makes its CRS available to other carriers.

[30] *Restated JSA* pages 53,498-53,499.
[31] C2001/601 13 November 2002 page 67. Available from www.accc.gov.au

215. Neither Air NZ nor Qantas have an equity interest in a GDS.

216. No material aggregation occurs in this market as Qantas currently does not supply services in the market. Consequently the Commission will not consider this market any further.

Engineering and Maintenance Services Market

217. Operators of airline services must ensure that their aircraft comply with the maintenance and safety requirements of manufacturers, such as Boeing and Airbus, and the relevant regulatory authorities.

218. No material aggregation occurs in this market as Qantas currently does not supply services in the market. Consequently the Commission will not consider this market any further.

Ground Handling Services

219. The provision of passenger air and freight services requires the acquisition of additional services provided at terminals and by airport ground-staff such as:

- counters, lounges, and terminal areas;
- gates and airbridges;
- departure and arrival slots (which are allocated to airlines by airports);
- baggage handling services;
- catering services; and
- aircraft cleaning and servicing.

220. Consistent with the Commission's determination in *Bodas*, the Applicants consider these services cannot be differentiated and comprise a market for the provision of terminal/ground handling services.

221. Based on information supplied during this investigation, the Commission is of the view that there is a national market for ground handling services. However, there is no material aggregation in this market. Consequently the Commission will not consider this market any further.

Conclusion on Market Definition

222. The Commission concludes that the relevant markets are those for:

- New Zealand main trunk passenger air services (main trunk market);
- New Zealand provincial passenger air services (provincial market);
- New Zealand - Australia passenger air services (Tasman market);
- New Zealand – Asia passenger air services (NZ-Asia market);
- New Zealand – Pacific Islands passenger air services (NZ-Pacific market);
- New Zealand – USA passenger air services (NZ-US market);
- Certain other international passenger air services (international market);
- Tasman belly hold freight services market (Tasman belly hold market);
- International belly hold freight services (international belly hold market);
- Domestic air freight services (domestic freight market); and
- National wholesale travel distribution services market.

223. Having defined the markets, the next step is to consider the factual and counterfactual scenarios that apply.

Question 2

The Commission seeks comment on its market definitions.

THE FACTUAL

224. For the competition analysis, the Commission compares the factual (the proposed Alliance) with the counterfactual.

225. There are two key parts to the proposed Alliance. The first, covered by the s67 Application, consists of Qantas subscribing for up to 22.5% of the voting equity in Air NZ – the proposed Acquisition.

226. The second, covered by the s58 Application, is the implementation of the terms of a Strategic Alliance Agreement (the proposed Arrangement) entered into by Qantas and Air NZ under which the Applicants will coordinate pricing and scheduling activities in respect of all flights operated by Air New Zealand (both domestic New Zealand and international) and all Qantas operated flights that arrive in, depart from or operate within New Zealand (together, "the JAO Networks").

227. The Applicants stated that in respect of the JAO Networks, they will co-ordinate the following services and activities:

- All aspects of the pricing of the Applicants' passenger and freight services, including setting fares, rebates, levies and promotions, level of service fees, development of new fare products, pricing and promotions of holiday destinations, commissions and agency incentives and joint tendering for corporate and government accounts;

- Exchange of information on schedules, financial information, pricing, yields, seat availability, sales and other information to enable co-ordination of the aspects of the parties' respective businesses referred to in (i) above;

- Operations, routing, capacity, frequencies, aircraft types, connection requirements and range of times for any service provided as part of the JAO Networks;

- Reciprocal Codeshare rights with each other for flights operated as part of the JAO Networks. Air New Zealand will also be able to codeshare on flights operated by Qantas that are not part of the JAO Networks where such flights reasonably connect to JAO Network flights;

- Enter into Special Pro Rate Agreements on terms no less favourable than the terms offered by an Applicant to a member of the global airline alliance of which that Applicant is a member, or, in the case of Freedom Air, until Freedom Air's business model permits a Pro Rate Agreement, the provision of blocked space seats on Freedom Air flights on terms no less favourable than offered by Freedom Air to third parties;

- Facilitate Qantas Holidays' maximising the provision of new tourism products which utilise the JAO Networks and promote New Zealand and Australia as a dual destination;

- Subject to existing contractual restrictions, co-ordinate respective freight operations to improve the scope and availability of freight services;

- Rights for members of each Applicant's frequent flyer programmes to accrue and redeem frequent flyer points on flights operated by the other; and

- Co-operate and give priority to the display of each other's flights on their respective reservation systems.

228.Under the agreement, the Applicants also, where it is efficient and beneficial to do so, in relation to non-JAO business:

- will co-operate in order to deliver additional benefits to each other's customers and frequent flyers;

- will co-operate in the identification and development of new consumer benefits, products, services and pricing strategies;

- will liaise with each other regarding fleet planning, flight operations, strategies;

- will develop and implement additional safety and security policies and co-operate on flight disruption and emergency planning and procedures;

- will explore joint purchasing options and may negotiate with suppliers on behalf of each other as expressly agreed from time to time;

- may co-operate in relation to in-flight services;

- may co-ordinate in respect of the information technology systems and requirements;

- may pursue joint human resource activities; and

- subject to any agreement Air New Zealand has with other airlines, may operate joint ground services (such as airport lounges, check-in facilities and baggage handling).

229.The Applicants advised that the JAO Networks, once fully implemented, would be commercially managed by Air NZ. The day to day flying operations would remain the responsibility of each airline. Air NZ's management of the JAO Networks would be supported by a Strategic Alliance Advisory Group that would consist of three representatives appointed by each airline.

Summary of Factual

230.In summary, the factual consists of:

- Qantas subscribing for 22.5% of the voting equity in Air NZ;
- Qantas appointing two directors to the Air NZ Board and Air NZ appointing one director to the Qantas Board.
- The Applicants coordinating pricing, capacity, schedules and all other aspects of normal business operations;
- Rationalisation of networks and resources;
- Air NZ to manage the commercial aspects of the JAO networks;
- No competition between the Applicants.

THE COUNTERFACTUAL

Introduction

231.The Commission has stated in previous decisions involving assessments of applications for authorisation under both s 58 and s 67 of the Act that it is necessary to employ a counterfactual of what might otherwise happen in the absence of the arrangements or acquisition in question.[32] This enables a comparison to be made between two hypothetical future situations, one with the acquisition ("the factual") and one without ("the counterfactual"). Thus, the Commission makes a "with" and "without" comparison rather than a "before" and "after" comparison. The differences between these two scenarios can then be attributed to the impact of the arrangements or acquisition in question. The focus is upon the likely competitive effects, and the public benefits and detriments likely to result.

232.In framing a suitable counterfactual, the Commission bases its view on a pragmatic and commercial assessment of what is likely to occur in the absence of the arrangements or acquisition.[33] In respect of an arrangement, the counterfactual is not necessarily that which might be preferred by the Commission or by particular groups or individuals in the industry, but is rather what is the most likely to occur, all things considered.

The Applicants' View

233.The Applicants consider six alternative counterfactuals, which are as follows:

(a) aggressive capacity competition by Qantas and Air NZ ("war of attrition");

(b) aggressive competition leading to one airline—most likely Air NZ—over time being forced to retrench in a drawn-out realisation of (a) ("retrenchment");

(c) a continuation of present trends ("status quo");

(d) competition between the two airlines eases, and prices rise ("cosy duopoly");

(e) Air NZ enters into an alliance with another airline ("alternative alliance"); or

(f) Air NZ receiving stand-alone equity injections ("equity injections").

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[32] For s 58 authorisations, see Commerce Commission, *Decision 473: Electricity Governance Board Limited*, 30 September 2002, paras 215-16, pp. 45-46. For s 67 authorisations, see Commerce Commission, *Decision 410: Ruapehu Alpine Lifts Ltd/Turoa Ski Resorts Ltd (in receivorship)*, 14 November 2000, para 240, p. 44.

[33] See the discussion in: Commerce Commission, *Decision No. 277: New Zealand Electricity Market*, 30 January 1996, p. 16.

234.Option (b) is considered in confidential Schedule 8 of the Application. Option (a) is regarded by the applicants as the most likely outcome, and therefore the preferred counterfactual.

235.In introducing their analysis of the counterfactual, the Applicants stress two considerations. The first is the importance of the network nature of the services they provide, and the interdependencies between those services across a wide range of routes. The viability of any one sector depends not only upon the traffic carried on that sector, but also the feed traffic it creates for inter-connecting sectors. For example, the carrying of traffic on domestic New Zealand routes will provide feed on international sectors, such as the Tasman. In addition, reductions in capacity have the disadvantage of creating opportunities for competing airlines to enter or to expand capacity.

236.The second factor is the contention, based on historical experience, that “the Australasian markets will not support more than one locally based full service network carrier”, especially with the market integration brought about by the Single Aviation Market. For example, competitors to Air NZ’s domestic services have come and gone, and Qantas’ domestic New Zealand services are said currently to be loss-making. It is claimed to be difficult for Air NZ to base its operations on a relatively small—albeit rather profitable—domestic market in a geographically isolated position.

237.The Applicants stated that they have independently come to the conclusion that the relevant counterfactual is “a more aggressive level of competition between them resulting in increased capacity being applied to material parts of their Australasian networks.” Qantas has stated its intention to materially increase capacity on New Zealand domestic main trunk and Tasman routes, although the modelling data used by NECG shows that the bulk of the increase is on the former, where its declared aim is to get an increased market share [ ]. This is said to be consistent with its business model, central to which is frequency of service in order to attract high yield business passengers. Air NZ would react by slightly expanding its capacity as a way of meeting this threat to its network profitability. This is regarded as a profit-maximising response, even though its profits would decline. Air NZ would also be vulnerable to market share loss to a new VBA entrant, despite having recently introduced its new Express service on its domestic operations, and a possible extension of that service to the Tasman routes. Such entry is considered likely in the counterfactual only on Tasman routes.

238.The Applicants presented the retrenchment case as being an extension of the “war of attrition” scenario. Here they argude that the capacity war would not be sustainable, and that one of the airlines—most likely Air NZ, being the financially weaker of the two—would ultimately be forced to reduce capacity. The exit of Air NZ is not discounted in the long term, but appears to be considered unlikely in the five year period of analysis used.

239.With respect to the status quo scenario, the Applicants stated that Qantas has made it clear that it does not intend to withdraw its operations on the New Zealand main trunk routes, and indeed that it is commercially rational (despite current losses) to remain and expand. They considered that as Qantas's New Zealand operations are an important part of its interconnected network, it is not plausible to argue that Qantas would exit the market.

240.The Applicants considered that the cosy duopoly counterfactual is implausible on three grounds. First, there is no recent history of such behaviour in the market. Secondly, given the low barriers to entry for an Australasian airline, any attempt tacitly to raise prices would be doomed to fail because of the ease of entry. Finally, the characteristics of liberalised aviation markets are not conducive to cosy duopoly. These include airline cost structures (high fixed and low marginal costs), perishable product, small units of sales and complex, difficult to observe, prices.

241.The Applicants rejected the alternative alliance scenario on the grounds that no airlines have indicated a willingness to enter into a strategic alliance that could resolve Air NZ's strategic imperatives, and that the key strategic imperative is to remove the threat of the war of attrition with Qantas, and that could be done only with an alliance with Qantas.

242.Lastly, the Applicants considered that equity injections, even if they were to be forthcoming, which is unlikely, would merely prolong the war of attrition, without curing the underlying problem. Such investment on the part of shareholders would be irrational.

243.On the basis of this assessment, the Applicants asserted that the war of attrition is the only likely counterfactual.

Views in Publicly Released Government Papers

244.The New Zealand Government holds one share ("the Kiwi share") in Air New Zealand Limited. That share has special rights attached to it, principally related to the maintenance of the status under which New Zealand international air rights are held and are used by Air New Zealand Ltd and the related economic value of those rights.

245.The Commission has had no communication from the Government in relation to its status as a principal shareholder or in relation to the Kiwi share. The Government has made a public statement (in a press release of 25 November 2002 by the Hon Dr Michael Cullen) in relation to the present Applications from a principal shareholder and from a Kiwi shareholder perspective:

> "We have made it clear that the proposal will have to satisfy all the normal regulatory and competition criteria. There is no way we will intervene legislatively to remove or even lower any of those hurdles. Only after this process has been completed will the government be in a position to make a final decision."

246.Section 26 of the Act requires the Commission to have regard to the economic policies of Government if they are transmitted in writing to the Commission.

247.No statement of economic policy under section 26 has been issued by the Government to the Commission.

248.A number of points bearing on the likely counterfactual may be drawn from a reading of publicly released Government papers, which cover the period 2001-02, and which largely concern advice received by the government on the proposed Alliance and its capital injection in Air NZ. A brief summary of these points is as follows.

249.First, the state of the aviation industry worldwide makes it difficult to find investors willing to put funds into airlines. The need to exercise air rights internationally limits foreign ownership in Air NZ to less than 50%, which means that the key investors must be New Zealand nationals. The Treasury received advice in December 2002 that Air NZ would be unlikely to be able to source the large amount of capital needed from the domestic market given the company's then fragile position and the riskiness of the aviation industry. The presence of the Crown as majority shareholder would also reduce the attractiveness of investing in the company for some investors.

250.Secondly, there seems to be no interest by other potential strategic partners in forming an alliance with Air NZ. Singapore Airlines is said to be not interested in an alliance with the company, and was interested in 2001 only when the company had Ansett, and thereby offered a means of access into the Australian market.

251.Thirdly, the Government has signalled its intention to remain a majority shareholder in Air NZ over the foreseeable future, and to maintain the company's long-term viability as an international airline. In terms of the national interest considerations, it is committed to maintaining the following: a clear majority ownership and control of the company by New Zealand nationals; a continuation of the company's ability to exercise the country's existing and future air rights; the unique New Zealand identity of the company; effective channels for international tourism and travel; a durable domestic air services network; and New Zealand-based employment.

252.Fourthly, in the absence of the proposed Alliance there would be a high probability that the Crown would be required to inject additional equity into Air NZ in the medium term. This is not regarded as an attractive proposition if cuts in the funding for health or education were required. This is regarded as a clear risk to the Crown.

253.Finally, in December 2002 it was reported that Air NZ's current financial position was better than forecast at the time of recapitalisation at the end of 2001. Early results had exceeded targets in the five-year business plan. Nonetheless, the company remained vulnerable because of its dependence upon its domestic routes, which are the only profitable ones (in terms of meeting the company's desired 15% return), and which were vulnerable to increased competition from Qantas or a new entrant.

254.A further comment from the papers is that financial analyses suggested that the proposed Alliance was likely to be the most profitable for Air NZ, and also the one that minimised downside risks.

Views in Submissions of Other Parties

255.All of the material in this section (and other similar sections later in the paper) present the views of parties who provided submissions to the Commission.

256.Virgin Blue suggested it is not plausible that, if the proposed Alliance were not approved, Air NZ and Qantas would enter into a costly five-year war of attrition in which both companies would increase their capacity to gain supremacy over the other. This would require the parties to incur losses (which are likely to be large) over the period, with a highly uncertain outcome. This could be a rational, profit-maximising strategy only if Qantas were able to drive its competitors from the market, and as a result earn above-normal returns in the future. This would require both that Air NZ withdraw, and that either there would be no entry by Virgin Blue, or that Virgin Blue would provide only a weak form of competition (the latter being inconsistent with the position adopted by the Applicants regarding the effective competitive restraint that Virgin Blue will impose on the proposed Alliance).

257.Virgin Blue considered that the most likely strategies are the following:

- Air NZ would consolidate its presence in domestic and Tasman routes, and continue to operate other important, profitable, international routes;

- Qantas would maintain its presence on Tasman routes, and might gradually increase services on New Zealand domestic routes, perhaps particularly targeting those routes on which Virgin Blue chooses to commence services; and,

- Virgin Blue will enter the Tasman and the New Zealand domestic markets. The timing and scale of entry will depend on its access to key bottleneck facilities such as landing slots, access to terminals, etc. and the extent to which Qantas and Air NZ respond to Virgin Blue's entry with strategic and predatory conduct.

258.Infratil et al. also disagreed with the "war of attrition" counterfactual proposed by the Applicants. First, they take issue with the contention that the Australasian markets are not able to support "more than one locally based full service network carrier." They recognise that although this may be the case for the relatively small domestic New Zealand market, this cannot be said of the Tasman or domestic Australian markets. Ansett failed for reasons other than the ability of the market to sustain two full service carriers. Air NZ's results over the past year, and forecasts for the current year, also run counter to this view, as does the fact that in recent years there has been entry on the Tasman from Fifth Freedom carriers serving Auckland.

259. Secondly, Infratil et al. argued that the proposed "war of attrition" counterfactual is incorrect for the following reasons:

- Qantas already has a strong presence on Tasman and domestic New Zealand routes (including via its codesharing with Origin Pacific);
- the success of Air NZ's new, lower cost, Express service suggests, contrary to the assertion of the Applicants, that Qantas would be more vulnerable to VBA entry than Air NZ;
- it is doubtful that Qantas's board and shareholders would accept mounting losses on the company's New Zealand services, especially given that the airline would be under pressure from Virgin Blue in the domestic Australian markets;
- the behaviour in the war of attrition would invite charges of predatory pricing which, if proved, would be a breach of the Act; and
- it is extremely unlikely that the Government, following its bail-out of Air NZ in 2001, would stand by and let the airline collapse in the face of increased competition from Qantas.

260. Instead, Infratil et al. proposed that a more likely counterfactual is that Air NZ would take more time to settle on a long-term strategy, and in the meantime proceed with its remodelling plans announced last year, which include extending its Express service to Tasman routes and reviewing its long-haul services. The company might need to receive financial backing from the government, but with improving performance it might be able to go to the domestic capital market for funding. Airlines in the Asia Pacific region have been growing strongly, and New Zealand tourism has benefited from the country being perceived as a safe destination. Singapore Airlines could re-emerge as a potential alliance partner, and given the dynamic nature of the airline industry other potential partners could emerge in time.

261. Infratil et al also considered that the "war of attrition" is not the relevant counterfactual since it ignores structural changes to the Air NZ business model, the improved financial performance of the company, and the significance of the Star Alliance. Infratil suggested that a superior counterfactual would be the airline remaining an effective competitor under a refined business model. It rejected the claim that two FSAs cannot operate in Australia and New Zealand as not having been substantiated.

262.Origin Pacific also did not believe the "war of attrition" counterfactual. It considered that it is more likely that a cosy duopoly would form. There may well be other potential alliances in the future. The scope of Air NZ's international business may change, but this is a natural requirement regardless of other circumstances.

263.Others have noted the possibility of other alliances in the future. The Importers Institute considered the Applicants' assertion that no airline has demonstrated a willingness to enter a strategic alliance, to be demonstrably untrue. Singapore Airlines was keen to inject a large amount of capital into Air NZ. Similarly, the New Zealand Chamber of Commerce and Industry considered that there are two alternatives: the taxpayer continues to support Air NZ, or Singapore Airlines buys back into Air NZ.

264.Save Air NZ submitted that there is no reason to give a doom scenario any more credibility than several others in which Air NZ could be a very successful company providing services of excellent quality at low cost. The factors that lead it to this view are the following: Air NZ suffers from no intrinsic weakness relative to Qantas; the company has shown itself to be a very tough competitor for value airlines (witness Kiwi International); it has a lower cost base and lower cost per seat-kilometre than Qantas; Freedom is reputed to have a lower cost base and lower cost per seat-kilometre than Virgin Blue; Air NZ's major and supportive shareholder is the New Zealand Government, which has considerable ability to support the airline into profitable growth if called upon to do so; and the New Zealand investing community has indicated a willingness to invest in the company.

265.Several other parties dismissed the counterfactual proposed by the Applicants. The Consumers Institute considers that the counterfactual is based on a series of worst case scenarios and is not a pragmatic and commercial assessment of reality. Professor Hazledine of the Economics Department of Auckland University considers that the counterfactual assumed is "a deeply unattractive" one, designed to make the factual look very good. Waikato Regional Airport Ltd. disputed the logic that the inevitable consequence of the Applications being declined is a war of attrition with only one airline surviving. It pointed out that both airlines are Government-owned (which is no longer true for Qantas, which has been fully privatised), and would in the end be able to manage such a situation if they so chose.

266.Wellington International Airport Ltd. ("WIAL") noted that although the Applicants' analysis assumes that Air NZ is profitable on domestic sectors and unprofitable on international routes, and that although this may be the case now, historically it has not always been so. WIAL considered that it is potentially misleading to rely on the current sector profitability to model future behaviour. WIAL also argued that the proposed counterfactual of aggressive capacity-driven expansion into the New Zealand market by Qantas is contrary to the past behaviour of the company. WIAL was not convinced by the explanations provided by the Applicants as to why Qantas would change its behaviour, rather than rely upon a more measured expansion into the market.

267.WIAL's view was that the competitive influence of Origin Pacific on the main trunk markets is overstated by the Applicants given its current market strength and reliance solely on turbo-props. WIAL also considered that the Applicants' scenario assumes a new VBA entrant would start in head-to-head competition with a single well-capitalised incumbent on the incumbent's strategic routes from the 'incumbent's' airports. This contrasts markedly with the overseas experience of the VBA establishment model. The Strategic Alliance may not enhance the likelihood of a VBA entering the market. The Applicants' forecast levels of domestic/trunk activity appear inconsistent with past experience.

268.In relation to the counterfactual, Gullivers Pacific noted that Air NZ has a history of seeing off reasonably established rivals in its home market like SPANZ, Mount Cook, Newman Air, and Ansett New Zealand, as well as new entrants like Kiwi International. The company is well equipped to defend itself against competition in most sectors of the New Zealand air services market because of its brand strength, flag carrier loyalty, home ground advantage, and the most comprehensive direct and indirect air services sales and distribution networks in the country. It is also the dominant New Zealand provider of essential aviation support services, such as engineering, flight crew training facilities, and ground-handling services. Gullivers Pacific suggested that the airline could re-enter the Australian domestic market on a selective basis in its own right via Freedom Air, or through a partnership with Virgin Blue.

269.Mr Geary, a former Chief Executive of Air NZ, noted in his submission that in the past Air NZ has been very successful by focusing on domestic and Pacific routes. An airline does not have to be large to be successful. In 1983 the company suffered a massive loss. During the period 1984-89 the company experienced strong growth in passenger numbers internationally and domestically even though during the early part of this period the international aviation industry was in considerable difficulty. In the past Air NZ has faced and overcome similar challenges to the one it faces today. Geary states that Air NZ could overcome the current challenge if it were properly managed.

270.Tourism Industry of New Zealand ("TIANZ"), in its submission, appeared to view the central issue as being a regulatory one in which there are four possible outcomes, as follows:

- the status quo, involving a continuation of head-to-head competition where new domestic and Tasman entrants seek a sustainable (profitable) market share;

- the proposed Alliance, involving the key incumbent suppliers providing the majority of domestic and Tasman services;

- a regulated Air Services Network on domestic and Tasman routes in which new entrants can enter the market and develop to the point of achieving a sustainable market share, after which regulation declines; and
- a public good controlled air services network which supports selected public good goals through the influence of the Crown as major shareholder of the incumbent service provider.

271. Although TIANZ did not express a view as to which is the likely counterfactual, it does conclude that the current market is too small to be sustainable for multiple full service providers, and that key players in the industry are struggling to obtain returns that are necessary to sustain a business while maintaining international standards of services.

272. The Travel Agents Association of New Zealand ("TAANZ") considered that if Air NZ is able to establish that its continued existence as a viable airline is under threat then other options which involve far less detriment to the New Zealand public are available to it and should be investigated.

273. Christchurch International Airport ("CIAL") considered that although the Applicants postulate a factual and a counterfactual, it believes that within a relatively short term the two will converge, in that where there are presently two airlines—Air NZ and Qantas—ultimately there will be one (the proposed Alliance or the survivor of a competitive war). It also considered it unwise to assume there will be new entry, including VBA entry. Historically such entry has been unreliable, and current market trends suggest it cannot be relied upon either. The threat of VBA entry will provide but limited constraints upon the proposed Alliance. CIAL took issue with the Applicants' argument that the opportunity for competition under the factual is greater than under the counterfactual. First, under the factual, the incumbent Alliance with a VBA offshoot (Freedom Air) would operate as an effective cartel on nominated routes. Consequently, it is counter-intuitive for the Applicants to argue that a new entrant would rather enter a market and compete against a cartel than it would enter a market where two FSAs were competing head to head. Secondly, the Applicants assumed that new entrants would be prepared to limit their ambitions to the amount of the market that the proposed Alliance, in effect, would allow them.

274. In summary, there is a substantial divergence of views between most other parties and the Applicants over the likelihood of the latter's proposed counterfactual.

The Commission's Assessment

275. As indicated at the beginning of this section, the Commission's practice is to base its view as to the appropriate counterfactual on a pragmatic and commercial assessment of what is likely to occur in the absence of the arrangements or acquisition in question. If the Commission were to decline authorisation for the proposals, what would happen? There seem to be six critical elements that would influence this

choice: the external environment; the ability to attract investor funding; profitability and financial projection; the strategic behaviour of Qantas; whether, and the extent to which, Virgin Blue enters the relevant markets; and the scope for Air NZ to form an alternative alliance. Each is now considered in turn, although there are links between them, as will be indicated.

The External Environment

276. Internationally, the airline industry is susceptible to cyclical fluctuations (particularly for full service airlines), caused in part by demand fluctuations related to variations in GDP, cost fluctuations caused by variations in fuel costs and exchange rates, excessive expansions of capacity in upturns, and to external shocks (e.g. the 11 September 2001 terrorist attacks). Hence, care has to be taken in drawing too much from one year's performance. For example, prior to the Ansett acquisition, Air NZ had had a good profit record over a number of years.

277. Currently, the Asia-Pacific aviation markets appear to have suffered from less severe downturns than those evident in North America and Europe, and to be recovering more quickly. New Zealand is still seen as a 'safe' destination for tourists. It appears to be less under the threat of terrorist attack. Hence, the references in the Application to the difficulties being experienced by a number of overseas airlines, and the strong inference that Australasian airlines are similarly threatened, do not appear to be realistic. Qantas is a very profitable airline currently. Nonetheless, market events can change quickly, and the SARS outbreak in Hong Kong and the war in Iraq have led Qantas recently to announce a 20% cutback in international flights, and Air NZ a 5% reduction. These differential reductions seem to reflect Qantas's greater vulnerability because of its long haul routes to Europe via Asia.

278. The current financial vulnerability of Air NZ is likely to be a short-term phenomenon, although in the longer term the ability of the company to attract additional funding would remain a concern. The recent half-year results suggest a strong recovery, reflecting the airline successfully following its strategy of holding its revenues whilst reducing its costs (this helped by the introduction of NZ Express and fuel cost savings caused by the strengthening dollar). There appears to be nothing that has fundamentally changed in the markets in which the company operates, apart from the threat posed by low-cost entry, which it has positioned itself to meet by the introduction of Freedom Air and NZ Express. Air NZ has not claimed to be a "failing firm" in the Applications, nor used such arguments to mitigate any anti-competitiveness consequences flowing from the Application. The company's recent financial difficulties seem almost entirely due to the consequences following the Ansett acquisition.

279. External shocks are largely outside of the control of the applicants (but some, such as exchange rate fluctuations, can be hedged), and hence will be the same for both factual and counterfactual. However, the degree of exposure of the company will

depend upon such factors as where the shock appears, and the alliance arrangements the company might have.

The Ability to Attract Investor Funding

280. The fact that the New Zealand Government is the major shareholder in Air NZ, with (now) a 78% shareholding, is an important consideration. The acquisition of this shareholding demonstrates a Government intention to preserve Air NZ as the national flag-carrier, with the perceived benefits from maintenance of tourism, which is a very substantial earner of overseas exchange for the economy. A New Zealand-owned and controlled airline is needed to exercise the country's bilateral air services rights negotiated by the Government.

281. On the other hand, it is possible that the government may not see itself as a long-term investor in a commercial airline, and would not wish to bear the risks inherent in such investments. Hence, it seems reasonable to suppose that it will sell down its stake if there are opportunities to do so in the future.[34] This raises the issue as to potential sources of private sector funding. But the Government may not contemplate a sell-down until the company has achieved a secure financial position, and so becomes more attractive to private investors. There may also be less concern in the future about the proportion of a shareholding by an overseas airline.

282. The Commission has considered whether Air NZ may be capital constrained in the future under the counterfactual. Air NZ has said that it needs about $1.4 billion to finance new investment in aircraft and infrastructure over the next five years. The government may be willing to provide some level of further funding, or might need to finance its desired rate of expansion, given pressures from the demands from other spending areas in the public sector. On the other hand, the same constraints might also apply in the factual, as Qantas might be equally unwilling to provide the full level of funding required, although the proposed Alliance might make an investment in Air NZ more attractive.

283. This suggests that capital funding (and the related matter of the company's balance sheet) would be an issue under both counterfactual and factual. However, Air NZ's need for funding, and the question mark over the Government's willingness to provide further capital, may suggest the need for an alternative cornerstone shareholder in the counterfactual.

Profitability and Financial Projection

284. In order to gain a comfort that Air NZ's balance sheet would be sustainable under the Commissions proposed counterfactual, the Commission has reviewed financial modelling for 2003-06 under various factual and counterfactual scenarios (with varying levels of competition) undertaken in 2002 by Cameron & Company in

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[34] There has been some speculation in the press that the Government is considering a partial sale-down to the public of its shareholding as a way of its contributing to an expected rights issue by the company.

conjunction with, and for, Air NZ as part of its consideration of the likely counterfactual. The modelling results forecast increasing profitability for Air NZ's total airline business under all scenarios, factual and counterfactual. As would be expected, given the difference in competition faced by Air NZ, profit forecasts under the factual are higher than under the counterfactual. However, given the Commission's preliminary view that a war of attrition between Qantas and Air NZ is not likely as a counterfactual, but instead that Qantas would increase its operations in line with market growth, the difference between profit forecasts under the factual and counterfactual is not as great as the war of attrition scenario predicts. Results also show that no scenario, factual or counterfactual, achieves Air NZ's target [ ]% pre-tax return for any year over the period 2003-06. Overall, the Cameron and Company forecasts, coupled with analysis of past results, suggest that Air NZ's airline business overall is currently, and will continue to be, a profitable operation in the near term.

285. In terms of Air NZ's financial position, the modelling results forecast increasing shareholders funds and gradually reducing gearing under all scenarios, factual and counterfactual. As would be expected, given the injection of capital by Qantas, Air NZ has a higher cash balance under the factual compared to the counterfactual (assuming no other sources of capital arise under the counterfactual - potentially a conservative assumption in the medium term). Having said that, under the counterfactual Air NZ is still projected under the Cameron & Company model to have sufficient funds to meet its capital expenditure needs forecast for the period (but not necessarily those beyond the forecast period). Overall, modelling done for Air NZ suggests that Air NZ's balance sheet is sustainable under the counterfactual in the near term.[35]

286. These findings accord with the fact that the Applicants have not attempted to claim that Air NZ is a "failing firm" in mitigation of the anti-competitive effects flowing from the proposed alliance

Question 3

The Commission seeks comment on the financial viability of Air NZ in the near term.

The Strategic Behaviour of Qantas

287. Few other parties considered the war of attrition to be a likely counterfactual. The Commission has interviewed six former directors or very senior managers of Air NZ, who had had first-hand experience of Qantas's behaviour. Two of them thought that

[35] The Commission notes that, in assessing the financial prospects for Air NZ under its counterfactual, it has not (at this time) made adjustments to the assumptions (economic and otherwise) or workings of the Cameron and Company model, but merely examined the results produced by the model. Nor has the Commission considered the impact of external international factors (such as war) now, or yet to occur, on Air NZ's future (or its ability to withstand such external shocks).

Qantas would expand capacity in the way suggested by the Applicants. One of these reported [ ] A third thought it was possible, but only after a delay of one or two years, and even then only gradually, as Qantas would not want to release planes from its Australian domestic fleet. The other three tended to dismiss the possibility, or to downplay its significance.

288. The claims regarding Qantas's behaviour have to be reconciled with its previous behaviour, and with assessments as to what its behaviour might rationally be should the proposed Alliance not proceed. The following considerations are relevant:

- If capacity expansion were Qantas's optimal strategy to improve its profitability on the Tasman and on domestic New Zealand routes, it might be expected that such behaviour would be evident now, although that does not appear to be the case.

- The threat to expand capacity in the future has to be credible. It is one thing to make threats in order to bring about changes in the behaviour of a rival (encouragement of Alliance negotiations); it is another to actually carry them out in the face of the negotiations breaking down or being refused regulatory consent.

- If the proposed Alliance were not to proceed, then pressure on Air NZ through Qantas expanding capacity might force it more quickly and more certainly into an alliance with another airline. As in the counterfactual, Qantas would probably prefer to face a stand-alone Air NZ than that company strengthened by an alliance, this could provide an incentive for Qantas not to compete over-aggressively.

- It would appear that Air NZ has a lower cost per passenger using smaller jets than Qantas even for the provision of a full service product, a difference that will be magnified with its Express model on the New Zealand domestic services. This implies that Qantas would incur a greater loss per passenger than Air NZ in the event of a price war.

- The Applicants readily admit that capacity dumping by Qantas would increase its losses. Such a strategy would only be economically rational if the losses were to be recouped by future profits, both measured in present value terms. Recoupment seems unlikely if reliance can be placed upon the weight the Applicants attach to the competitive threat posed by Virgin Blue.

- A Qantas Board meeting paper of July 2002 notes that in the event of authorisation for the proposed Alliance not being obtained, the [ ], implying that profitability is a critical consideration for the company;

- It seems plausible to argue that Qantas could not afford a bruising battle with Air NZ given its current competition with Virgin Blue in Australia and retrenchment due to external events. Arguably, it stands to lose more from that competition in Australia, if it diverts resources from confronting it, than it can hope to gain from enlarging its market share in New Zealand.

- Even if Qantas, through its strategy, were to dominate Air NZ, this would not necessarily be advantageous for it on a number of grounds. Labour and other factors would be likely to gain some of the rents from market power, and push up costs on a system-wide basis. Entry would be a threat, and the entrant would be likely to be a VBA, not an FSA, especially given the origin-destination (OD) nature of the Tasman and domestic New Zealand markets. Hence, planes could not be redeployed as they would continue to be needed as the basis for the strategic entry barrier.

- The strategy would be unlikely to succeed if the Air NZ shareholders were to demonstrate a willingness to resist such behaviour by committing to support the company through any war of attrition. As a cornerstone shareholder with potentially large resources to call upon, the Government would be in a position credibly to support the company. Moreover, it has other means to influence behaviour, such as through its role in negotiating and allocating bilateral air rights;

- Previous instances of wars of attrition suggest that the outcome is either the stronger carrier acquiring the weaker, or the weaker exiting.[36] Neither of these scenarios seems feasible in the present case, as the exit of Air NZ would leave no other airline available to exercise the country's bilateral air rights.

- If Qantas's preferred option is to enter into what is effectively a cartel with Air NZ, and this were blocked by an inability to gain authorisation, then Qantas's next most preferred option might be to enter into tacit collusion with Air NZ instead.

289. Some evidence of capacity expansion and/or price-cutting can be found in Australasian markets, but these relate to responses to entry by new VBAs, or to expansions by smaller domestic operators. For example, Qantas's alleged "capacity dumping" behaviour against Virgin Blue on the Adelaide-Brisbane route is the subject of enforcement action by the ACCC. Virgin Blue has complained of similar behaviour by Qantas on other routes it entered in Australia. Similarly, Air NZ's introduced Freedom Air as a 'fighting brand' to target the new entrant, Kiwi International. Origin Pacific has claimed [ ]

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[36] In Europe Air France took over UTA which was smaller and Lufthansa acquired competitors that were small and undercapitalised. In the UK Ryanair took over Buzz and easyjet acquired Go. In North America Air Canada took over the smaller Canadian Air and American Airlines took over TWA and Reno Air.

290.The Commission is therefore inclined to discount the war of attrition claimed of Qantas in the proposed counterfactual.

New Airline Entry

291.Currently, the only likely entrant into some of the relevant air services markets is Virgin Blue, although in the future others could appear. However, Virgin Blue's position is uncertain. It has said that it intends to enter the Tasman and domestic New Zealand routes, but that there are significant barriers to entry posed by the need to get access to essential ground-based facilities, and the threat from incumbent response. It believes that entry would be more difficult with the proposed Alliance than without it, reflecting the ability of the proposed Alliance to organise a collective response. It would like to purchase Freedom Air as a means of mitigating its concern about incumbent response, but this is something that Air NZ (from recent public announcements) appears unwilling to contemplate. Given this, together with its current capacity constraints [ ], and the range of other potentially more profitable options available to it in Australia and elsewhere, it is possible that entry by Virgin Blue might not occur for some time.

292.The possibility of other, as yet unknown, airlines to enter the relevant markets in the relevant timeframe is very difficult to assess.

293.The Tasman routes are primarily OD and VFR), which makes them ideal for VBA entry. On the other hand, there are few secondary airports that a VBA could use, so that entry would draw it into head-to-head competition with the incumbent FSAs, which generally they are disinclined to do. The alternative is to serve routes that are under-serviced, or not serviced at all, by the incumbents, but these would tend to be relatively low traffic routes, and therefore unattractive. Further, Freedom Air operates on the Tasman in part from the few secondary airports available. The difficulty for a VBA entrant is that there are few unexploited market opportunities left available by the incumbents.

294.Nonetheless, a factor favouring VBA entry is low costs, suggesting that entry is possible sooner or later, depending upon availability of aircraft, the profitability of alternative routes, and the strategies of the incumbents. Entry seems more likely on the Tasman initially, with a subsequent expansion onto the New Zealand main trunk being possible later. Virgin Blue's entry strategy could be influenced by the possibility of an alliance with Air NZ (see below).

The Scope for an Alternative Alliance

295.One alternative possibility for Air NZ is an alliance with fellow Star Alliance member Singapore Airlines. It seems that Singapore and Hong Kong are competing to become major hubs in the east Asia region; the proposed Alliance, if it were to lead Air NZ to join Qantas in the oneworld Alliance, would favour the latter, hence providing an incentive for Singapore Airlines to ally with Air NZ. Against that, Singapore Airlines is very particular about its product offering, and may not wish to ally with another airline whose product offering might be significantly different. Also, in the past, Singapore Airlines has been more concerned to get access to the Australian markets, which an alliance with Air NZ would not provide.

296. The Commission also understands that [ ]

297. An alliance with Virgin Blue would be another option, and one that would overcome Air NZ's lack of feed from Australia following the demise of Ansett. Virgin Blue has declared its interest in finding interlining partners, and has such an arrangement with United, [ ]. Moreover, the Commission understands that [ ]

298. The Star Alliance has not appeared to show any inclination to support Air NZ to date.

299. In short, there appear to be other possible alliance options available, aside from the one with Qantas, and others could emerge over time for a variety of reasons. From Air NZ's perspective these would be less desirable in that they would not neutralise the perceived competitive threat posed by Qantas.

Conclusion on the Counterfactual

300. On the basis of the information it has received to date, the Commission has reached the preliminary conclusion that the likely counterfactual has the following characteristics:

- a gradual recovery in the financial position of Air NZ and ongoing financial viability;
- a continuation of the present support by the Government for Air NZ, but with a question mark over whether sufficient capital in addition to retained earnings, would, if necessary, be forthcoming to pursue its preferred network strategy;
- 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";

- Air NZ standing alone in the short term, while seeking, and perhaps in the medium term gaining, an alternative alliance with another airline; and

- incremental entry by Virgin Blue being likely on the Tasman, with possible expansion onto the New Zealand main trunk.

Question 4

The Commission seeks comment on its definition of the counterfactual.

Question 5

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

COMPARISON OF COMPETITION UNDER THE FACTUAL AND COUNTERFACTUAL

301. The purpose of this section is to identify whether there is a substantial lessening of competition in the markets defined in the section above. The analysis of the main trunk market is substantially greater than that in the other markets as it is the market which has the greatest impact and its analysis can be applied to most of the other markets.

The Main Trunk Market

Introduction

302. An examination of concentration in a market post the Alliance can provide a useful guide to the constraints that market participants may place upon each other, including the combined entity. Both structural and behavioural factors have to be considered.

303. Market shares can be measured in terms of revenues, volumes of goods sold, production capacities or inputs (such as labour or capital) used. All measures may yield similar results in some cases. Where they do not, the Commission may, for the purposes of its assessment, adopt the measure which yields the highest level of market share for the combined entity. The Commission considers that this will lead to an appropriately conservative assessment of concentration, and that the factors which lead to the other different market share results are more appropriately considered elsewhere during the assessment of the acquisition.[40]

304. In determining market shares, the Commission will take into account the existing participants (including 'near entrants') and where appropriate, inter-firm relationships, and the level of imports.

305. Following this consideration of existing competition, barriers to entry for each market are considered and the coupling of these allows the Commission to make a conclusion on unilateral market power for all the markets.

306. New Zealand's main trunk routes are defined as routes between Auckland, Wellington, and Christchurch.

Participants

307. Existing participants in this market comprise Air NZ, Qantas, and as an expanding participant, Origin Pacific.

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[40] For example, where market share measured in terms of capacity produces a significantly lower share of the market in the hands of participants than a measure in terms of sales volumes, the constraint on a combined entity from that unemployed capacity might be taken into account when identifying near entrants or the constraint from new market entry. In some cases, the model of market power being used may influence the choice as to which market share measure is used.

308.Origin Pacific recently expanded its services by entering the New Zealand main trunk market (the Wellington – Christchurch route) using larger turbo-prop aircraft.

309.The Applicants submitted that given the ready availability of appropriate jet aircraft and turbo-prop in the international market, there is no reason, given the right financial incentives, why Origin Pacific cannot continue its steady expansion and become a full geographic competitor in the New Zealand Main Trunk Market. They claimed that Origin Pacific can expand as slowly or as quickly as it desires and can minimise sunk costs.

310.[

]

311.In assessing counterfactual and factual, the nature of the Alliance under the Factual is such that the parties can be considered as one and therefore their market shares are combined in the section below.

Market Shares

312.Table 3 below outlines the market share figures (by capacity, that is, seats available) in the main trunk market.

Table 4
Market Shares Based on Capacity in Main Trunk Market

Route	**Qantas**	**Air NZ**	**Origin Pacific**	**JAO SHARES (%)**
AKL-WLG	[ ]	[ ]		100
WLG-AKL	[ ]	[ ]		100
AKL-CHC	[ ]	[ ]		100
CHC-AKL	[ ]	[ ]		100
CHC-WLG		[ ]	[ ]	[ ]
WLG-CHC		[ ]	[ ]	[ ]
Market Shares %	**[ ]**	**[ ]**	**[ ]**	**[ ]**

313.If the proposed Alliance were to proceed it would have a market share of [96] %.

Competition under Counterfactual and Factual

314. Industry participants stated that Qantas and Air NZ currently compete heavily with each other. Competition is even more intense on the Wellington – Christchurch route which Origin Pacific operates on. This competition is evidenced by Air NZ's recent release of 5000 seats between Christchurch and Wellington for $49. [ ]

315. Virtually all industry sources that made submissions or who were spoken to by the Commission stated that the proposed Alliance would result in an almost complete loss of competition with capacity being reduced and prices increasing. Gullivers Pacific, for example, said in its submission that the proposed Alliance would be in a dominant competitive position in the main trunk market and would control all areas of pricing, scheduling, capacity, retail and wholesale remuneration (if any), and distribution channels.

316. Origin Pacific, in its submission, pointed out that anti-competitive practices are a well documented concern in relation to various alliances overseas and that there is no reason to believe that New Zealand would not be faced with the same concerns if the Alliance proceeded as proposed. It said that predatory behaviour can cripple a small airline by denying it break-even load factors and revenue. Origin Pacific stated that if the proposed Alliance proceeded in its present form, the future of all airline competition in New Zealand would be at risk.

317. WIAL submitted that the proposed Alliance would be able to manage the factors affecting yield and would be able to increase average fares by limiting availability of discounted price seats. They stated that the proposed Alliance would be able to control the overall capacity offered on each route and will be the sole or dominant carrier at most of the airports they operate out of in New Zealand.

318. [ ] Gullivers Pacific [ ]

319. Air NZ and Qantas are the only operators on the majority of the main trunk routes. The proposed Alliance would result in aggregation of market share to 100% on all routes other than the Wellington – Christchurch route. The Commission is of the view that the constraint that Air NZ and Qantas currently exercise on each other would be lost.

Constraints from Potential Competition

<u>Introduction</u>

320.The proposed Alliance is unlikely to result in a substantial lessening of competition in a market if behaviour in that market continues to be subject to real constraints from the threat of market entry.

321.Where barriers to entry are clearly low, it will not be necessary for the Commission to identify specific firms that might enter the market. In other cases, the Commission will seek to identify likely new entrants into the market.

322.The Commission will consider the history of past market entry as an indicator of the likelihood of future entry. The Commission is also mindful that entry often occurs on a relatively small scale, at least initially, and as such may not pose much of a competitive constraint on incumbents within the relevant time frame.

Types of Entry

323.Airlines can be differentiated according to the level of frequency they offer, their cost-base, and the type of service and add-ons offered.

324.The range of entry types can extend down from a FSA, progressively reducing incentives and comfort factors to approach the level of a no-frills service, where air travel is treated as a basic commodity.

325.All round the world FSAs are retrenching and it appears to be a commonly held view amongst industry participants that if any airline is likely to enter a market, it will be a VBA.

Barriers to Entry/Expansion

Introduction

326.The likely effectiveness of the threat of new entry in constraining the conduct of market participants firstly those in counterfactual and secondly in the factual, following the proposed alliance that might otherwise lead to a substantial lessening of competition in a market, is determined by the nature and height of barriers to entry into that market. These barriers can be strategic (arising from behaviour of incumbents) as well as structural (resulting from inherent structural characteristics of the market).

327.The Commission considers that, for the purpose of considering this issue, a barrier to entry is best defined as an additional or significantly increased cost or other disadvantage that a new entrant must bear as a condition of entry. This cost may be a cost that must be incurred in order to enter, and it may be sunk, or it may represent an on-going disadvantage. In evaluating the barriers to entry into a market, the Commission will generally consider the broader 'entry conditions' that apply, and then go on to evaluate which of those constitute entry barriers.

328. It is the overall obstacle to entry posed by the aggregation of the various barriers that is relevant in determining whether entry is relatively easy or not, and therefore whether or not potential entry would prevent a substantial lessening of competition.

329. The Applicants submitted that the history of entry and expansion activity in airline markets suggests that the perceived barriers to entry and expansion into the relevant markets have not protected incumbents from the threat or reality of entry or expansion. Incumbents are constrained and will continue to be constrained from exercising market power in the relevant markets because entry or expansion is likely if they were to increase price or decrease quality.

330. The Applicants considered that the conditions of entry and expansion on the New Zealand Main Trunk and Provincial routes do not amount to material barriers to entry for a VBA or to barriers to expansion for an incumbent airline.

331. The Commission considers the following conditions of entry to the main trunk routes for entrants below:

- capital requirements;
- regulatory requirements;
- incumbent response;
- scale and scope of entry;
- access to facilities;
- access to travel distribution services;
- access to feeder services;
- access to CRS;
- access to catering services;
- loyalty schemes;
- brand awareness;
- size of market;
- availability of pilots; and
- availability of aircraft.

Capital requirements

332.In *Bodas*, the Commission stated it considered that estimates of start-up capital of NZ$30 million for entry in the New Zealand main trunk market were conservative, and in the absence of access to further financial backing, might not be sufficient to sustain an entrant. The Commission was of the view that a VBA was likely to build in a considerable amount of funding to help it withstand operating losses during its initial entry period.

333.The Commission was of the view that the capital required to effect entry to the main trunk routes by an FSA would be at the higher end of the scale, and that a considerable amount of funding would need to be built-in to withstand initial operating losses. This would be true if the FSA was starting from scratch, but entry by an FSA is generally an expansion and thus is an incremental cost, whereas a VBA, being point to point is a fresh entrant in most cases.

334.The Applicants claimed that the success of Origin Pacific suggests that significant capital in terms of sustaining initial operating losses may not be required and further demonstrates that entry strategies significantly impact the cost and success of entry. They consider that expansion by incumbent Australasian air services providers such as Virgin Blue and Origin Pacific would require less capital than the type of entry considered by the Commission in *Bodas*, and that for these reasons they are of the view that capital requirements are not of an extent to constitute a barrier to expansion. The Applicants claimed that having a code-share with Qantas significantly reduced the strategic barriers to entry for Origin Pacific.

335.Origin Pacific pointed out that it had focused on the provincial routes, not the main trunk market, and that it [ ] It also pointed out that [ ]. Origin Pacific also [ ]

336.Origin Pacific advised that for it to enter the main trunk market to an extent that would be competitive with the proposed Alliance, [ ] A 737 300 dry lease costs US$2.2 million a year, approximately US$20 million to purchase second- hand and approximately US$35 million to purchase new. It pointed out that there are other major costs in establishing the profile and infrastructure of the airline and of dealing with the response of the proposed Alliance. These include operational, marketing and distribution costs. They said that advertising alone, to create and maintain a sufficient profile, could be of the order of [ ] or more. They advised there are also costs involved in obtaining terminal facilities, web infrastructure and call centres.

337.Many industry participants spoken to advised that one of the main reasons new entrants into passenger air services markets, including the New Zealand market, fail is the lack of capital. Virgin Blue and other industry sources stated inter alia, that the failure of Compass in Australia and Kiwi International in New Zealand was due to a lack of capital. The Commission is aware however, that this was one of several factors that led to their failure.

338.WIAL stated that it would take a minimum of 12 to 18 months for an entrant to become profitable and that it would in consequence need considerable capital to survive the unprofitable period.

339.Virgin Blue advised that it would[ ]. Virgin Blue advised that [ ].

340.WIAL submitted that the need for considerable capital backing is increased by the volatility of the aviation industry. The Airline industry has recently been very unstable with many airlines around the world failing. The environment is particularly uncertain now and investors are likely to view investing in an airline very cautiously.

341.The Commission is of the view, as it was in *Bodas*, that the costs of competitive entry in the main trunk market would be very considerable and an entrant would require ongoing and substantial financial backing.

Question 6

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

Sunk Costs

342.Sunk costs are the costs of an investment that cannot be recovered once they have been incurred. Typically, sunk costs in the aviation industry are represented by start-up sunk costs, market-specific assets, product differentiation, and investments necessary to overcome disadvantages presented by the strategic behaviour of incumbent firms. Start-up sunk costs might include some of the costs of obtaining computerised information and reservation systems, terminal facilities, engineering facilities, advertising costs, painting aircraft, hiring and training pilots and flight attendants, setting up operations manuals and schedules, and test flights. In the case of failure of the entrant, further sunk costs might be incurred, for example, in financial penalties from early termination of aircraft leases.

343.The Applicants stated that sunk costs are not a material barrier to entry for a VBA, nor a barrier to expansion for an incumbent airline. They claimed that sunk costs are appreciably less for an incumbent Australasian air services provider as it would already have brand recognition, operating manuals prepared, existing computerised information and reservation systems, and potentially underutilised aircraft that might be diverted to the new routes. They stated that there is only a marginal cost associated with the infrastructure needs associated with adding additional aircraft.

344.The Commission is of the view that these points are not correct as VBAs typically do not have excess capacity due to high aircraft utilisation and flying point to point services. If an aircraft is moved from one route to another there is an opportunity cost of forgone revenue and of "disappointing" the market.

345.The Commission is still of the view, as it was in *Bodas*, that sunk costs represent a risk to a prospective entrant. Sunk costs increase the downside risks of entry. They make the "failure" outcome worse, and hence the overall prospects from entry less attractive, and the risk and uncertainty associated with entry increases. This increased risk is likely to delay entry and affect the entrant's ability to raise funds for entry.

Question 7

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

Regulatory Requirements

346.New Zealand's domestic aviation industry is deregulated to the extent that there are no quantitative restrictions, and the only regulatory requirements are based on qualitative licensing. This means that any airline, even if foreign owned, able to satisfy the regulatory requirements of the CAA as to the safety and competency of a planned service, would be permitted to operate domestically. Air NZ and Qantas NZ are the only two operators currently licensed to operate jet aircraft domestically.

347.The primary impact of the regulatory requirements for an entrant relates to aircraft maintenance. An aircraft requires regular periodic servicing and maintenance triggered by the accumulation of flying hours, take off/landing cycles and calendar time. An "A" check occurs after between 250 and 400 operating hours, while the more demanding C check occurs after between 3,000 and 7,000 operating hours, both sets of timing depending upon the aircraft and operator.

348.Maintenance must be carried out by a maintenance organization approved by the CAA. The CAA needs to be satisfied that the operator has established a system, as shown in its Operators Maintenance Manual (OMM), to ensure that it will undertake the required maintenance work to the frequency and standard indicated by the aircraft manufacturer.

349. These requirements are achievable for a new entrant, although the lead-in time and cost involved would depend to a certain degree on the manner in which the entrant obtained these engineering services. All the jet aircraft engineering facilities in New Zealand are owned by Air NZ. In the event that an entrant might not be able to obtain engineering services from the incumbents, then an entrant may need to set up its own engineering facilities, or contract with an approved overseas facility to carry out the work

350. The Commission is of the view that that the regulatory requirements relating to engineering services are achievable and transparent for a new entrant. However, it should be noted that the costs of setting up engineering facilities would increase the already considerable capital requirements for entry. The Civil Aviation Authority advised that Virgin Blue would need to pay [ ] for an Air Operator's Certificate (AOC) and would incur a further substantial cost in writing the necessary manuals.

Question 8

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

Incumbent Response to Entry

351. In order to provide effective competition, a potential entrant must be prepared to enter and secure a viable position in the market against the likely responses from incumbents. The potential entrant would always look at the post entry values of expected fares, revenues and costs in making its decision to enter. Incumbent operators have a number of natural advantages. They include:

- established operation, with sunk costs already incurred;
- brand loyalty;
- relationships with travel distributors;
- loyalty schemes;
- market share;
- economies of scale and of network density;
- Alliance membership; and

- reputation, particularly for safety.

352.The proposed Alliance would also have the benefit of enlarged CRS displays. Code-shared flights achieve several advantages in CRS display over other flights. A code-shared non-stop flight is listed twice in CRS screens because both partners list the same flight as their own flights; code-shared connecting flights get listed ahead of interline flights on the CRS screens; and a code-share flight with one connection gets listed three times in CRS screens. These multiple listings of same flight and priority displays push other airlines' flights further down the screen or onto the next screen. Therefore, alliance partners are likely to reap sizable benefits from this CRS display advantage because travel agents tend to book flights that are listed on the CRS's first screen as often as 90% of the time.[41]

353.These advantages enable an incumbent to maximise the effectiveness of its response to the new entrant, particularly during the period immediately prior to entry being effected. The incumbent might take steps such as a vigorous advertising campaign to increase membership in passenger loyalty programmes, increasing frequency/capacity, discounting of fares, and free add-ons such as car hire and overnight accommodation. It can focus its "competitive response" on a few routes on which an entrant enters, gaining strength from operations across a number of routes.

354.The Applicants submitted that the traditional model for incumbent response was to undercut the fares offered by a competing FSA using the benefits of incumbent economies of scope and scale. They claimed that such a response is no longer logically available to incumbent FSAs faced by a VBA entrant which, utilising a "greenfield" low-cost base, is always able to undercut the FSA pricing usually without detriment to its business model or profitability.

355.The Commission notes that the response has often been to both lower price and increase capacity. While the price reduction can be loss-making, the increased capacity has an impact on the VBA by drawing passengers away from the VBA. Airlines operate on margin and thus it is the last few passengers who generate the profit for the VBA. If an FSA can drain away these five to seven passengers, it can affect the profitability of the new VBA.

356.The Applicants submitted that it would be difficult for incumbents to apply selective strategies given that VBA entry into the New Zealand main trunk market will be based on price and that the mere threat of entry into the New Zealand main trunk market is sufficient to constrain the incumbents.

357.Several of the parties who were interviewed or who made submissions stated that one of the main barriers to entry would be the threat and likelihood of response of the proposed Alliance. They stated that the dominance of the proposed Alliance in the

[41] US General Accounting Office, US GAO, 1995.

New Zealand domestic market, would deter future entrants. This is because it is the post entry values of fare, revenues and cost that are important.

358. Virgin Blue in its submission said that the threat of strategic capacity and pricing conduct by Air NZ and Qantas, particularly through their low cost operations, Freedom Air, and Jet Connect respectively, were enough to deter entry. They stated that such conduct includes strategic capacity deployment, yield management, flexible price adjustments and the bracketing of flights. Virgin Blue pointed out that [ ] Virgin Blue claimed that a combined Qantas and Air NZ would be able to strategically target their combined fleets, and constrain the growth of Virgin Blue.

359. Origin Pacific also stated that Freedom Air represented a formidable barrier and [ ].

360. Origin Pacific stated that the proposed Alliance would have several considerable advantages, e.g. frequent flyer programmes, access to slots, and corporate and travel agent contracts which are often bundled with international travel. They pointed out that an entrant without international feed would have considerable difficulty obtaining such contracts. [ ]

361. Origin Pacific said that [ ] Origin Pacific recently increased capacity on the Wellington to Christchurch route. Air NZ is now offering 8,500 seats at $39 each on that route, [ ]

362. The House of Travel, said that the proposed Alliance [ ] [ ] Gullivers Pacific Ltd stated that [ ] In its submission, Gullivers Pacific stated that the proposed Alliance will deter new entry and diminish the growth prospects for competitors of the proposed Alliance.

363. A former Air NZ director, Liz Coutts also described [ ] Former Air NZ CEO, Jim McCrae said that [

]. Former Air NZ CEO, Gary Toomey stated that [

] Norm Geary pointed out that Air NZ could overcome Virgin Blue as it has more products to offer and more deals it could do.

364. In *Bodas*, the Commission said that the entry of a VBA on the main trunk routes is likely to add capacity, and generate demand by offering low prices, thus expanding the existing market to attract more price-sensitive customers. The Commission was of the view that the incumbent is likely to seek to share that market expansion, through heavy fare discounting, and the addition of capacity, possibly by the introduction of a rival VBA, much the same way that Freedom had been established for the Tasman in response to Kiwi International's entry. The Commission said that sharing the expanded market will put pressure on the entrant by reducing its load factors and thus increasing the period of operating losses which it must sustain.

365. The Commission is of the view that this scenario is as likely under the current proposed Alliance as it was in 1996. When Kiwi International commenced offering scheduled services on the Tasman in August 1995, both the incumbent airlines, Air NZ and Qantas, expanded output and engaged in significant price cutting in response. In the case of Air NZ this was done not only directly, but also through the creation of Freedom Air, which, as referred to above, appeared to be targeted at the routes to which Kiwi International flew.

366. Air NZ has recently set up its NZ Express service which operates closer to the VBA end of the continuum between an FSA operation and a true VBA operation. It is likely that the proposed Alliance would use this against an entrant in a similar manner to which Air NZ used Freedom against Kiwi International.

367. The Commission considers that the proposed Alliance would mount an immediate and vigorous response against a new entrant to the main trunk market and that the threat of this occurring as well as the response itself, amount to significant barriers to entry. Again this serves to increase the downside risk for entry, making entry all the less attractive overall.

368. The Commission also considers that the response by the incumbent Alliance would be a greater barrier than under the counterfactual with a response by Air NZ and Qantas acting independently. The proposed Alliance would be more profitable than the airlines acting independently and would be able to devote more profits to subsidising price reductions and/or capacity dumping on routes that an entrant enters on. The greater strength of route coverage of the proposed Alliance would also increase the ability to respond to entry. Furthermore, the two airlines would be able to coordinate responses if the proposed Alliance proceeds than if they were operating independently. The perception of the sheer size and strength of the proposed Alliance as against the two airlines acting independently and in competition with each other

has also been cited as a barrier to entry by industry participants as compared to the counterfactual.

Question 9

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

Scale and Scope of Entry

369.In *Bodas*, the Commission said that frequency and capacity are primary considerations of competition in the airline industry. The scale of a new entrant's operations would depend on the frequency of flights provided. Capacity is also relevant to the scale of operations, but frequency is the main consideration for an entrant wishing to appeal to business travellers.

370.The scope of a new entrant will depend on its expansion into different markets or associated services, for example, operating on provincial or tourist routes, or in the travel distribution services market. A new entrant can also widen its scope by providing add-on services such as passenger loyalty programmes or business lounges.

371.Some VBAs emphasise capacity, but others do not and there is no standard model. The Applicants argue that a VBA entrant targeting leisure passengers would be competitive against the proposed Alliance. The Commission said in *Bodas* that a VBA would not enter on the scale of an FSA but would seek to expand the market with a more price sensitive customer base. The importance of the business traveller has, however, been emphasized by industry participants spoken to. They point out that business travellers are high yield passengers and are an important part of the profitability of an airline seeking to operate in the main trunk market. Approximately 50% of passengers in the main trunk market are business travellers.

372.As the Commission pointed out in *Bodas*, any airline wishing to gain access to the high yield business traveller would need to match the frequency and level of service of the present incumbents. Any entry at a frequency significantly less than that provided by the incumbents would likely only attract a limited portion of the business traveller sector. Accordingly, a full service entrant would be required to match the frequency and, to a degree, the levels of service of the present incumbents in order to compete effectively on the main trunk routes, including the timing of flights to match business needs. This would place pressure on airport access and facilities. A VBA entrant, if it was to be in a position to constrain the proposed Alliance would also need to be able to attract business travellers, although it would almost certainly start off quite small and gradually build from there.

373. Large network FSA's can enjoy both cost and demand advantages over smaller network FSA's, although these advantages can sometimes be partially offset by carriers that have substantially lower costs. Travellers prefer connections between flights of the same airline to flights between different airlines.[42] It should be noted that Air NZ has emphasized the benefits of having a larger network.

374. The Commission notes that possible entrants would see New Zealand and Australia as one market and would be unlikely to enter New Zealand without first also entering Australia and the Tasman.

375. The Commission is of the view that any new entrant to the main trunk market, whether FSA or VBA, would need to match the frequency of the incumbent Alliance in order to capture the business market and provide a constraint on the Alliance. They may also need to match the service levels of the proposed Alliance though business travellers appear to becoming more price sensitive, particularly on short hauls as in New Zealand. The likelihood of an entry of a sufficient extent to constrain the proposed Alliance is discussed below under the LET Test.

Question 10

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

[42] *Airline Mergers and Alliances,* Directorate for Financial, Fiscal and Enterprise Affairs Committee on Competition Law and Policy, 26/1/00, p 8.

Access to Facilities

376.Several activities are involved in the processing of passengers and the servicing of aircraft at airports. These include:

- Access to check-in counter space, terminal areas and in some cases, business lounges;
- Pier space and departure and arrival slots;
- Baggage handling services;
- Catering services; and
- Aircraft cleaning and servicing.

377.The Applicants submitted that access to terminal and ground handling services does not constitute a barrier to entry or expansion. They stated that although there are some constraints at Auckland Airport in terms of access to gates and terminal facilities, the entrant airline and the Auckland Airport would be able to resolve these constraints.

378.Air NZ and Qantas currently use the two terminal buildings at Auckland Airport. Virgin Blue advised that [ ] The removal of the constraints at Auckland therefore comes at a substantial cost, and construction would take anything up to a year. As an indication, Ansett NZ took 12-18 months to complete its terminals when it entered the New Zealand market in 1987.

379.If a new entrant is to be competitive with the proposed Alliance so that it can act as a constraint, it would have to be able to fly all the main trunk routes. Accordingly, access to terminal space at Auckland for the same or similar commercial rates as incumbents is essential for successful entry. [ ] The land is currently owned by the Defence Force, and although Waitakere City Council is planning to convert it to a commercial airport, there is no indication at this stage whether this may occur, and whether it would be a suitable alternative to Auckland Airport.

380.WIAL advised that, in contrast to Auckland Airport, there is very little restriction in access to facilities at Wellington Airport. However, Simon Gunson, a former baggage handler intending to set up a Tasman freight airline, advised that at busy time at Wellington Airport, all large jet docking piers can be occupied by Air NZ and Qantas aircraft and that there is a severe shortage of space to accommodate the service vehicles, tugs and baggage trolleys an entrant would use. He stated that Air NZ controls 50% of the check-in counters with Qantas controlling a further 25%.

381. The smaller airports all provide common terminal space. There is no congestion at these airports and they would probably welcome new traffic. However, this might require reallocation of space and negotiations with the incumbents.

382. A ‘landing slot’ is the period of time used by an aircraft when it occupies air space and runway space during a take-off or landing manoeuvre. Aircraft wishing to take-off or land at airports file their flight schedules or flight plans with the Airways Corporation of New Zealand Ltd (ACNZ). ACNZ manages the flow of traffic on a demand basis, ensuring the safe separation of aircraft.

383. The Applicants submitted that the availability of landing slots is not an impediment to entry or expansion in the New Zealand domestic markets. They quoted the Commission in *Bodas* as saying that generally in New Zealand there are no difficulties in accessing slots, although the Commission did highlight that some smaller airlines that operate non-jet aircraft did suffer from a lower priority in Auckland and Wellington airports during peak times or bad weather conditions. They submitted, however, that a new entrant or expanding incumbent operating jet aircraft would not be affected during such circumstances.

384. Airlines spoken to advised that landing slots are difficult to obtain for any aircraft in Auckland and that they are virtually impossible to obtain at peak times. Virgin Blue stated in its submission that no gates are available during peak times at Auckland Airport. Auckland Airport advised that there may not be airbridges available for a new entrant at peak times but that it could offload its passengers onto the tarmac, a method that is used by VBAs overseas. Industry participants also advised that there is limited availability of landing slots at Christchurch Airport at peak times.

385. The situation regarding landing slots has changed since the *Bodas* decision in that there are currently constraints on availability of landing slots at both Auckland and Christchurch Airports.

386. Ground handling services are supplied by Air NZ throughout New Zealand, Menzies at Auckland and Aviation Ground Services at Wellington. Air NZ’s control of ground handling at Christchurch could also become a barrier to entry. Virgin Blue has expressed concern about this situation.

387. Industry participants have stated that access to engineering services may be a barrier. Air NZ is currently the only supplier of engineering services.

388. Industry participants have suggested that Air NZ is the only supplier of engineering services and bundles other services such as catering, aircraft cleaning and ground handling with this. Accordingly, if an entrant did not have its own engineering

services, it would be forced to use other Alliance services at a price nominated by the Alliance.

389.The Commission is of the view that a new entrant would have difficulty accessing terminal space and landing slots at Auckland Airport. As Auckland is an essential part of the main trunk market, this would amount to a barrier to entry. The bundling of services by Air NZ may also amount to a barrier to entry.

Question 11

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

Access to Travel Distribution Services

390.In *Bodas*, the Commission said that most domestic air travel was sold through retail travel agents and that access to travel distribution services may be problematic for an FSA entrant, because incumbent airlines might apply pressure on travel wholesalers and travel agents. The Commission also commented that an established airline would be unlikely to encounter this problem as it would have existing relationships with travel agents and that a VBA could choose to bypass the travel agents by booking direct.

391.The Applicants submitted that the travel distribution services market has changed considerably since *Bodas* in that the launch of NZ Express has resulted in a substantial increase in the number of flights booked directly with Air NZ. They submitted that it is expected that a VBA entrant would heavily promote direct booking, which would be consistent with the behaviour of Virgin Blue in Australia, and easyJet and Ryanair in Europe. The Applicants submitted that because entry is likely to be by a VBA, and if not, by an established FSA, the Commission's observations in *Bodas* support the Applicants' view that access to travel distribution services is not a barrier to entry or expansion.

392.Travel agents and wholesalers spoken to have expressed concern that the proposed Alliance through its existing travel centres and outlets and Qantas Holidays could obtain dominance in the travel distribution market. Industry participants also referred to the risk of the proposed Alliance putting pressure on travel businesses not to deal with an entrant.

393.As described below with respect to the wholesale travel distribution market, it appears from information supplied to the Commission that the proposed Alliance would have a considerably strengthened position in the wholesale travel market and that this position may discourage new entrants. The Commission is of the view that access to wholesale travel distribution services is likely to amount to a barrier to entry.

Question 12

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

Access to Feeder Traffic

394. Feeder traffic has an important impact on airline profitability, as the last handful of interconnecting passengers often make the difference between a flight operating profitably and it making a loss. Almost all of the revenue they provide goes directly to the bottom line, once the costs of the flight have been covered, as additional passengers add very little to costs.

395. For a New Zealand main trunk operator, two sorts of feeder traffic are relevant: that supplied by incoming international flights, such as those crossing the Tasman; and that derived from provincial services feeding the main trunk at the major airports. In *Bodas* the Commission said that as a high proportion of the total population is concentrated in the three main centres—Auckland, Wellington and Christchurch—the feed traffic from provincial and tourist routes is not a substantial proportion of total main trunk traffic. The Commission also concluded that international feed accounted for a relatively small amount of domestic traffic, and that there were other airlines flying into New Zealand who could provide feed apart from Qantas and Air NZ, although their combined volumes were much lower.

396. Industry participants have not raised feeder traffic as an issue. Feed is not generally an issue for VBAs because they generally operate point-to-point networks, and assess the profitability of routes on a stand-alone basis, without considering feed potential.

397. The Applicants submitted that a new entrant on the main trunk market would potentially be able to access provincial feeder traffic from Origin Pacific. However, Origin Pacific itself relies significantly on feed traffic from Qantas across the Tasman and on the main trunk, and it would likely lose this feed with the proposed Alliance, as Qantas would be expected to direct that feed to Air NZ instead. This loss of feeder traffic would certainly impact on the ability of Origin Pacific to [ ].

398. It is possible that a new main trunk operator could ease its feed problem if it were also to enter the Tasman market. However, this would entail simultaneous entry in two major markets, which would add greatly to the costs and risks of entry. The Commission considers that simultaneous entry of this kind is most unlikely.

399. Overall, the Commission is of the view that access to feed traffic is a barrier to entry for an entrant into the main trunk market. It is also likely to be a significant barrier to possible expansion by Origin Pacific into that market.

Question 13

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

Access to CRS

400. Airlines have computerised systems for seat inventory/yield management, reservations, making and pricing bookings, issuing tickets, processing passengers at airports and associated functions such as obtaining credit card clearances. There are two types of system:

- a CRS, used by an airline for its own operations including reservations and bookings; and

- a GDS, used by travel agents for information on services available from a number of airlines, and to make reservations, and bookings.

401. Air NZ and Qantas previously held equity stakes in GDS suppliers, but this is no longer the case.43 There are a number of GDS providers from which airlines can purchase services, including Sabre, Galileo, Worldspan, Amadeus, Infini, and Topaz.

402. Air NZ operates its own CRS, whereas Qantas works off Amadeus. However, there are independent CRS providers from which an entering or expanding airline could obtain services if airlines were unable to reach a hosting agreement with Air NZ, including EDS/Sabre, Unisys, Equant (SITA), and Amadeus.

403. There appears to be no significant barriers to entry in this market. A VBA would be likely to use the Navitair Open Skies System, a software suite designed for VBAs, currently utilised by Ryanair, easyJet and Virgin Blue; and for VBAs concentrating on point to point traffic, the use of the internet is rapidly becoming an effective substitute for GDSs.

404. In *Bodas* the Commission concluded that access to CRSs and GDSs did not amount to a barrier to entry. The Commission is still of this view.

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[43] *GDS* distribute their services through National Marketing Companies (NMC) in each geographic territory. Previously, Air NZ and Qantas had equity stakes in two NMCs through the travel distribution company TIAS. Specifically, TIAS used to own two NMCs, namely SCDS and Sabre which distributed Cendant/Galileo and Sabre GDS, respectively. In 2001, TIAS sold its shares in the two NMCs to their respective GDS' owners

Question 14

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

Access to Catering Services

405. There are two major providers of catering services, Pacific Catering Services Ltd (Pacific Catering), and LSG Sky Chefs, which is owned by Air NZ. Pacific Catering is able to meet the catering needs of any entrant even though VBAs do not require catering services in general.

Question 15

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

Loyalty Schemes

406. Airlines enhance demand for their services through loyalty programmes such as frequent flyer programmes or travel agent commission override programmes, which provide incentives for travellers and travel agents to focus their bookings on a single airline. These programmes have been especially targeted at attracting and retaining high-margin time-sensitive business travellers[44]. However, more recently, they are attracting leisure travellers as well as they can accumulate points through credit cards and other purchases.

407. The value of using loyalty points is also of higher value on a larger carrier like Qantas or Air NZ since they go to more destinations and more valuable destinations than do small carriers.

408. The existence of a loyalty scheme is one of the factors involved in choice of airline by business passengers and to some degree to leisure travellers. As approximately 50% of passengers travelling on the main trunk routes are business passengers, it would seem that the lack of a loyalty scheme could be an issue. Virgin Blue stated that [
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[44] *Airline Mergers and Alliances,* Directorate for Financial, Fiscal and Enterprise Affairs Committee on Competition Law and Policy, 26/1/00, p 8.

409. The Commission is of the view that loyalty schemes, given their importance to business passengers in particular, are barriers to customers switching to a new entrant.

Question 16

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

Brand Reputation

410. Qantas and Air NZ both have strong brands in the Australasian region. Industry participants advised that loyalty to the Air NZ brand within New Zealand is considerable with many New Zealand passengers preferring to fly Air NZ because it is New Zealand's national airline. Air NZ also has a reputation for safety and quality of service.

411. New carriers will tend not to have such reputations, or the longevity in the market that would reassure customers that their forward bookings will be honoured. The history of recent failures of start-up airlines in Australasia may tend to undermine customer confidence in a new entrant's ability to survive.

412. The strength of both the Qantas and the Air NZ brands could amount to a barrier to entry in that it would require considerable investment in brand awareness to offset or equal the brand value of the incumbents. When Air NZ entered the main trunk market, it was a new industry and it did not have to counter existing brands. A new entrant would have to establish its own brand in the face of the competing incumbents at considerably greater expense. However, this barrier would be low for Virgin Blue and fifth freedom carriers as they already have established brands.

413. The Commission is of the view that the need to establish a new brand would be a barrier to entry.

Question 17

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

Size of Market

414.If an entrant needs a certain scale to benefit from economies of scale, it would need to be a certain size to compete effectively. In the case of the main trunk market, an entrant would need a large share of the market to be viable and would need to displace the incumbents to a certain degree to obtain this. Qantas stated it needs a 40% market share in the main trunk market to be profitable.

415.Furthermore, because the main trunk market would be considered to be a small market by any potential entrant, any entrant, particularly a VBA, would need to see a potential to grow the market and if this potential has already been taken up by the proposed Alliance, it would be very difficult for any airline to enter on a sustainable basis.

416.The Commission is of the view that the establishment of NZ Express by Air NZ has already taken up some of the potential for growth in the main trunk market, thus limiting the potential for growth by an entrant. The Commission is of the view that this limited scope for growth would not relax the barrier created by inability to access economies of scale.

Question 18

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

Availability of Pilots

417.The Commission concluded in *Bodas* that availability of pilots was not a barrier to entry. Since that time, the collapse of Ansett and the general downturn in the aviation industry has resulted in a greater pool of available pilots, so the Commission retains the view expressed in *Bodas.*

Availability of Aircraft

418.In *Bodas*, the Commission concluded that an entrant would have no difficulty obtaining aircraft. There is an active operating lease market for aircraft, accounting for approximately one-third of new aircraft activity, and enabling airlines to expand their fleet without significant capital outlay. The availability of aircraft to lease has increased since September 11 and the subsequent recession in the aviation industry. Airlines are also able to purchase aircraft on an active second-hand aircraft market.

419.The Commission therefore concludes that availability of aircraft is not a barrier to entry.

Question 19

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

The "LET" Test

420. In order for the threat of market entry to be such a constraint on the exercise of market power as to alleviate concerns that the proposed Alliance could lead to a substantial lessening of competition, entry of new participants in response to the exercise of market power must be likely, sufficient in extent and timely (the *let* test).

Likelihood of Entry

421. The mere possibility of entry is, in the Commission's view, an insufficient constraint on the exercise of market power to alleviate concerns about a substantial lessening of competition. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational firm will be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on its investment, including allowance for any risks involved.

422. The size of the main trunk market means that entry is likely to come from an airline already established in the region, in this case, either Virgin Blue or Origin Pacific.

423. Various industry participants have stated that entry into the New Zealand domestic markets is unlikely in the face of the proposed Alliance. Virgin Blue in its submission said that it wished to provide services to New Zealand and within New Zealand. It has signed an agreement with Boeing for the supply of ten aircraft from August 2003 and options for the purchase of a further 40 aircraft. Virgin Blue advised the Commission that these aircraft would [ ] Virgin Blue, however, [ ]

424. Other industry participants were of the view that the entry of Virgin Blue is very uncertain if the proposed Alliance were to proceed, as New Zealand would not be high on Virgin Blue's priority list as it would have several more profitable alternatives.

425. Origin Pacific advised the Commission that if the proposed Alliance were to proceed,[

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426. Other parties have expressed an intention to enter the New Zealand domestic markets. However, none of them have obtained any funding or aircraft.

427. There is no evidence of any international airline intending, or even considering, entering the main trunk market.

428. It appears that the only likely entrant into the main trunk market is Virgin Blue. The extent and timeliness of such entry is discussed below.

<u>Extent of Entry</u>

429. If entry is to constrain market participants, then the threat of entry must be at a level and spread of sales that is likely to cause market participants to react in a significant manner. The Commission will not consider entry that might occur only at relatively low volumes, or in localised areas, to represent a sufficient constraint to alleviate concerns about market power.

430. Small-scale entry into a market, where the entrant supplies one significant customer, or a particular product or geographic niche, may not be difficult to accomplish. However, further expansion from that "toe-hold" position may be difficult because of the presence of mobility barriers, which may hinder firm's efforts to expand from one part of the market to another. Where mobility barriers are present in a market, they may reduce the 'extent' of entry.

431. Virgin Blue in its submission said that the proposed Alliance raises the risk that Virgin Blue's entry into New Zealand may not be as substantial as it would otherwise be. It stated that in any event, [

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432. Virgin Blue, when spoken to by the Commission, said [

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433. The Commission is not satisfied on the information currently available to it that there is likely to be entry into the main trunk market of sufficient extent to constrain the proposed Alliance.

<u>Timeliness of Entry</u>

434.If it is effectively to constrain the exercise of market power to the extent necessary to alleviate concerns about a substantial lessening of competition, entry must be likely to occur before customers in the relevant market are detrimentally affected to a significant extent. Entry that constrains must be feasible within a reasonably short timeframe from the point at which market power is first exercised.

435.Virgin Blue has said that if the proposed Alliance were to proceed[ ]

436.One major industry participant advised the Commission that it believed that there would not be entry by Virgin Blue within the next 18 to 24 months and queried why Virgin Blue would want to put aircraft in a market where they would have to battle it out with the proposed Alliance. Another industry participant in its submission said that there is no reason to believe that Virgin Blue would enter and develop a reasonable scale in the medium-term.

437.The Commission is of the view that there is not sufficient certainty that Virgin Blue would enter the main trunk market within a sufficiently short timeframe (four to five years) to alleviate concerns about substantial lessening of competition in the market.

Question 20

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

Question 21

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

Question 21

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

Constraint from Buyers or Suppliers

438.There appears to be little evidence of buyer or supplier constraint in this market.

Conclusion on the Main Trunk Market

439.A comparison between the counterfactual and the factual results in:

- the proposed Alliance having a high market share;
- insufficient constraint from competitors, either existing or potential;
- an increase in the barriers to entry when all of the barriers are taken together;
- Virgin Blue being unlikely to enter, and if it did, it would not be to a sufficient extent or within a sufficient timeframe;
- Origin Pacific facing barriers to expansion [ ]; and
- no constraint from buyers or suppliers.

440.Consequently, the Commission is of the preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the main trunk market when compared with the counterfactual.

Question 23

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

The Provincial Market

Participants

441.Origin Pacific operates over 100 flights each week day, servicing 14 destinations. It currently services Auckland, Tauranga, Hamilton, Rotorua, New Plymouth, Napier, Palmerston North, Wellington, Nelson, Blenheim, Christchurch, Queenstown, Dunedin and Invercargill.

442.A number of small operators provide limited scheduled services on provincial routes. These operators include:

- Great Barrier Airlines (Great Barrier Island, Whangarei, Auckland, Coromandel, and Tauranga);
- Wairarapa Airlines (Masterton – Auckland and Masterton – Wellington);
- Air Adventures/Air Chathams;
- Air Fiordland;
- Air Kaitaia, Mountain Air,
- Southern Air;
- Aspiring Air;

- Air Kapiti/Wairarapa Alpine;
- Air Coromandel.;
- Sunair;
- Great Barrier Express; and
- Soundsair

443.Qantas does not operate its own flights in the provincial market but code-shares on Origin Pacific flights.

Competition under Counterfactual and Factual

444.The Applicants submitted that there will be no material impact in the market and that Origin Pacific and Air NZ will continue to compete in the same manner as presently. The Applicants submitted that this market will remain competitive after the proposed Alliance due to the ability of Origin Pacific to expand

445.Although the proposed Alliance does not result in an aggregation in the provincial market, the Commission is of the view that it will reduce Origin Pacific's ability to compete. As previously discussed, [

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446.As with the main trunk market, industry sources believe that the proposed Alliance would result in an almost complete loss of competition in the provincial market with prices being increased. The comments by Gullivers Pacific, Origin Pacific and Waikato Regional Airport Ltd ("WRAL") referred to above applied to both the main trunk and provincial markets. Save Air NZ said that the proposed Alliance would eliminate price and service competition on large parts of the New Zealand air transport network.

447.Access to feeder traffic from international flights is said to be important to survival and existence in this market. Around 20% of all traffic on provincial routes is derived from feeder traffic. Should the proposal proceed it is very unlikely that any other market participant would be able to access this feeder traffic, therefore reducing its chance of success.

Constraint from Potential Competition

Barriers to Entry/Expansion

448.The conditions to entry for the provincial market are less onerous than for the main trunk market. Three conditions that may, however amount to barriers to entry are access to feeder services, incumbent response and loyalty schemes.

Access to Feeder Services

449.If a new entrant was to provide effective competition against the proposed Alliance it would need feed traffic from the main trunk services. Qantas and Air NZ currently account for [96] % of traffic on the main routes and if Qantas terminates its agreements with Origin Pacific as a result of the proposed Alliance, Origin Pacific may have to exit the main trunk route it currently flies with the result that the proposed Alliance will account for [ ]% of the traffic in the main trunk market.

450. For those provincial routes which are primarily tourist routes such as those servicing Queenstown and Rotorua, feed from international airlines is essential. The proposed Alliance would account for approximately [ ] % of visitor arrivals and it would be highly unlikely that much of this traffic would interline with a provincial only carrier that was not aligned with the proposed Alliance.

451.A new entrant and indeed, existing airlines flying on provincial routes will be at a serious disadvantage with respect to feeder traffic. The Commission concludes that access to feeder services may amount to a significant barrier to entry on a scale sufficient to provide effective competition against the proposed Alliance.

Incumbent Response

452.In *Bodas* the Commission stated that entry on a level required to provide effective competition could elicit a strong response from the proposed Alliance. As stated above, the Commission considers that the proposed Alliance would mount an immediate vigorous response against a new entrant to the main trunk market. The Commission also considers that there would be a similar response to any entry of sufficient scope to be competitive against the proposed Alliance.

453.As with the main trunk market, the Commission considers that the response by the incumbent Alliance would be a greater barrier than a response by both Air NZ and Qantas acting independently.

Loyalty Schemes

454.Some industry participants indicated that presence of loyalty schemes may increase the difficulty of entry. The existence of a loyalty scheme is one of the factors involved in choice of airline by business passengers and to some degree by leisure passengers.

455.The Commission is of the view that loyalty schemes, given their importance to business passengers in particular, are barriers to customers switching to a new entrant.

The "LET" Test

456.Since deregulation there have been many examples where locally-owned operators have entered the market. Air Nelson and Eagle both expanded to form networks and were subsequently acquired by Air NZ. Origin Pacific entered six years ago and has gradually increased its presence until it is now servicing 14 destinations. It should be noted, however, that as stated above, [ ]. Other small airlines such as Soundsair and Wairarapa Airlines have also entered on localized routes, but are not competitive against Air NZ.

457.The Commission acknowledges that entry on individual local routes might be possible with a small operator entering with small aircraft and taking a limited market share, but such entry is very unlikely to be on a scale that would be competitive against the proposed Alliance. Origin Pacific has advised the Commission that it will [ ]. Virgin Blue may enter on some of the provincial routes, but there is considerable uncertainty as to whether this would occur and as to the extent and the timeliness of Virgin Blue's entry into the New Zealand domestic markets.

458.The Commission is of the view that the only entry to the provincial market that would be sufficient to act as a constraint on the proposed Alliance would involve entry on multiple routes and would include either entry in the main trunk market or guaranteed feed from the main trunk routes. The Commission has not seen any evidence that there is likely to be entry into the provincial market of a sufficient extent and within a sufficiently short timeframe to constrain the proposed Alliance and thus alleviate concerns about substantial lessening of competition in the provincial market.

Constraint from Buyers or Suppliers

459.There appears to be little evidence of buyer or supplier constraint in this market.

Conclusion on the Provincial Market

460.A comparison between the counterfactual and the factual results in:

- the proposed Alliance having a high market share;

- insufficient constraint from competitors, either existing or potential;
- an increase in the barriers to entry when all of the barriers are taken together;
- no likely entry to a sufficient extent or within a sufficient timeframe;
- Origin Pacific facing barriers to expansion and [ ]; and
- no constraint from buyers or suppliers.

461. Consequently, the Commission is of the preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the provincial market when compared with the counterfactual.

Question 24

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

Question 25

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

Question 26

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

Question 27

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

The Tasman Market

Participants

462. Air NZ and Qantas have the greatest market share in the Tasman market.. Auckland to Sydney is the route with the largest operating capacity. A number of fifth freedom operators also operate in this market. These are:

- Thai International Air Lines;
- Malaysian Air;

- Garuda;
- Lan Chile;
- Polynesian Air;
- Royal Tongan;
- United Airlines; and
- Aerolineas Argentinas.

Market Shares

463.The market shares in the Tasman market are set out in Table 4 below.[45]

Table 5
Market Shares by Capacity in the Tasman Market

Air NZ and Freedom Air	Qantas	**JAO**	QF equity & close commercial partners	**JAO with QF equity & close commercial partners**	Other oneworld Alliance carriers	**Combined Air NZ / Qantas / oneworld**	Other Star Alliance carriers	Other airlines
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]

464.If the proposed Alliance were to proceed, it would have a high market share of [ ].

Competition under Counterfactual and Factual

465.Air NZ and Qantas are the two main competitors in the Tasman market currently with Air NZ's Freedom Air providing VBA style services.

466.The Applicants submitted that should the proposal proceed, existing competition will derive from the expanding Fifth Freedom Carriers, which they claim now account for approximately 15% of the capacity on the Tasman market. They quoted the ACCC in its submission to the Australian Productivity Commission which recognised the constraint imposed by Fifth Freedom operators where it commented:

> "Examination of routes where fifth freedom carriers have operated would suggest that consumers are likely to benefit from their operations. For example, fifth freedom carriers on the Australia - UK route such as Singapore Airlines and Cathay Pacific have provided a credible competitive force to Qantas and British Airways. Even on the Australia - New Zealand route, fifth freedom carriers have provided strong competition (e.g. Continental Airlines in the 1980s). In these cases the fifth freedom carriers have provided a countervailing force to the third/fourth freedom carriers and been a significant determinant in setting prices."[46]

[45] Note that Qantas uses spare Air Pacific and Polynesian Airlines aircraft time for Tasman operations from time to time.
[46] "Submission to the Industry Commission Inquiry into International Air Services", 20 April 1998, page 5

467.The Applicants claimed this constraint is evident on the Auckland-Sydney route where the Fifth Freedom carriers account for approximately 25% of total capacity, and on the Auckland-Brisbane route where they account for approximately 44% of total capacity. A proportion of this capacity is through-traffic (i.e. passengers with a final destination in the airline's home port).

468.Tasman capacity as at 9 December 2002 is 19% higher than December 2001 capacity (47,284 to 56,246 one way seats). Qantas has increased its seats on the Tasman over the same period by approximately 17.5% (19446 to 22860 one way seats).

469.Virtually every industry source stated that the proposed Alliance would result in a considerable loss of competition in the Tasman market. United Travel, for example, stated that the proposed Alliance would be formed to the substantial detriment of competition in the airline and related services market of and between New Zealand and Australia.

470.Origin Pacific pointed out that the fifth freedom operators do not have sufficient frequency to be a constraint on the proposed Alliance and that the passengers on the Tasman leg of their flights are only seen as a top-up to the other legs. STA Travel also made this point, saying that the Tasman leg is low yielding and that the fifth freedom airlines would rather sell seats out of the other sectors.

471.Cathay Pacific said [ ] Both Qantas and Air NZ are losing money on the Tasman. Gullivers Pacific advised that although the fifth freedom airlines may have 400 seat aircraft, the actual capacity for the Tasman sector is much lower and that there may not be any seats available at all on occasion. Expansion on the Tasman requires expansion on beyond markets. The Commission does not believe that the capacity of fifth freedom operators is as flexible as the Applicants claim.

472.Several industry participants pointed out that all the fifth freedom flights are out of Auckland only. United Airlines also advised that none of them fly to Melbourne.

Constraint from Potential Competition

<u>Barriers to Entry</u>

473.The Applicants submitted that the barriers to entry and expansion are low in the Tasman market. The Commission determined in *Bodas* that the barriers were low as was evidenced by the entry of Kiwi International. Since then Kiwi International has failed primarily because it did not have sufficient financial backing. The Commission is of the view that the information now available to it supports the conclusion that there are some barriers to entry. These are discussed below relying on the analysis and principles already discussed with regard to the main trunk market..

Capital Requirements/Sunk Costs

474.The Applicants submitted that capital requirements are not a barrier to entry or expansion in the New Zealand domestic markets and that the capital required to enter or expand into the Tasman market is no more burdensome than that in the New Zealand domestic markets, especially in light of the ability of Fifth Freedom carriers such as Malaysian Airways, Thai Airlines and Garuda to utilise otherwise idle aircraft while only needing to cover marginal costs. These carriers would not increase capacity on the Tasman routes unless they had decided to increase capacity on the primary leg from their home countries to Australia.

475.Industry participants advised that one of the main reasons new entrants into passenger air services markets fail is that they do not have sufficient financial backing, and that they do not "have deep enough pockets". They said that the failure of Kiwi International was due to its lack of capital.

476.The Commission is of the view that the capital requirements for entry into the Tasman market are likely to be considerable, and as with the main trunk market, would need to incorporate substantial provision for an initial period or operating losses.

477.The Commission is also of the view that, as with entry into the main trunk market, sunk costs represent a risk to a prospective entrant which is likely to delay entry and affect an entrant's ability to raise funds for entry although requirements may be less for an existing participant expanding into this market.

Incumbent Response to Entry

478.The Applicants submitted that incumbent response is not a barrier to entry by a VBA or expansion by an incumbent airline.

479.Several of the parties who were interviewed or who made submissions stated that one of the main barriers to entry to the Tasman market as well as the New Zealand domestic markets was the threat and likelihood of response by the proposed Alliance. Origin Pacific said that [

] An industry expert referred to Freedom as "the sentry at the door to keep entrants out".

480.Gullivers Pacific in its submission said that the joint Air NZ/Qantas strategy will be to ensure that the only VBA airline on the Tasman is to be Freedom and that there is no evidence anywhere in the world that two VBAs can co-exist on a route on a sustainable basis. In fact, there are a number of routes served by more than one VBA. However, where this occurs, the VBAs are following somewhat different models; serving many destinations versus serving mainline airports.

481.CIAL in its submission said that the Applicants, together with Freedom, create substantial barriers to entry. It said that Freedom is well placed to virtually close out, in a co-ordinated effort with the JAO, any new entrant on the Tasman routes and that recent events, for example the demise of Kiwi International, suggest this is a real risk.

482.Virtually all industry participants spoken to referred to Freedom as a weapon to be used against new entrants into the Tasman market and the role it had played in the demise of Kiwi International.

483.When Kiwi International commenced on the Tasman in August 1995, both the incumbent airlines, Air NZ and Qantas expanded output and engaged in significant price cutting in response. In the case of Air NZ this was done not only directly but also through the creation of Freedom Air, which was directly targeted at the Kiwi regional market. The Commission considers that the proposed Alliance would mount a similar vigorous response against a new entrant into the Tasman market and that the threat of this occurring as well as the response itself amount to significant barriers to entry. For the reasons set out above with respect to the main trunk market, the Commission also considers that the response by the incumbent Alliance would be a greater barrier than a response by both Air NZ and Qantas acting independently.

Access to Facilities

484.The Applicants submitted that obtaining access to terminal and ground services and landing slots is not an impediment to entry or expansion in the Tasman market. They said that although there are some constraints at Auckland Airport in terms of access to gates and terminal facilities, an entrant airline and the Auckland Airport would be able to resolve these constraints. Further these constraints would be lessened under the Factual, given the wider spread and services contemplated. They added that since the demise of Ansett, access to slots in Australia is not an impediment.

485.As described in the discussion above on access to facilities in the main trunk market, an entrant would have difficulty gaining access to terminal facilities at Auckland.

486.Furthermore, landing slots are difficult to obtain at Auckland and virtually impossible at peak times. Auckland Airport advised that there may not be airbridges available for a new entrant at peak times but that it could offload its passengers onto the tarmac, a method that is used by VBAs overseas. Industry participants advised that access to facilities is also very limited at Sydney Airport. Any new entrant would have to have access to facilities at both Auckland Airport and Sydney Airport if it was to be competitive against the proposed Alliance.

487.The Commission is of the view that access to facilities at Auckland and Sydney airports is likely to be a barrier to entry to the Tasman market.

Loyalty Schemes

488.Some industry participants indicated that the presence of a loyalty scheme of the proposed Alliance may increase the difficulty of entry. The existence of a loyalty scheme is one of the factors involved in choice of airline by business passengers and to some degree by leisure passengers. As approximately 35% of passengers travelling on the Tasman routes are business passengers, it would seem that the lack of a loyalty scheme could be an issue.

489.The Commission is of the view that loyalty schemes, given their importance to business passengers in particular, are barriers to customers switching to a new entrant.

Brand Reputation

490.Qantas and Air NZ both have strong brands in the Australasian region. Industry participants advised that loyalty to the Air NZ brand within New Zealand is considerable with many New Zealand passengers preferring to fly Air NZ because it is New Zealand's national airline. Australians have a similar loyalty to Qantas.

491.The strength of both the Qantas and the Air NZ brands could amount to a barrier to entry. However, it would be low for Virgin Blue and fifth freedom carriers as they already have established brands.

Size of Market

492.If an entrant needs a certain scale to benefit from economies of scale, it would need to be a certain size to compete effectively. In the case of the Tasman market, an entrant would need quite a large share of the market to be viable and would need to displace the incumbents to a certain degree to obtain this.

493.Furthermore, any entrant, particularly a VBA, would need to see a potential to grow the market and if this potential has already been taken up by the proposed Alliance, it would be very difficult for any airline to enter on a sustainable basis.

494.The Commission is of the view that the existence of Freedom Air has already taken up some of the potential for growth in the Tasman market, thus limiting the potential for growth by an entrant. The Commission is of the view that this limited scope for growth is a barrier to entry.

Question 28

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

The "LET" Test

495.The ability of fifth freedom carriers to constrain the proposed Alliance and whether they would be likely to expand was discussed by industry participants. As Virgin Blue pointed out, fifth freedom carriers do not determine their schedules and their operations by reference to, and therefore do not competitively respond to, price and capacity signals on the Tasman routes. It is therefore unlikely that they would expand their operations in the Tasman market as a constraint on the proposed Alliance.

496.As stated above, Virgin Blue said in its submission that it wished to provide services to New Zealand and has taken some steps towards that end. It said that if and when it did enter any of the New Zealand or Tasman routes, if the proposed Alliance proceeded, [ ]

497.Industry participants were of the view that Virgin Blue would enter very carefully and one said that there is no reason to believe that Virgin Blue would develop a reasonable scale in the medium term.

498.Origin Pacific has advised the Commission that [ ] Industry participants were of the view that Origin Pacific did not have the resources to enter the market in competition with the proposed Alliance.

499.Jumpjet intends to fly from Wellington to Tasmania, Sydney and Melbourne or Brisbane. It described itself, however, as being still in an embryonic stage and has not yet obtained funding. There is no evidence of any other airlines intending to enter the Tasman market.

500.The Commission cannot be satisfied that there is likely to be entry into the Tasman market of a sufficient extent and within a sufficiently short timeframe to constrain the proposed Alliance and thus alleviate concerns about substantial lessening of competition in the Tasman market.

Question 29

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

Constraint from Buyers or Suppliers

501.There appears to be little evidence of buyer or supplier constraint in this market.

Conclusion on the Tasman Market

502.A comparison between the counterfactual and the factual results in:

- the proposed Alliance having a high market share;
- insufficient constraint from competitors, either existing or potential;
- an increase in the barriers to entry when all of the barriers are taken together;
- Virgin Blue being the only likely new entrant but not to a sufficient extent or within a sufficient timeframe; and
- no constraint from buyers or suppliers.

503.Consequently, the Commission is of the preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the Tasman market when compared with the counterfactual.

Question 30

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

The NZ-Asia Market

Participants

504.Existing participants in this market include Singapore Airlines, Malaysian Airlines, Cathay Pacific, Thai Airways, EVA Air, and Korean Air.

505.Table 5 below sets out the market shares by capacity in the NZ-Asia market. The Commission acknowledges that there may be separate markets within the NZ – Asia market but has aggregated the various routes for convenience of analysis. This does not impact the analysis of benefits and detriments.

Table 6
Market Share by Capacity in the NZ-Asia Market

Asia	Air NZ	Qantas	**JAO**	QF equity & close commercial partners	**JAO with QF equity & close commercial partners**	Other oneworld Alliance carriers	**Combined Air NZ / Qantas / oneworld**	Other Star Alliance carriers	Other airlines
China,	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]

Asia	Air NZ	Qantas	**JAO**	QF equity & close commercial partners	**JAO with QF equity & close commercial partners**	Other oneworld Alliance carriers	**Combined Air NZ / Qantas / oneworld**	Other Star Alliance carriers	Other airlines
People's Republic of									
Hong Kong (SAR)	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
India	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Indonesia	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Japan	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Korea, Republic of	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Malaysia	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Singapore	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Taiwan	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Philippines	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Thailand	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Total	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**

506. The Applicants submit that the proposed Alliance would be constrained by competition from the existing carriers in this market. It also submits that prices on the various Asia and Pacific sectors are constrained by the price of other sectors.

507. The Commission has been advised that the ability of each of the other airlines to divert capacity to alternate routes with relative ease provides strong competition within Asia. However, the Commission notes that on some routes, particularly NZ-Japan, the proposed Alliance would have a high market share and might not face sufficient constraint. On other routes, such as NZ-Hong Kong, the proposed Alliance, will also have a high market share when combined with other oneworld Alliance partners and likewise, might not face sufficient constraint from competitors.

Constraint from Potential Competition

508. The Applicants combined New Zealand-Asia and New Zealand-Pacific into one market and submitted that there are low barriers to entry or expansion on the market. It said that New Zealand has concluded bilateral arrangements with a number of countries in this region, including Fiji, Cook Islands, Samoa, Tonga, Thailand, Malaysia, and Singapore. The regulatory and legal conditions of entry do not constitute a material barrier to entry or expansion in respect of the Asia/Pacific Destinations routes.

509.The Commission is of the view that the barriers identified with respect to the Tasman market also apply to the NZ-Asia market and that an entrant would need to have substantial financial backing. Several airlines in the Asian region are large enough to have the necessary capital. Many can fly to any point in New Zealand and are not using their full capacity under IASL and/or ASA licences. Most can also have unlimited capacity available on a code-share basis.

510.However, it is necessary to consider whether they are likely to enter or expand current operations to a sufficient extent to constrain the proposed Alliance. Cathay Pacific which flies between Hong Kong and Auckland said [ ] The Commission is unaware of any other expansion plans.

511.The Commission is of the view that airlines already operating in the NZ-Asia market are capable of expanding their operations to a sufficient extent to constrain the proposed Alliance, if the proposed Alliance attempted to exercise market power. However, the Asia to New Zealand sector is low yielding and not considered to be a major focus by these airlines. Furthermore, the East Asian market is expanding rapidly and Asian airlines will be focusing on growth in that market rather than the routes to New Zealand. Accordingly, the Commission cannot be satisfied that the proposed Alliance will be constrained by potential competition.

Constraint from Buyer or Suppliers

512.The Applicants submit that a significant proportion of traffic to Asia destinations is carried pursuant to travel packages assembled by travel wholesalers. These packages typically include airfares, transfers, accommodation and in some cases additional activities (e.g. tours). Wholesalers typically determine which airline to use for the packages it is assembling. Many wholesalers are vertically integrated with downstream retail outlets, which enhances their bargaining power.

513.The Commission is not of the view that, as with the other markets, the proposed Alliance would be constrained by the travel wholesalers.

Conclusion on the NZ-Asia Market

514.A comparison between the counterfactual and the factual results in:

- insufficient constraint from existing competition on some routes;
- the Commission not being satisfied that entry or expansion will occur; and
- no constraint from buyer or suppliers.

515.Consequently, the Commission is of the preliminary view that, on some routes, the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the NZ-Asia market.

Question 31

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

The NZ-Pacific Market

Participants

516.Aggregation occurs in this market by virtue of Qantas' 46.32% shareholding in Air Pacific, (in which Air NZ also holds a 1.97% stake). The only ex-New Zealand sector that Air NZ and Air Pacific overlap is Auckland – Nadi, on which they compete directly with Korean Air.47

517.The proposed Alliance would not result in aggregation on any other Pacific Destination route.

518.Other participants in the NZ-Pacific market are:

- Air Caledonie;
- Air Tahiti Nui;
- Air Vanuatu;
- Polynesian Airlines; and
- Royal Tongan Airlines.

519.The market shares in the NZ-Pacific market are set out in Table 6 below.

Table 7
Market Share by Capacity in NZ-Pacific Market

Pacific Islands	Air NZ	Qantas	**JAO**	QF equity & close commercial partners	**JAO with QF equity & close commercial partners**	Other oneworld Alliance carriers	**Combined Air NZ / Qantas / oneworld**	Other Star Alliance carriers	Other airlines
Cook Islands	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Fiji	[ ]	[ ]	[ ]	[ ][48]	[ ]	[ ]	[ ]	[ ]	[ ]

[47] Air NZ and Air Pacific also compete on the Nadi-Los Angeles sector.
[48] Air Pacific

France (incl F Poly, N Cal)	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Samoa	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Tonga	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Vanuatu	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Total	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**

520.If the proposed Alliance were to proceed it would have a high market share.

521.The Applicants submitted that prices on the various Asia/Pacific Destinations sectors are constrained by the price of other sectors.[50] That is, that any attempt by the parties to increase price, or decrease service, on any service in this market will result in either substitution by these price sensitive passengers to other Asia/Pacific Island destinations, or the foregoing of such travel altogether, at a level sufficient to render the price increase unprofitable.

522.The Applicants submitted that the constraint imposed by Fifth Freedom carriers on a New Zealand/Asia-Pacific route is evidenced by Korean Air. Korean Air offers twice weekly services from Auckland to Nadi utilising a Boeing 777-200 as part of its Auckland-Seoul service, although currently, South Korea's bilateral with Fiji limits it to carrying 100 Fifth Freedom passengers.

523.Industry sources pointed out that should the proposed Alliance proceed, because of the inclusion of Air Pacific in the Alliance, the Alliance would be the only operator on the NZ-Nadi route apart from Korean Air which is very limited in the passengers it can carry.

524.Polynesian Airlines submitted that Air NZ is the principal competitor to Polynesian on all international routes Polynesian Airlines operates on. The proposed Alliance would result in a shifting of competition from Polynesian Airlines and Qantas together (because of Qantas code-sharing on Polynesian Airlines) against Air NZ to Air NZ and Qantas together against Polynesian with the result that Polynesian Airlines could be forced out of its international routes.

525.Bon Voyage Marketing pointed out that the competition on the Pacific is already limited with higher fares comparatively than other more competitive regions and that the proposed Alliance would make this worse.

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[50] Qantas code-shares with Polynesian to Samoa, Tonga and Tahiti and with Air Tahiti to Papeete,. However Qantas and the operating carrier retain absolute pricing discretion on these services. Qantas also code-shares on Pacific routes with Air Pacific, Polynesian Airlines, Air Caledonie International and Air Vanuatu.

Constraint from Potential Competition

526.The Applicants submitted that New Zealand-Asia and New Zealand-Pacific were one market and that there are low barriers to entry or expansion in this market. They pointed out that that New Zealand has concluded bilateral arrangements with a number of countries in this region, and stated that the regulatory and legal conditions of entry do not constitute a material barrier to entry or expansion.

527.The Commission is of the view that the barriers identified with respect to the Tasman market also apply to the NZ-Pacific Islands market and that an entrant would need to have substantial financial backing. There is no evidence that any of the airlines currently operating in this market, all of which are small regional airlines, would be in a position to expand their operations to an extent that would be competitive against the proposed Alliance. Polynesian Airlines advised that it will in fact be unable to remain in operation on its B737-800 routes. It certainly would not be in a position to expand.

528.The Commission is of the view that entry to the market by any airline other than Virgin Blue which has stated that it is considering flying into Fiji, is also unlikely due to the presence of the proposed Alliance and the other barriers to entry. The Commission is not satisfied on the information currently available that Virgin Blue would enter to such an extent and within a sufficiently short timeframe to constrain the proposed Alliance.

529.The Commission is not satisfied that the threat of potential competition in the NZ-Pacific market would constrain the proposed Alliance.

Constraint from Buyer or Suppliers

530.The Applicants submitted that a significant proportion of traffic to Asia/Pacific destinations is carried pursuant to travel packages assembled by travel wholesalers. These packages typically include airfares, transfers, accommodation and in some cases additional activities (e.g., tours). Wholesalers typically determine which airline to use for the packages it is assembling. Many wholesalers are vertically integrated with downstream retail outlets, which enhances their bargaining power.

531.As stated above with respect to the NZ-Asia market, the Commission is of the view that the proposed Alliance would not be constrained by travel wholesalers.

Conclusion on the NZ-Pacific Market

532.A comparison between the counterfactual and the factual results in:

- the proposed Alliance having a high market share;

- insufficient constraint from competitors, either existing or potential;
- Polynesian Airlines might be forced to retrench;
- an increase in the barriers to entry when all of the barriers are taken together;
- no likely entry to a sufficient extent or within a sufficient timeframe; and
- no constraint from buyers or suppliers.

533.Consequently, the Commission is of the preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the NZ-Pacific market when compared with the counterfactual.

Question 32

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

The NZ-US Market

Market Shares

534.Air NZ and Qantas are the only current competitors in this market since the recent withdrawal of United Airlines from the Auckland – LA route. The proposed Alliance would therefore result in a 100% market share. There would also be no existing competition to constrain the proposed Alliance.

Constraint from Potential Competition

535.The Applicants stated that the Commission considered in *Bodas* there were no regulatory barriers to entry on the New Zealand – USA market because of the liberal bilateral agreement between New Zealand and the USA.[53] They pointed out that this condition prevails today. They submitted that in terms of capital requirements, scale and scope economies and incumbent response, these are not likely to pose a barrier to entry given the likelihood that new entrants in this market will be large established international airlines.

536.The Commission is of the view that the barriers identified with respect to the Tasman market also apply to the NZ-USA market and that an entrant would need to have substantial financial backing. Several of the American airlines would, on the face of it, be large enough to be able to overcome the entry barriers. However, in fact the

[53] *Brierley/Air New Zealand*

airlines that are most likely to consider entering this market are unlikely to do so because of financial problems. United Airlines has recently withdrawn from the market and has filed for bankruptcy protection under Chapter 11. American Airlines has begun seeking commitments for up to $2 billion in financing should it decide to seek bankruptcy protection.

537. Even if these airlines were financially sound, there is considerable doubt as to whether they would enter the market against the market power of the proposed Alliance. United Airlines withdrew because the market was not sufficiently profitable. American Airlines has entered and withdrawn twice for the same reasons. Continental has entered and withdrawn once.

538. There is also a considerable threat provided by the presence of only one alliance in the NZ-US market. Any entrant would be a member of another alliance, most likely the Star Alliance, but such an entrant would have no possibility of receiving beyond the gateway passengers or feeding beyond the gateway passengers. Entry could only occur on international routes if entry occurred simultaneously on domestic and possibly Tasman routes.

539. The Commission is not satisfied that the threat of potential competition in NZ-US market would constrain the proposed Alliance.

Constraint from Buyers or Suppliers

540. There appears to be little evidence of buyer or supplier constraint in this market.

Conclusion on the NZ-US Market

541. A comparison between the counterfactual and the factual results in:

- the proposed Alliance having a high market share;
- no constraint from competitors, either existing or potential;
- an increase in the barriers to entry when all of the barriers are taken together;
- no likely entry to a sufficient extent or within a sufficient timeframe;; and
- no constraint from buyers or suppliers.

542. Consequently, the Commission is of the preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the NZ-US market when compared with the counterfactual.

Question 33

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

The International Market

Market Shares

543.Air NZ flies to London via Los Angeles. It also code-shares on flights from Los Angeles to other European destinations and from Asia to European destinations including London.

544.Competition on international routes is strong with the presence of many large and fringe competitors. The Commission is therefore of the view that the proposed Alliance would be constrained by existing competition in this market.

Constraint from Potential Competition

545.The Commission is of the view that for the NZ-Asia sector of the west bound routes, the proposed Alliance will not be constrained by potential competition. The reasons are discussed above with respect to the NZ-Asia market. The Commission, however, considers that the proposed Alliance would be constrained by potential competition on the NZ-Asia and Asia to Europe sectors of these routes, due to the large number of airlines that already fly those routes or that could commence flying on them.

546.The Commission is also of the view that the proposed Alliance could be constrained by potential competition on the LA to Europe and London sectors of the east bound routes because of the large number of airlines that already fly those routes or that could commence flying on them. The Commission, however, as discussed with respect to the NZ-US market, is not satisfied that the threat of potential competition in the International market would constrain the proposed Alliance on the New Zealand to Los Angeles sector of those routes.

547.The Commission concludes that the proposed Alliance would be constrained by potential competition in the international market.

Conclusion on the International Market

548.A comparison between the counterfactual and the factual results in:

- constraint on the proposed Alliance from existing competition; and

- the Commission being satisfied that entry or expansion will occur and would constrain the proposed Alliance.

549. Consequently, the Commission is of the preliminary view that the proposed Alliance would not have or be likely to have the effect of substantially lessening competition in the international market when compared with the counterfactual.

Question 34

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

The Domestic Air Freight Market

550. Belly hold air freight capacity is a by-product of passenger services. Accordingly, the competition analysis with respect to the Main trunk and provincial passenger services markets is also applicable to this market.

551. The Commission is of the view, as it is for the Tasman market, that existing competition will not provide a constraint on the proposed Alliance.

Constraint from Potential Competition

552. All freight in New Zealand is carried by passenger aircraft except for some mail and courier parcels which are carried in aircraft owned by NZ Post and NZ Couriers. Virtually all freight carried in passenger aircraft is carried by Qantas and Air NZ as Origin Pacific operates small aircraft that are not suited to carrying freight.

553. As stated in respect of the main trunk and provincial markets, the Commission is not satisfied that the threat of potential competition would constrain the proposed Alliance. The barriers to entry and expansion are sufficiently high to deter Origin Pacific from expanding sufficiently in the market to constrain the proposed Alliance. They are also sufficiently high to deter all entrants except one with very substantial sources of funding to enter. The only such airline is Virgin Blue and the Commission is not satisfied that it would enter to such an extent and within a sufficiently short timeframe to constrain the proposed Alliance. Furthermore, the entry of Virgin Blue because of the type of aircraft it flies, would have little effect on the domestic air freight market.

Constraint from Buyers or Suppliers

554. There appears to be little evidence of buyer or supplier constraint in this market.

Conclusion on the Domestic Air Freight Market

555.A comparison between the counterfactual and the factual results in:

- the proposed Alliance having a high market share;
- insufficient constraint from competitors, either existing or potential;
- an increase in the barriers to entry when all of the barriers are taken together;
- Virgin Blue being the only likely new entrant but not to a sufficient extent or within a sufficient timeframe; and
- no constraint from buyers or suppliers.

556.Consequently, the Commission is of the preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the domestic air freight market when compared with the counterfactual.

Question 35

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

The Tasman Belly Hold Freight Market

557.Belly hold air freight capacity is a by-product of passenger services. Accordingly, the competition analysis with respect to the Tasman passenger services market is also applicable to this market.

558.The Commission is of the view, as it is for the Tasman market, that existing competition will not provide a constraint on the proposed Alliance.

Constraint from Potential Competition

559.The Applicants submitted that there are no material barriers to entry or expansion in relation to freight services. Belly hold air freight capacity is largely a by-product of passenger services. This means that the available capacity for freight on any given flight will not only depend on the type of aircraft being operated, but also the passenger loading and fuel requirements. There are distinct commercial advantages in carrying passengers ahead of freight, and as such, freight usually attracts a lower priority.

560.Because belly hold freight capacity is a by-product of passenger services, the barriers to entry for the Tasman belly hold freight market are the same as those discussed above with respect to the Tasman markets. The Commission is of the view, therefore, that the barriers to entry to the Tasman belly hold freight market are such that entry other than by an airline with very considerable financial backing will be deterred.

561.Freight services industry participants such as Export NZ, the Importers Institute, Emery Forwarding and Asian Express confirmed the views of the passenger air services industry participants, discussed above with respect to various passenger air services markets, that any entry or expansion in the Tasman market is unlikely.

562.Industry participants also pointed out that even if there was entry by a VBA such as Virgin Blue, on any of the routes, this would have little effect on the freight markets as they use 737s which carry only small amounts of freight that must be hand loaded. They would only provide these freight services if it did not degrade their core passenger services. Emery Forwarding advised that pallets and units cannot be used in 737s and that loading freight such as high value technical goods by hand is not feasible as there is too great a risk of breakage or pillage.

563.For the reasons discussed above with respect to the Tasman market, the Commission cannot be satisfied that there is likely to be entry into the Tasman belly hold freight market of a sufficient extent and within a sufficiently short timeframe to constrain the proposed Alliance and thus alleviate concerns about substantial lessening of competition in the market.

Constraint from Buyers or Suppliers

564.There appears to be little evidence of buyer or supplier constraint in this market.

Conclusion on the Tasman Belly Hold Freight Market

565.A comparison between the counterfactual and the factual results in:

- the proposed Alliance having a high market share;
- insufficient constraint from competitors, either existing or potential;
- an increase in the barriers to entry when all of the barriers are taken together;
- Virgin Blue being the only likely new entrant but not to a sufficient extent or within a sufficient timeframe; and
- no constraint from buyers or suppliers.

566.Consequently, the Commission is of the preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the Tasman belly hold freight market when compared with the counterfactual.

Question 36

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

The International Belly Hold Freight Market

567. Belly hold air freight capacity is a by-product of passenger services. Accordingly, the competition analysis with respect to the NZ-Asia, NZ-Pacific, NZ-US and international passenger services markets is also applicable to this market.

568. The Commission found in the NZ-Pacific and NZ-US markets that the proposed Alliance would be not be constrained by existing competition. Although the Commission found that the proposed Alliance would be constrained in the NZ-Asia and international markets, it is of the view that the overall effect of the proposed Alliance on these markets is such that the Commission is of the view that existing competition will not provide a constraint on the proposed Alliance in the international belly hold market.

Constraint from Potential Competition

569. The barriers to entry for the international belly hold freight market are the same as those discussed above with respect to the NZ-Asia, NZ-Pacific and NZ-USA markets. The Commission is of the view, therefore, that the barriers to entry to the international belly hold freight market are such that entry other than by an airline with very considerable financial backing will be deterred.

570. Freight services industry participants confirmed the views of the passenger air services industry participants that any entry or expansion in the Tasman, NZ-Pacific Island and NZ-USA markets is unlikely. The freight industry participants also felt that there was unlikely to be any entry or expansion on the NZ-Asia market that would constrain the proposed Alliance with respect to freight.

571. For the reasons discussed above with respect to the NZ-US, NZ-Asia and NZ-Pacific markets, the Commission cannot be satisfied that there is likely to be entry into the international belly hold freight market of a sufficient extent and within a sufficiently short timeframe to constrain the proposed Alliance and thus alleviate concerns about substantial lessening of competition in the market.

Constraint from Buyers or Suppliers

572.There appears to be little evidence of buyer or supplier constraint in this market.

Conclusion on the International Belly Hold Freight Market

573.The Commission found in the NZ-Pacific and NZ-US markets that there would be or likely to be a substantial lessening of competition in those markets. Although the Commission found that the proposed Alliance would be constrained in the international market, the Commission is of the preliminary view that the overall effect of the proposed Alliance on these markets is such that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the international belly hold freight market when compared with the counterfactual.

Question 37

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

National Wholesale Travel Distribution Services Market

Participants

574.Qantas operates Qantas Holidays as well as its corporate travel arm, Qantas Business Travel and has a 50% stake in Harvey World Travel's wholesale travel operation, Escape Holidays. Air NZ operates Air NZ Destinations (events and tour packaging), Travel Centres (retail outlets), Business Direct (a unit marketing business travel services), call centres and internet bookings.

575.NECG acknowledged that the proposed Alliance might foreclose customers to independent travel agents if Air NZ and Qantas tickets were exclusively sold through the airline's distribution channels and through Qantas's travel agencies. They claim, however, that in the short to medium term such an outcome seems unlikely as at present Air NZ and Qantas tickets are not exclusively distributed through their own related entities or through similar arrangements with independent agencies and that for international tickets at least, travel agents are the distribution channel through which most consumers purchase air tickets. NECG also stated that the increasing use of direct forms of distribution such as call centres and the internet are the cause of loss of business by travel agencies rather than the proposed Alliance.

576.House of Travel stated that it has concerns that the New Zealand market for wholesale holiday packages is likely to suffer from significantly reduced competition as a result of the proposed strategic alliance and the resultant entry by Qantas Holidays into New Zealand. House of Travel believes that the experience in the equivalent Australian market is indicative of the likely outcome in New Zealand if the proposed transactions are allowed to proceed. This would be exacerbated by the fact that the Air NZ Qantas alliance would be in a totally dominant position whereas in the Australian market the airline does have competition.

577. Qantas Holidays currently provides wholesale holiday packages to the Australian market. House of Travel said that Qantas Holidays used to compete with a number of other holiday package wholesalers. In creating any given holiday package, wholesalers had previously been able to approach both Qantas and Ansett to obtain the essential airfares component of a package. Both airlines were therefore under an incentive to provide wholesalers with the best possible airfare, to ensure that they were the successful provider of the air services in question. Qantas Holidays also had to ensure that its packages were priced at a level competitive with the other holiday packages available.

578. House of Travel submitted that Qantas is the dominant provider of airfares to holiday package wholesalers, as well as being the dominant wholesaler in this market through Qantas Holidays. Qantas Holidays continues to compete aggressively with other wholesalers by offering them prices for the essential airfare components that are rather higher than the fares that had previously been available. At the same time, Qantas Holidays continues to offer packages to travel agents and directly to the public at prices that were only slightly higher than the wholesale cost at which other package holiday wholesalers could wholesale similar packages. Accordingly, the difference between the wholesale cost and the retail price of these packages is not sufficient to enable wholesalers to maintain an adequate margin to cover their own costs. Consequently, all but one major wholesaler that had previously been operating in Australia have exited the market, leaving Qantas Holidays as essentially the sole provider of wholesale holiday packages. Qantas Holidays initiates all product and price incentives on all package tour sales out of Australia to all destinations.

579. House of Travel believes that if Qantas Holidays were to begin competing in New Zealand as aggressively as it did in Australia then wholesalers will have no choice other than to sell Qantas Holidays' packages and will ultimately be forced to exit the market as the margins offered to wholesalers by Qantas would be insufficient to operate profitably.

580. Gary Toomey said that [ ] United Travel submitted that the proposed Alliance would allow Air NZ to exercise dominance in the travel distribution market, particularly in the Government and business travel segment of the market.

581. Gullivers Pacific stated that Air NZ currently uses its dominant position to favour its own distribution system. Gullivers Pacific claimed that should the proposed Alliance proceed, Air NZ would be in a position to further favour its own distribution services by offering corporate clients and Government bodies discounts and other inducements such as free Koru Club memberships in return for a commitment to booking exclusively through its distribution system.

582.Gullivers Pacific also claimed that the proposed Alliance focus on expansion of Qantas Holidays would lead to domination by Qantas Holidays and Air NZ Destinations of the New Zealand travel industry as Qantas Holidays already does on Australia. They pointed out that Qantas Holidays operates in a different way to other travel wholesalers through a combination of internally managed preferential fares, promotional expenditure and exclusive capacity arrangements that cannot be matched in either price or capacity by any third party wholesaler. Gullivers Pacific stated that Qantas Holiday's net profit is greater than the gross margin most wholesalers are given to operate with and that if this position was allowed into New Zealand independent wholesale and tour operation distribution, excluding minor niche marketers, would disappear.

583.Gullivers Pacific also submitted that the ability of Air NZ to publicly promote price differential by using its CRS to the exclusion of all travel agents has enabled Air NZ to dominate the New Zealand domestic airline market. It claimed that the proposed Alliance will produce even greater dominance of the airlines' CRS as it commits Air NZ to having a CRS compatible for interfacing with the Qantas CRS as to fares, conditions and capacity.

584.The internet has a strong presence in this market, being adopted by airlines selling directly to the public. Airlines are now more active and competitive participants in the market for the wholesaling and retailing of airline tickets. The ACCC recently reported that in Australia around half of all domestic air ticket sales are through airlines, either through call centres or through the internet.

585.In New Zealand, the role of travel agents in respect of domestic New Zealand is changing, with an increasing focus on "value added" services, e.g. House of Travel's "Searchflight" service, which searches across airlines' websites and constructs the cheapest itinerary. This is not, however, likely to be a sufficient constraint on the proposed Alliance in the wholesaling of travel services.

586.It appears, from information supplied to the Commission by industry participants, that the proposed Alliance would have a considerably strengthened position in the wholesale market.

Constraint from Potential Competition

587.The Applicants submitted that entry barriers to this market are low as evidenced by the large number of operating travel agents.

588.In *Bodas* the Commission stated that while new entrants need sufficient knowledge, skills, contacts, standing, accreditation with airlines and provision of a bond, to be able to establish a presence in the market, the barriers to entry at both the travel wholesaler and travel agent levels would appear to be low.

589.The situation described above by industry participants may discourage entry into the market to any extent that could constrain the proposed Alliance from exercising market power, particularly as Air NZ and Qantas make up between 70% and 80% of all airline sales for each travel distributor in New Zealand.

590.The Commission is not satisfied that the proposed Alliance would be constrained by potential competition.

Constraint from Buyers or Suppliers

591.There appears to be little evidence of buyer or supplier constraint in this market.

Conclusion on the National Wholesale Travel Services Distribution Market

592.A comparison between the counterfactual and the factual results in:

- the proposed Alliance having a high market share;
- insufficient constraint from competitors, either existing or potential;
- an increase in the barriers to entry when all of the barriers are taken together;
- no likely entry to a sufficient extent or within a sufficient timeframe; and
- no constraint from buyers or suppliers.

593.Consequently, the Commission is of the preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the national wholesale travel distribution services market when compared with the counterfactual.

Question 38

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

Deemed Substantial Lessening of Competition

594.Section 30 of the Act[54] deems provisions that have the purpose, effect, or likely effect of fixing, controlling, or maintaining the price of goods or services, supplied or

[54] Set out in paragraph 53

acquired by parties who are in competition to have the purpose, effect, or likely effect of substantially lessening competition for the purposes of s 27.

595. The Commission notes that under the proposed arrangement Qantas and Air NZ will (inter alia) co-ordinate the following services and activities in respect of the JAO Networks:

- All aspects of the pricing of the Applicants' passenger and freight services, including setting fares, rebates, levies and promotions, level of service fees, development of new fare products, pricing and promotions of holiday destinations, commissions and agency incentives and joint tendering for corporate and government accounts. The Applicants will also co-ordinate procedures for pricing and inventory management.

- Exchange of information on schedules, financial information, pricing, yields, seat availability, sales and other information to enable co-ordination of the aspects of the parties' respective businesses.

- Operations, routing, capacity, frequencies, aircraft types, connection requirements and range of times for any service provided as part of the JAO Networks.

- Reciprocal Codeshare rights with each other for flights operated as part of the JAO Networks. Air NZ will also be able to codeshare on flights operated by Qantas that are not part of the JAO Networks where such flights reasonably connect to JAO Network flights.

- Enter into Special Pro Rate Agreements on terms no less favourable than the terms offered by an Applicant to a member of the global airline alliance of which that Applicant is a member, or, in the case of Freedom Air, until Freedom Air's business model permits a Pro Rate Agreement, the provision of blocked space seats on Freedom Air flights on terms no less favourable than offered by Freedom Air to third parties.

- Facilitate Qantas Holidays' maximising the provision of new tourism products which utilise the JAO Networks and promote New Zealand and Australia as a dual destination.

- Subject to existing contractual restrictions, co-ordinate respective freight operations to improve the scope and availability of freight services.

- Rights for members of each Applicant's frequent flyer programmes to accrue and redeem frequent flyer points on flights operated by the other.

- Co-operate and give priority to the display of each other's flights on their respective reservation systems.

596.The Commission is of the preliminary view that many aspects of the proposed arrangement, which applies across all of the identified markets, have the purpose, or will have the effect or likely effect, of fixing, controlling or maintaining the price of goods or services and is therefore deemed by s 30 to substantially lessen competition for the purposes of s 27 in each of the identified markets.

Question 39

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

Conclusion on Comparison of Competition under the Factual and the Counterfactual

597.The Commission is of the preliminary view that under the proposed Alliance there would likely be a substantial lessening of competition, when compared with the counterfactual, in the following markets:

- The main trunk market;
- The provincial market;
- The Tasman market;
- The NZ-Asia market;
- The NZ- Pacific market;
- The NZ-US market;
- The domestic air freight market;
- The Tasman belly hold freight market; and
- The national wholesale travel distribution services market.

598. In addition, the Commission is of the preliminary view that the proposed arrangement has the purpose, or will have the effect or likely effect, of fixing, controlling or maintaining the price of goods or services and is therefore deemed by s 30 to substantially lessen competition.

PUBLIC BENEFITS AND DETRIMENTS

Overview

599. Given the preliminary conclusion that the Commission is not satisfied that the proposed Acquisition[55] would not result, or would not be likely to result, in a substantial lessening of competition in the identified markets, it could not be cleared under s 67(3)(a) of the Act.

600. Having found that the proposed Arrangement[56] is deemed to substantially lessen competition and would likely result in a substantial lessening of competition, the Commission must consider whether the proposed Alliance can be authorised under s 67(1) and 61(1) of the Act.

601. The authorisation procedures under ss 61(6) and 67(3)(b) are the same. Both require the Commission to identify and weigh the detriments likely to flow from the substantial lessening of competition in the relevant markets, and to balance those against the identified and weighed public benefits likely to flow from the proposed Alliance as a whole. It is important to note that the detriments may only be found in the market or markets where competition is lessened, whereas benefits may arise both in those and in any other markets. Only where the Commission is satisfied that the benefits clearly outweigh the detriments would it be able to grant an authorisation for the proposed Alliance.

602. The principles used by the Commission in evaluating detriments and benefits are set out in: *Guidelines to the Analysis of Public Benefits and Detriments* ("the Guidelines"), a revised version of which was issued by the Commission in December 1997.[57] The various issues raised have been discussed in a number of decisions by the Commission and the courts in recent years. In assessing both benefits and detriments the focus in those decisions has increasingly been on economic efficiency. For example, the Court of Appeal stated in Tru Tone Ltd v Festival Records that the Act:[58]

> . . . is based on the premise that society's resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources.

603. The Commission considers that a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. In contrast, changes in the distribution of income, where one group gains while another simultaneously loses, are generally not included because a change in efficiency is not involved. However, an issue does arise

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[55] The Acquisition having been considered with the Arrangement.
[56] The Arrangement having been considered with the Acquisition.
[57] Although these Guidelines have not been updated to reflect the changes in the Act relating to the thresholds in ss. 36 and 47, the economic principles used in assessing benefits and detriments remain the same.
[58] *Tru Tone Ltd v Festival Records* [ ] 2 NZLR 352, at 358.

in connection with the treatment of inter-country transfers in this case, which is discussed below. The Commission is also mindful of the observations of Richardson J in *Telecom*[59] on the Commission's responsibility to attempt to quantify benefits and detriments where and to the extent that it is feasible, rather than to rely on purely intuitive judgement. This is not to say that only those gains and losses that can be measured in dollar terms are to be included in the assessment; those of an intangible nature, which are not readily measured in monetary terms, must also be assessed.

604. A further important consideration in the assessment of benefits is that there needs to be a nexus with the proposed Alliance, and that there is no alternative and less anti-competitive means available to achieve those benefits.

605. In the following sections the detriments and benefits are considered in turn.

Detriments

Introduction

606. The approach of the Applicants, through NECG, is to focus on allocative inefficiency (and associated transfers) as being the source of potential detriment from the proposed Alliance, and to discount the prospects for productive and dynamic inefficiencies to arise. In what follows the potential for losses in all three elements of economic efficiency to be generated by the proposed Arrangement, as compared to the relevant counterfactual, are considered in turn.

Allocative Efficiency

<u>Introduction</u>

607. The impact of reduced competition—or, in other terms, of increased market power—is generally to cause the market price to be increased further above, and market output to be reduced further below, the level which prevailed prior to the introduction of a proposed merger or set of arrangements. To model the price effects of the proposed Arrangement, NECG stated that it has used a Cournot-based model of oligopoly, an approach it justifies by the use of this model in several studies of airline competition in the economic literature.

608. The standard Cournot model assumes that the product offered by different suppliers is undifferentiated, and that each maximizes profit by independently choosing a level of output (or capacity) on the assumption that the others hold their observed output levels constant. This leads to an equilibrium in which all firms maximise profits, and the aggregate of the outputs produced interacts with the market demand to determine the price that clears the market.

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[59] *Telecom Corporation of New Zealand Ltd v Commerce Commission* [   ] 3 NZLR 429,447.

609.Some key results of the standard Cournot model are as follows:

- if all firms have the same (constant) marginal costs, the market will be shared between them equally;
- where firms' costs differ, firms with lower marginal costs will have larger market shares than firms with higher costs.
- regardless of output shares, all firms receive the same price; and
- price will exceed, and market output will fall below, the competitive level, and the fewer the firms, the more pronounced this divergence will become.

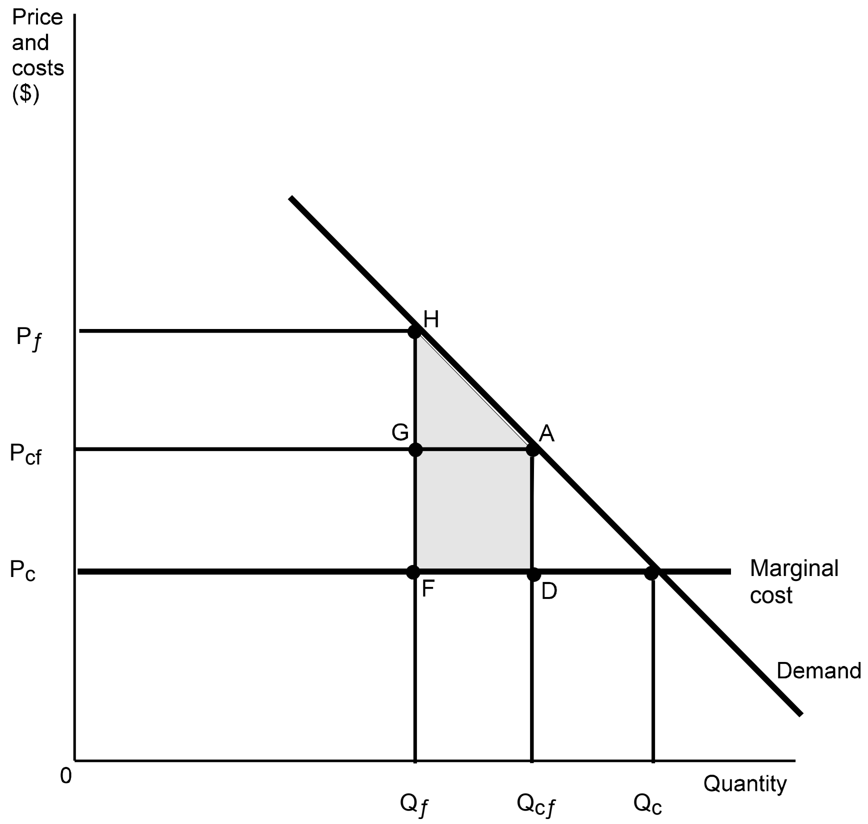
610.Thus, in a merger where costs would not change (and entry would not occur), the Cournot model predicts that market output would fall and price rise – in other words, market power would be enhanced.

611.By opening (or widening) a gap between price (representing the willingness of consumers to pay to consume the good) and the cost of producing each extra unit, market power results in a harmful distortion in the allocation of resources in the economy. This in turn leads to a loss of economic welfare. Buyers who would be prepared to pay a price less than the new price (but still higher than the old price), and above the extra cost of supplying additional units of the good, are no longer supplied. The inputs no longer used to produce those units of output are transferred to other, less socially valuable, uses.

612.Figure 1 shows the basic model needed to analyse the welfare effects. This model is the one relevant to this case because it incorporates pre-existing market power, as is appropriate given the assumed Cournot interaction between firms. That is to say, in the counterfactual, the price, Pcf, is above the competitive level, Pc, and output of Qcf is below the competitive level, Qc. The proposed Alliance then, in the factual, have the effect of causing a further rise in price and reduction in output, to Pf and Qf respectively. The loss of allocative efficiency associated with the output restriction from Qcf to Qf is measured by the difference between consumers' 'willingness to pay', as revealed by the height of the HA segment of the demand curve, and the cost saved, given by the height of the FD segment of the marginal cost curve. The loss is represented by the shaded area HADF, of which HAG represents a loss of consumers' surplus, and GADF a loss of producer surplus (profit). This loss of allocative efficiency is called the "dead-weight welfare loss". It is the loss to society from the price being raised, for which there is no compensating gain.[60]

[60] An alternative way of viewing the deadweight loss is as the gross social value of the output no longer produced (area $HAQ_{cf}Q_f$) less the value of the inputs no longer used in producing it ($FDQ_{cf}Q_f$). The inputs no longer used are transferred to other, less socially valuable, uses where they are assumed to yield a social value equal to area $FDQ_{cf}Q_f$. In practice this may be an overly strong assumption.

FIGURE 1
The Basic Model of Allocative Inefficiency



613.In addition, the rise in price caused by market power also results in a transfer of income from those consumers acquiring the good at the higher price, to the company and its shareholders who receive the higher revenue in the form of higher profits. In Figure 1 this transfer is represented by the area P_fHGP_{cf}. Normally, using the economic efficiency standard, this transfer of wealth is ignored, as one group (shareholders) gains whilst another (consumers) loses, leaving society as a whole no better nor worse off. However, the focus of the Act is on the welfare of New Zealanders; in its Guidelines, the Commission defined the term "public" in "public benefit" as follows:

> The 'public' is the public of New Zealand; benefits to foreigners are to be counted only to the extent that they also involve benefits to New Zealanders.

614.This raises the issue as to what constitutes a benefit to the New Zealand public. For example, if the transfer were to be paid by New Zealand consumers, but were to accrue to a foreign-owned firm and its shareholders, the transfer might no longer be neutral from a New Zealand perspective. This issue arose in the AMPS-A case, where the High Court on appeal stated:[61]

> We reject any view that profits earned by overseas investment in this country are necessarily to be regarded as a drain on New Zealand. New Zealand seeks to be a member of a liberal multilateral trading and investment community. Consistent with this stance, we observe that improvements in international efficiency create gains from trade and investment which, from a long-run perspective, benefit the New Zealand public.
>
> On the other hand, if there are circumstances in which the exercise of market power gives rise to functionless monopoly rents, supra-normal profits that arise either from cost savings or innovation, and which accrue to overseas shareholders, we think it right to regard these as exploitation of the New Zealand community and to be counted as a detriment to the public.

615.This means that the redistribution of income associated with a business acquisition or restrictive trade practice would not necessarily be welfare neutral when there is an international dimension to the firm's operations, as in the present case, which would involve transfers between nationals of different countries. Transfers from New Zealanders to foreigners would potentially be losses, just as transfers from foreigners to New Zealanders would potentially be gains. To qualify for this treatment, transfers would have to be "functionless monopoly rents". In the present case this means that some of the transfers could count as a welfare loss, and that only a portion of the deadweight losses may be a welfare loss to New Zealanders.

616.In what follows, the modelling approach of NECG is first considered. The views of other parties on this modelling are then reviewed. An alternative model proposed by Professor Hazledine, in an independent submission, is then considered. This is followed by the Commission's own analysis and modelling, which includes coverage of a further model commissioned from Professor Gillen, its economic expert.

<u>NECG's Approach</u>

617.In its application of the model, NECG focused on the main city-pair routes that would be served by the proposed Alliance, in particular, the New Zealand domestic main trunk, major provincial, Tasman and some other international routes. Each was treated as a separate market, which thereby ignores all network effects (which the Applicants otherwise emphasise the importance of). In each route market the model was used to predict the prices and the capacities supplied with the proposed Alliance and those expected in the counterfactual. Since on a number of these routes, Air NZ and Qantas currently have the bulk of the market share, the elimination of the competition between them would be expected to cause prices to rise, and certainly to be higher than in the counterfactual, where the proposed Alliance partners are assumed to compete vigorously. There may also be a reduction in product quality as competition is diminished, a feature not contemplated by the Cournot model.

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[61] *Telecom Corp. of New Zealand Ltd. v Commerce Commission* (1991) 4 TCLR 473, 531; 3 NZBLC 102.340, 102.386.

618.A force that NECG assumed will serve to off-set higher prices to some degree is the assumed likely and greater entry of a VBA operator on the Tasman in the factual, as compared to the counterfactual (and entry on main trunk routes only in the factual). NECG argues that the model is likely to under-estimate the impact of VBA entry, since VBAs, unlike the incumbents, focus on the more price sensitive segment of the demand curve, whereas the model can predict only average price. Hence, a VBA entrant is likely to have a bigger impact on market prices than an FSA entrant of comparable size.

619.Another feature of the model is the incorporation of a capacity elasticity of demand of 0.125, which links the capacity put on a route to demand from passengers to fly on that route. Capacity is taken to be a measure of flight frequency and therefore of product service quality, so that more capacity means higher quality, which in turn is expected to result in greater demand. In this case, a 10% increase in capacity is assumed to lead to a 1.25% increase in demand.

620.The modelling approach used broadly by NECG appears to have been as follows. For each market, the initial (base case) market shares of the airlines, the initial weighted average price and the assumed price elasticities of demand were used through the model to estimate each airline's marginal cost. The prices on domestic New Zealand routes were reduced by 20% to reflect the lower fares available through New Zealand Express. The price elasticity used was the weighted average of those for business (-0.70) and leisure (-1.65) passengers suggested by the two airlines, with weights provided by the proportions of passengers of the two types on each of the routes. The resulting price elasticities were used, in conjunction with the preliminary price-quantity points, to determine the slopes and positions of the linear demand curves. The estimates of costs, demand and oligopoly (Cournot) interaction assumption, together with further assumptions about airlines' capacities in the future, were then used to predict price and output outcomes in the future both with and without the proposed Alliance. A five year future timeframe is used for these projections, starting from the base case in 2001/02.62

621.The projections of capacities in both scenarios were supplied to NECG by the two proposed Alliance partners. For the factual scenario a single schedule was supplied, based on the commercial agreement that had been reached between them as to what would exist under the proposed Alliance. The counterfactual schedule was derived by NECG as an amalgam of the schedules supplied on a confidential basis by each of the airlines. NECG states that these 'quantity commitments' were tested informally in terms of their consistency with overall airline behaviour, fleet characteristics and financial considerations.

622.In a similar fashion, events such as entry, expansion and exit were decided by assumption, rather than being determined within the model. The capacity introduced by the VBA entrant, and its route coverage and timing, were projected by the two

[62] Natural growth factors are built into the demand forecasts for the period, based on tourism forecasting by Covec. For example: Tasman, 4.4%; domestic, 3.4%; and Asia, 8.0%.

Alliance partners. Hence, such events were assumed, and NECG used indirect tests to test for their plausibility – for example, profitability, information from network planners and fleet commitments (e.g., Virgin Blue's recent order for new aircraft). NECG assumed that the higher prices in the factual (see below) would encourage entry on a greater and broader scale than in the counterfactual.

623. For each of the 43 city-pair routes modelled, NECG calculated the impact on prices in the factual and counterfactual scenarios over the five year timeframe. The price increases in the factual over the counterfactual in Year 3 tended to be largest on routes where the two partners are the only operators pre-Alliance, but the increases are still significant on other routes where they have the major market share but face some competition from other airlines. Of the 16 routes affected, 14 have price increases ranging up to [ ] Overall, the modelled price increases appear to the Commission to be rather modest, given the extent of the market aggregation, and the "price war" conditions assumed to apply in the counterfactual. On 25 routes there is no price increase as the two do not both operate on them. However, to claim, as NECG does, that therefore they do not compete currently is slightly misleading, as the non-operator of the two might be the most likely entrant. The proposed Arrangement, by eliminating that source of potential competition, would then allow price to rise (all else being the same).

624. The level of output in each market, in terms of passenger volumes, is determined by three factors: the weighted average price, combined with the two factors that cause the demand curve to shift, namely the capacity elasticity of demand and the natural growth rate. However, it would appear that these factors that determine output are not linked to those that determine capacity, resulting in situations where capacity and passenger demand are not well matched. This is arguably a shortcoming that Professor Hazledine has addressed in his modelling work.

625. In broad terms, the detriments arising from the higher prices on each route affected by the proposed Alliance have two components. The first component is the loss of allocative efficiency, or deadweight loss, measured as the social loss of the output that is no longer consumed because of the higher price induced by market power being exercised. Because of the New Zealand-focused nature of the 'public benefit test' in the Act discussed above, only the deadweight losses borne by New Zealand residents are relevant. Hence, for each market the proportion of the loss borne by New Zealanders is calculated as the proportion of New Zealand passengers carried on that group of routes (e.g., Tasman, New Zealand domestic, etc.). NECG estimated that the deadweight loss allocated to New Zealand in Year 3 of the proposed Alliance is -$25.9 million. The balance of this detriment is ignored because it would be borne by non-New Zealand residents.

626. The second component of the detriments from higher prices in the factual compared to the counterfactual stems from the wealth transfers from consumers to producers. As noted above, the New Zealand focus of the public benefit test requires that account be taken of the detrimental effect of transfers that would be extracted from

New Zealand consumers that would pass into the hands of non-New Zealand producers, and vice versa. Similarly, transfers from foreign passengers to New Zealand producers represent an offset to these detriments. NECG allocated these transfers as follows. Transfers from consumers to producers are allocated to New Zealand on the basis of passenger shares. The net positions of each airline may then be adjusted according to the Alliance agreement. For Year 3 the net relevant transfer for New Zealand is claimed to be $15.6 million (i.e., a net gain).

627. Although the Commission accepts this basic approach as being appropriate, it has proved very difficult to check the accuracy of the estimates. Also, it would appear that NECG has not mentioned (and presumably has not taken account of) certain other adjustments that may be required. First, Air NZ is not 100% locally-owned currently, and the extent of its overseas ownership would increase if Qantas's proposed equity holding were to be implemented. Hence, the Commission considers it likely that a proportion of transfers accruing to the company as higher profits would be remitted overseas, rather than be retained within the country. Secondly, any transfers accruing as higher profit to the airlines would be subject to company income tax prior to distribution, and to that extent would be retained within the country.

628. According to NECG, the sum of the deadweight loss of $25.9 million and net transfer gain of $15.6 million in Year 3 generates a total detriment associated with allocative effects of about $10.3 million.

629. The detriment calculations just discussed include only four of the more substantial provincial city-pair routes. NECG noted that the proposed Alliance would have some impact on other provincial routes as it is likely that Origin Pacific will lose the benefit of feed from Qantas if the proposed Arrangement were to proceed. Its market share would then be expected to shrink, and its subsequent ability to continue expanding might be impeded by the loss of code-sharing with Qantas. Overall, NECG considered that this detriment on other provincial routes is "unlikely to be significant".

630. Two further issues have been raised in relation to global alliances and to freight. Given the degree of integration envisaged by the proposed Alliance, particularly with regard to code-sharing, pricing and capacity coordination, the Commission understands it to be very unlikely that the two airlines could remain in separate global alliances. NECG stated that Air NZ would be likely to leave the Star Alliance and join Qantas in the oneworld Alliance. NECG has not imputed any financial detriment to New Zealand arising from Air NZ's possible change in alliance status, apparently on the basis that any cost would be more than offset by the advantages to be gained.

631. However, the Commission has been told that Air NZ would have [

]. These would seem to be one-off costs to New Zealand flowing from the proposed Arrangement. In addition, NECG has not considered the losses due to Air NZ arising from the transfer from one alliance to another. The value of alliances stems from both cost savings and demand-side benefits, in particular, the receipt of feed passengers at network intersection nodes. [

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Question 40

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

Question 41

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

Views of Other Parties and NECG's Response

632. Frontier Economics ("Frontier"), acting on behalf of Virgin Blue, has criticised NECG's model on a number of grounds. First, it points out that the model is not used in the conventional way to predict outputs of firms and market price on the basis of the numbers of firms in markets and their relative costs. Instead, capacity decisions are pre-determined on the basis of information provided by the Applicants. Market shares are then related to capacities, and they in turn determine prices. Frontier also criticise the NECG model for allowing costs to vary between firms, and yet not allowing costs to have an impact on the outputs of those firms, as they should do in a Cournot model.

633. Secondly, Frontier raised the concern that to apply a uniform measure of the capacity elasticity factor in all circumstances seems very crude. An additional flight might increase demand very little if existing capacity were substantially under-utilised, or if it were added at the same time as an existing flight, or if it were a flight added to a large number of existing flights.

634. NECG has responded by agreeing that in terms of moving from the counterfactual to the factual, when flight numbers would generally be reduced, the uniform application of the capacity elasticity factor probably overstates the reduction in demand (and hence the adverse welfare effects). This is because the flights eliminated are expected mainly to be duplicate flights, and so the loss of product service quality would be less than implied by the demand response embodied in the capacity elasticity factor. However, the Commission considers that the prior move from the base case to the counterfactual could have led, by application of the same capacity elasticity factor, to an equally exaggerated expansion in demand by reason of duplicated flights.

Combining both shifts in the factual might not then lead to an overstated demand shift (and adverse welfare effects), as NECG claims.

635.Thirdly, Frontier pointed out that the scheduling projections provided by the Applicants reveal instances where the counterfactual has substantial excess capacity compared with the factual. However, the presence of this excess capacity is not allowed to influence marginal costs, whereas on under-utilised flights the marginal cost would be expected to be close to zero. NECG responded by challenging the wider modelling framework proposed by Frontier, and by appearing not to engage in the specific point made by Frontier. However, the Commission notes that airlines do use sophisticated yield management systems in order to price discriminate, and empty seats are often sold at the last minute at low fares, rather than being flown unoccupied, which provides support for Frontier's argument.

636.Fourthly, Frontier argued that NECG's modelling results are difficult to assess as they arise from a combination of effects that are difficult to separate. On 15 out of 43 routes the proposed Alliance are predicted to cause prices to rise and output to fall, as would normally be expected from an increase in market concentration in the Cournot model. For the other route markets the results are mixed. For example, in nine markets output is forecast to increase with the proposed Alliance, but in various cases that is associated with a rise, fall or zero change in prices. NECG explained the five categories of apparently counter-intuitive results as follows:

- The 13 markets where there is a zero impact on price and quantity are those where Qantas would not operate services in either factual or counterfactual, and there is no change in capacity. Hence, competition is the same in both scenarios.

- The markets with zero price impact but negative output impact in the factual are those where there is no change in competition brought about by the proposed Arrangement (because only Air NZ or Qantas operate on the route), but there is a reduction in capacity which—through the capacity elasticity factor—caused output to fall, but with an assumed zero impact on price.

- The markets with zero price impact but positive output impact in the factual are those where there is no change in competition brought about by the proposed Arrangement, but there is an expansion in capacity which induces a higher output.

- The two markets with a negative price impact but positive output impact in the factual occurs in special circumstances associated with VBA entry, where the VBA is assumed to enter in the factual but not the counterfactual. Hence there would be two airlines competing in both scenarios, but in the factual one it would be the VBA which, because of its lower costs, would result in price being lower (the lower costs in these instances being sufficient to offset the lessening of competition effect).

- The one market where both price and output is higher in the factual compared to the counterfactual reflects partly a lessening of competition, which accounts for the increase in price, and a substantial increase in capacity, which results via the capacity elasticity factor in an increase in output that more than offsets the decrease caused by the rise in price.

637.Fifthly, Frontier complained that the NECG report provides no details as to how the detriments associated with the price changes are calculated. NECG responded by explaining that the pairs of prices and outputs for the factual and counterfactual scenarios are derived using its model, and plotted in its Figure 1 (page 116), a standard demand and supply diagram of the welfare effects of market power.[63] However, the Commission suggests that this explanation does not answer Frontier's point that no account is provided on how the impacts of shifts in demand (through the capacity elasticity factor) or cost curves are factored into the welfare calculations. This is an important question which is considered below.

638.Finally, Frontier pointed out that NECG has effectively subsumed the competition analysis of freight services within passenger services, and then in the modelling the freight is completely ignored. Yet Frontier considered that the proposed Arrangement are likely to have similar effects on freight as for passengers. Frontier questioned why the freight capacity expansion has no impact on price, which is counter to the outcome expected for passengers in the Cournot world modelled. In contrast, NECG argued that the proposed Alliance would increase freight capacity, and that no competitive detriment is likely in freight as the market is a competitive one with low entry barriers. As discussed earlier, the Commission is of the view that there would be a substantial lessening of competition in freight markets.

The Hazledine Model

639.Professor Hazledine's model broadly replicates NECG's approach, but at a more aggregated level of markets (Tasman and domestic main trunk), and with two significant modifications which his research into airline markets suggests are needed for realism.[64] The first modification is required because of the product differentiation evident in the offerings of FSA and VBA carriers. VBAs typically offer a 'no frills' service at a relatively low price, compared to FSAs. Professor Hazledine incorporates product differentiation by giving the VBA entrant a lower demand curve. This enables him to use differing levels of marginal costs for the two types of airline, something that NECG was not able to do, as discussed above, but without the

[63] The figure contains an error, in that the dark shaded triangular areas above the demand curve and below the supply curve are not part of the deadweight welfare loss. The upward sloping supply curve is also unexpected, as the prior discussion (and the Cournot modelling) leads the reader to expect the curve to be horizontal.
[64] D. Haugh and T. Hazledine, "Oligopoly Behaviour in the Trans-Tasman Air Travel Market: The Case of Kiwi International", *New Zealand Economic Papers*, vol 33(1), July 1999, pp. 1-25.

problem of the VBA gaining an unrealistically high market share. The evidence worldwide is that VBAs typically win only small shares in broadly defined markets.

640.NECG criticised his approach by seeming to claim that his use of the same price on all city-pairs contradicts the product differentiation assumption. Professor Hazledine was obliged to group city-pairs into Tasman and domestic New Zealand markets for want of more disaggregated data. His results show clearly lower prices for the VBA entrant compared to the FSA incumbents, in keeping with market evidence and with his product differentiation assumption.

641.The second modification relates to the assumed state of competition between Air NZ and Qantas. As already noted, NECG assumed Cournot interactions apply now, and would continue to do so over the five year forecast period (albeit in a "war of attrition" scenario, further discussed below). Professor Hazledine believed that this is to misjudge the nature of airline competition on the Tasman and in domestic New Zealand. His research suggests that in recent years competition between the two has become increasing aggressive, such that prices are lower and outputs higher than would be found if Cournot interactions were to apply. His model is adjusted accordingly to provide for a more-competitive-than-Cournot interaction.65 This means that the proposed Alliance, under which competition between Air NZ and Qantas would cease, would lead to a larger increase in prices than modelled by NECG.

642.NECG argued strongly against this approach. It asserted that Hazledine "changes the rules of the game as between the factual and counterfactual", such that "the factual is characterised by collusive behaviour (more collusive than Cournot) and the counterfactual is characterised by highly competitive behaviour (more competitive than Cournot)." However, Hazledine's approach seems reasonable given the magnitude of the changes that would be wrought by the proposed Arrangement. His recent empirical research on the markets relevant to the present Application leads him to consider that competition between Air NZ and Qantas is more competitive than Cournot. Hence, there seems to be better grounds for building such an assumption into the model, than for NECG arbitrarily to assume a pure Cournot conjecture. It also seems obvious that by implementing the proposed Arrangement, Air NZ and Qantas would effectively enter into a cartel on the routes covered by the JAO. Hence, there appears to be good grounds to assume that the rules of the game would change with the implementation of the proposed Arrangement.

643.Professor Hazledine also made another adjustment in relation to the assumed competitive stance adopted by a VBA entrant such as Virgin Blue. Whereas NECG assumed Cournot behaviour on the part of the entrant, he took the NECG forecasts of capacity it would bring into the market, and assumes it would lower price to the extent needed for it to raise load factors to 75%, given the prices set by the incumbents. Although this seems realistic to the extent that VBAs typically operate

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[65] Technically, this is done by changing the conjectural variation of the firms in the markets from the (implicit) Cournot value of zero to a value of -0.5.

on a high load factor basis, this mechanism is clearly a simplification as it seems implausible that the incumbents would not react to such price-cutting. Indeed, evidence from the United States, Canada and Europe suggests that price-cutting would be the reaction of the incumbents. Otherwise, Professor Hazledine adopted the assumptions used by NECG in order to aid comparisons of the results produced by the two models.

644. For his two markets, Professor Hazledine set up two base cases for 2002/03, one that replicates the NECG starting position, and the other that incorporates the more competitive conditions he has found to exist. He then examined the outcomes in various pairs of counterfactual and factual scenarios that embody different assumptions.

645. Taking the New Zealand domestic market first, he approximately replicated the core NECG scenarios, which assume Cournot behaviour, a war of attrition in the counterfactual, and VBA entry in the factual. This generated the following results. Under the proposed Alliance, the incumbents' price rises by 16%, but the weighted average price increase is 7% when the VBA entrant is taken into account, relative to the counterfactual. In the counterfactual the incumbent load factor falls from 70% to 63% because of their capacity expansion (90% of which is supplied by Qantas), but in the factual this falls to 47% because the VBA gains a 30% market share, despite a small reduction in incumbent capacity. This suggests that the factual flight schedules supplied to NECG may imply unsustainably low load factors, although the market share obtained by the VBA entrant is larger than has generally been experienced by any comparable entrant overseas, save perhaps in Australia with Virgin Blue, which is the potential entrant here.

646. Professor Hazledine then considered other alternative scenarios. The first is based on the more competitive interaction between the incumbents. In the counterfactual he assumes that they would attempt to maintain base case load factors following the capacity expansion, which would imply enhanced competition between them.[66] This results in a 10% lower price and a 13% increase in output compared to his base case. The impact of the proposed Alliance is then greater. The weighted average price increases by 30%, even with the moderating influence of the VBA entrant, which gains a 35% market share. The incumbent load factor falls from 70% to 39%, which again is implausibly low and not sustainable.

647. In the second alternative scenario, the base case capacity levels are assumed throughout. A VBA entrant is assumed to enter in the counterfactual, and this would be accommodated to some extent by the incumbents reverting to Cournot behaviour. With the proposed Alliance, entry would be deterred by the incumbents, perhaps by threatening a price war. This reflects Virgin Blue's view of likely events. Hence, the entrant gains a 29% market share in the counterfactual, and zero in the factual. Again, this widens the 'gap' between the two outcomes, with the incumbents having low load factors (which presumably may be needed to preserve the capacity needed to

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[66] Technically, this was accomplished by reducing the CV parameter from -0.5 to -0.75.

threaten any intending entrant), and prices increase on a weighted average basis by 31%.

648. A similar approach is adopted for the analysis of the Tasman market. The core NECG scenarios assume Cournot behaviour, a war of attrition in the counterfactual, and VBA entry in both the factual and the counterfactual, albeit on a smaller scale in the latter. This generates the following results. In the counterfactual the weighted average price falls by 3% compared to the base case, reflecting an output expansion caused by the entrant, which gains a market share of 14%. The incumbents' load factor falls from 70% to 58%. In the corresponding factual the VBA is assumed to enter on a larger scale (84% greater capacity). It gains a 30% market share, but the incumbents contract output (reducing load factors further to 47%) and raise price, causing the weighted average to increase by 9%.

649. Professor Hazledine then presented what he considered to be more realistic scenarios. The first incorporated the more-competitive-than-Cournot levels of competition he believes exists on the Tasman, and made the war of attrition a real war by having the airlines make use of the additional capacity they say they will have. In the counterfactual this involves a 20% reduction in price compared to the base case in order to maintain load factors, implying a substantial increase in output, with the entrant gaining a 12% share. In the factual, price increases by 42.5%, with a 38% drop in output.

650. Alternatively, if the incumbents were to revert to Cournot behaviour in the counterfactual, with VBA entry, but were able to exclude entry in the factual, the weighted average price would increase by 28% and output would fall sharply. In both cases the load factors of the incumbents would be very low.

651. NECG strongly criticised these results for the implausibly low load factors to which they give rise. It argues that having made capacity choices, and invested heavily in expensive yield management systems to secure high loads, the airlines would not then fly their planes more than half empty. Professor Hazledine responded by agreeing that some of the results are implausible, but that they are in essence NECG's results implied by their scenarios, not his results. It is worth noting that while not as low, the NECG model does generate load factors on some routes that may be uneconomic. Its model does not allow for fares to be adjusted in response to load factors, which is a response that might be expected of airlines.

652. Professor Hazledine's research suggests that projections of capacities of the incumbents need to be squared with the corresponding patterns of behaviour, and with the capacity added by an entrant. In particular, capacity cannot be expanded without there being consequences for price, output and load factors. Weighted average prices may be lower in the counterfactual, and higher in the factual, than contemplated by NECG's model. He also found that NECG's model may understate the impact of entry on the proposed Alliance's profits. Overall, welfare losses to New Zealand of the order of $200 million per annum are predicted. Significantly, NECG

also recognised, in commenting on Frontier's submission, that the use of broader markets by Hazledine, rather than the city-pairs it favours, has the effect of reducing the sizes of the price and output impacts, and hence make the deadweight loss correspondingly smaller.

Question 42

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

The Commission's Approach

653. The Commission first assesses the NECG model, and then describes its own modelling work.

Assessment of the NECG Model

654. The Commission's understanding of the modelling work by NECG can be summarised in a simplified form in Figure 2.[67] This model represents a typical city-pair route market. It is important to note that in NECG's modelling there is a lot of variation between such markets, but the Figure attempts to capture the general scenario as expressed by NECG (page 137) as follows:

> . . . there are considerable cost savings available from aircraft rationalisation, because the counterfactual schedule involves significant under-utilised capacity compared with the factual schedule.

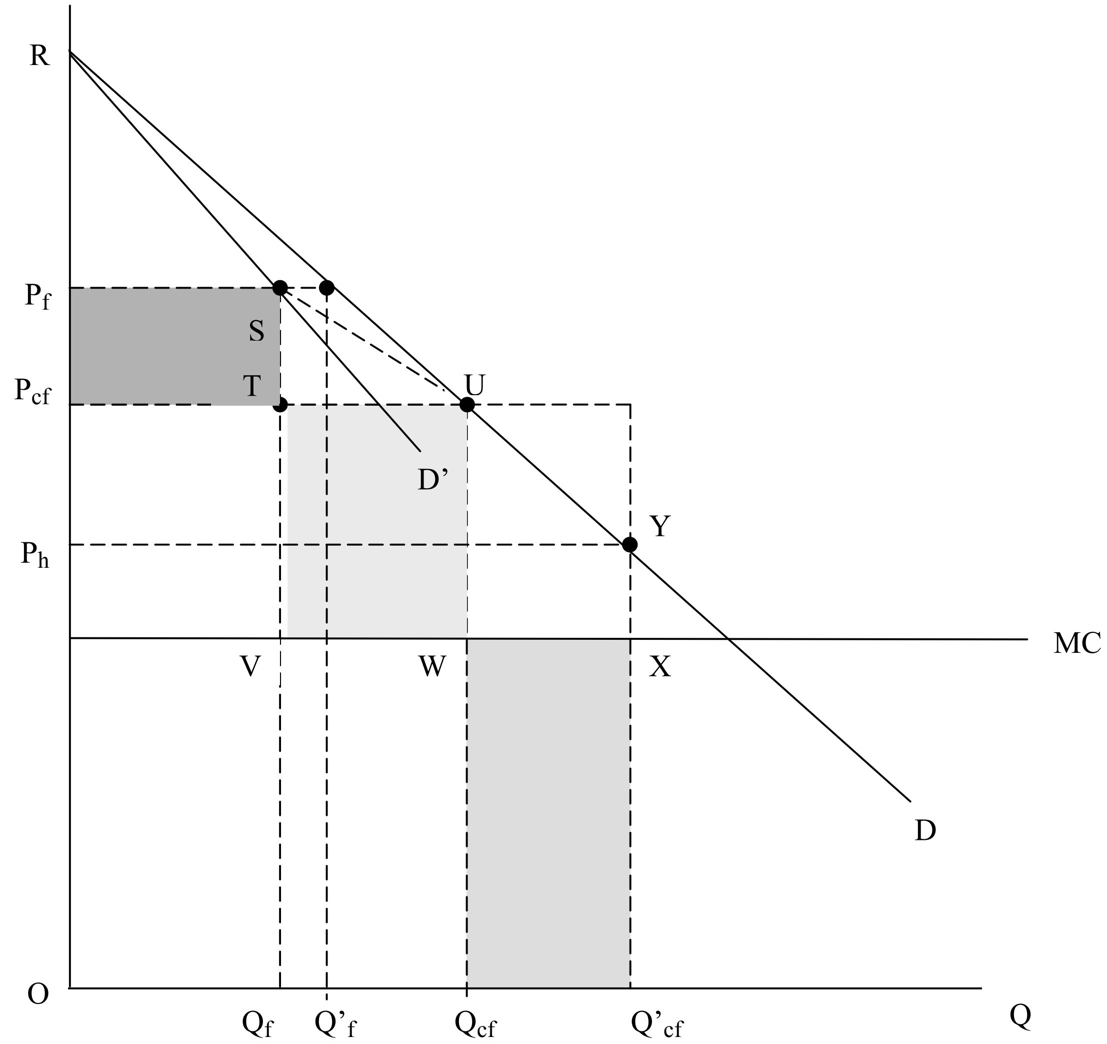
655. NECG's counterfactual scenario resulted in a large expansion of capacity which, through the capacity elasticity factor, causes a small rightward shift of the demand curve, which leads to the demand curve D. However, capacity expansion in the NECG model does not cause the price to change, which remains at Pcf, with a quantity of Qcf. Quantity is measured as number of passengers at the standard load factor.

656. Because of the capacity expansion, the number of passengers that could be carried at standard load factors is actually much higher, at Q'cf, leading to excess capacity of QcfQ'cf. Professor Hazledine argued that in a war of attrition this excess capacity would cause price to fall to Ph, when standard load factors would be restored. Starting from this lower price base, the proposed Alliance would result in a much larger increase in price than NECG finds starting from its higher price base (Pcf). Also, the fact that the excess capacity is not used—it is a pure economic waste—means that NECG is able to claim that the proposed Alliance would generate a cost saving benefit through the elimination of the waste of $WXQ'_{cf}Q_{cf}$. However, this

[67] The model is simplified because, for example, it ignores entry, differences in the costs of different airlines and natural demand growth.

would be a benefit only if that particular counterfactual proposed by the Applicants were to be accepted. Alternatively, if the capacity were used, with price at P_h, the reduction in capacity with the proposed Arrangement would lead to an increase in the deadweight welfare loss of UYXW.

FIGURE 2



657.With the proposed Alliance, competition is substantially lessened and excess capacity is eliminated. The former causes a shift up the demand curve to $P_fQ'_f$. The latter, through the capacity elasticity factor, causes the demand curve to pivot inwards to D' but—in NECG's model—this has no effect on price. Hence, NECG's factual outcome is found at P_fQ_f.

658.As noted earlier, NECG stated that the factual and counterfactual prices and outputs are those derived using their model for solving the outcomes in those scenarios. In

Figure 2 the two pairs of price-quantity points are PfQf and PcfQcf respectively, and these define a small deadweight loss triangle, SUT, which appears to be what NECG has in mind in its graph (see its Figure 1 on page 116). In addition, NECG recognised that there is also a loss of producer surplus arising from the output contraction in the factual, represented by the rectangle TUWV. However, NECG overlooked one other element of deadweight loss. As the two price-quantity points fall on different demand curves, the loss of consumers' surplus should also include the triangular area RSU between the two demand curves and above the counterfactual price level. Thus, NECG's approach significantly understates the size of the loss of allocative efficiency.[68]

659. In summary, this analysis suggests that the NECG model tends to understate the loss of allocative efficiency and overstate the prospect from benefits in terms of cost savings flowing from the proposed Alliance.

Question 43

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

The Commission's Modelling Work

660. The issues raised in the preceding discussion have been dealt with by the Commission in its own analysis, primarily through its use of a different counterfactual, and in other ways discussed below. In addition, two further issues raised by NECG's model were addressed. These were as follows.

661. First, the approach using the 'averaged' demand curve and price seems inappropriate, given that business and leisure passengers have very different demand characteristics, as reflected in the demand elasticities used for each, and that price discrimination is a critical feature of airline pricing. The weighted average fare is actually an amalgam of a wide variety of fares stretching along the demand curve. To pick one point—the weighted average—may not give a good description of the aggregate effects of different fare levels, especially when the associated output level is, by definition, less than that actually produced.

662. Even if one product market for both were assumed, the impact of the proposed Alliance on the two demand segments could differ significantly, as any price increase would be expected to fall more heavily on passengers with the less elastic demand. Alternatively, to fill planes by decreasing price, the price decreases are likely to be concentrated at the bottom end, in order to appeal to price-sensitive passengers. This effect might be accentuated where competition is expected only from a VBA entrant. NECG claims that the use of average prices constitutes a conservative approach.

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[68] Both the total allocative inefficiency loss discussed, and the transfer of P_fSTP_{cf}, will be included only where the loss is borne by New Zealanders, as discussed above.

663.Secondly, a problem with a Cournot model in the present context is that since the VBA is recognised to have a lower marginal cost than the incumbents,69 a standard application of the Cournot model would result in the VBA getting a larger share of the markets it enters than either of the incumbents. NECG suppresses this effect in its projections by linking output to capacity, as it obviously (and quite reasonably) believes that this will not occur. However, one reason why the VBA entrant gains only a small market share is that it offers a service of a lower quality to that offered by the incumbents, which contradicts the homogeneous product assumption in the standard Cournot model. NECG attempts to get round this issue by assuming that in quality-adjusted terms the products are the same (e.g., the VBA offers the lower quality product at a lower price). However, this is unsatisfactory as consumers with different preferences would not consider the two price-quantity combinations as being comparable. In short, it would seem to be more realistic to allow the VBA's market share to be determined by reference to its lower costs and differentiated product, than to 'artificially' restrict its modelled market share by constraining its assumed capacity.

664.The Commission has addressed the first issue—that of price discrimination—by using actual price-quantity data for city-pair routes supplied by the Applicants to derive the residual demand curves for both airlines. The impact of the proposed Alliance would be to cause these curves to be aggregated, from which can be estimated the price-quantity outcomes likely to emerge in the factual. This preliminary analysis is described in Appendix 2. A preliminary result is that for the Tasman and domestic New Zealand routes covered by NECG, the net deadweight welfare loss (excluding transfers) would be of the order of $32 million per annum under a five-step form of price discrimination and $85 million under three-step form.

665.The Commission addressed the second issue—that of differential costs and products—by commissioning Professor David Gillen[70], its economic expert, to construct an alternative model for use in assessing allocative efficiency effects. This model and its results, which form the main basis for the Commission's assessment of allocative inefficiency, are now considered.

Question 44

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

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[69] A VBA entrant is assumed to have costs 20% below, and NZ Express 12.5% below, those of an FSA.

[70] David Gillen is a Professor of Economics at Wilfred Laurier University, Waterloo, Ontario and an expert in the economics of the international airline industry.

The Gillen Model

666. The Gillen model was developed out of the Hazledine model described above. The technical specification of the model is set out in Appendix 3. It has the following characteristics:

- it is Cournot based, but with a facility to vary the conjectural variations of firms;[71]

- the incumbents are sales (revenue) maximisers, not profit-maximisers, as this seems to better reflect their actual motivation in maintaining market share;[72]

- the VBA entrant (when present) is a profit-maximiser;

- some market growth is assumed with VBA entry, in keeping with the observation that VBA entry tends to cause the overall market to expand;

- a capacity elasticity factor of 0.125 is used for the incumbents, and 0.525 for the VBA, the latter reflecting the previous dot point;

- varying degrees of product differentiation are assumed. A relatively high degree of output substitutability between Qantas and Air New Zealand is assumed, but with allowance for preferred national airline. This means a passenger faced with a higher fare on one carrier will not switch until the difference reaches 5%. In the case of the VBA the degree of substitutability is assumed to be less since they offer a differentiated product, so that fares have to be approximately 20% lower before a FSA passenger will shift to a VBA;

- two scenarios are modeled: the factual, which assumes the proposed Alliance and no VBA entry; and the counterfactual, which assumes no VBA entry and a substantial Qantas presence on domestic New Zealand routes, and some VBA entry on Tasman routes; and

- the natural market growth factor is ignored.

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[71] The conjectural variation of a firm represents its expectations as to the responses of other firms in the market, in terms of changes in their combined output, to changes in its own output. For example, in the pure Cournot model, the firm in questions expects a zero response.

[72] The assumption of revenue maximization for full service airlines such as Qantas and Air New Zealand seems plausible given that both carriers have stated in their presentations to the Commission that this is effectively what they do. Their use of demand price elasticities of close to -1 reflects how a revenue-maximizing firm would set price. This assumption is also in keeping with the observed behaviour of full service airlines in adding capacity to ensure maintenance of market share. This is known as the 'S' curve effect, in that the carrier with more capacity obtains a greater proportion of the market. This is not the same as NECG's war of attrition since revenue maximization will be subject to a minimum profit constraint.

667. The data used are taken from the NECG report, supplemented by information provided separately by Air New Zealand and Qantas. Values are expressed in 2002 dollars. The basic assumptions are as follows:

- year 3 data for capacity on domestic New Zealand and Tasman routes;
- average fares based on passengers, revenue and yields in each market ($124 for domestic New Zealand and $384 for Tasman);
- data provided by the airlines to approximate average load factors;
- total market value established as average fare times number of passengers currently, giving: Tasman, $1,502,025,567; domestic New Zealand, $433,165,546; and total market value, $1.935 billion;
- demand price elasticities are similar to those used by Professor Hazledine, but with additional support based on a recent research report;[73]
- the observed yields for the two airlines were used to obtain an average FSA yield, measured by revenue less cost per available seat kilometer (ASK), the cost per ASK being based on reported expenditures in the 2002 *Annual Reports* of the airlines; and
- the VBA entrant has costs equal to 90% of those of the incumbents in the domestic New Zealand market (reflecting the relatively low costs of the Express service), and 75% of the incumbents' costs on the Tasman (since a VBA would have lower costs than the FSA incumbents, particularly when stage length is adjusted).

668. The equilibrium quantities thus derived were very close to the values estimated in the Hazledine model, so that his mechanism for estimating the residual demand functions could be used, which incorporate the assumptions regarding demand elasticities (except that revenue maximizers price at MR=0 rather than MR=MC). Both price and output are indexed to a value of one so that any changes can be interpreted easily as proportional changes.

669. The CV parameter is set equal to -0.4 to approximate revenue maximization. The resulting equilibrium will mean lower prices and a higher output than in a pure Cournot market (and compared to Professor Hazledine's results), although compared to (perfectly) competitive equilibrium prices are higher and output lower. In general, the results simply reflect assumptions based on what the airlines have said they do.

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[73] David Gillen, William Morrison and Chris Stewart, *Air Travel Demand Elasticities, Concepts, Issues and Measurement*, Department of Finance, Canada, February 2003.

670. Since both FSAs are assumed to have the same cost structure, they will have equal outputs and neither firm dominates. However, market share can then be reallocated on the basis of ex ante shares of capacity operated. Since they are assumed to have the same load factors, this is straightforward to do.

671. It is assumed (as did Professor Hazledine) that the divisions of profit and cost changes between Australia and New Zealand are determined as follows:

- any VBA entrant is Australian;
- Qantas has the full 22.5% share in Air NZ;
- Qantas receives a share of Air NZ's profits from the profit sharing agreement that is part of the proposed Alliance; and
- any excess capacity costs are not included in the welfare calculation.

672. Based on all these assumptions, the model suggests that welfare losses would amount to $91 million for domestic New Zealand and $41million for the Tasman, which equate to about 21% and 3% respectively of the revenue sizes of those markets. These losses are measured in the same way as did NECG and Professor Hazledine, that is, they represent the portions of the deadweight losses borne by New Zealanders, plus the New Zealand gain of transfers from foreigners less the transfers lost to foreigners. Together, these losses of $132 million, which represent the welfare losses arising from the reduced competition in the factual compared to the counterfactual, amount to 6.8% of the aggregate market sizes.

673. In conclusion, a variety of models suggest that the potential loss of allocative efficiency flowing from the proposed Alliance is likely to be substantially larger than that estimated by NECG's model.

Question 45

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

Dynamic Efficiency

674. Monopolists have a reputation for being poor innovators, because of the absence of any competitive spur to take risks and embrace new ideas. The removal of competitive pressure lessens the incentive for companies to innovate in order to match or keep ahead of rivals. Lack of innovation may also arise from a conscious decision of the incumbent not to innovate in order to continue to reap returns on its investment in current products and processes. The recent interest on innovation market analysis in merger cases stems from the belief that innovation activity in an industry may suffer from excessive levels of concentration brought about by mergers.

675.A reduction in innovation may cause social welfare to suffer in two ways: buyers may be deprived of the benefit of improved products ('product innovations'); and the public as a whole may fail to benefit from the introduction of new and better ways of producing and distributing existing products ('process innovations'), measured by the additional outputs that could be produced by the saved inputs being used in alternative employments.

676.The advantage of having more than one player in a market is that it increases the number of centres from which innovations can emerge, and raises the pressure on all players to improve their performances. An airline example of the way in which competitive pressure encourages innovation is to be found in the Tasman markets. When Kiwi International entered the market with low priced services, this prompted Air NZ to respond by introducing its subsidiary, Freedom Air, to provide similar services. Normally, full service airlines tend to be unwilling to introduce cut-price fares on a regular but selective basis because such fares lower consumers' perceptions as to the appropriate fares across all services. Another example is that one-way fares were not introduced until VBAs entered markets.

677.Loss of innovative efficiency is potentially large in industries which are otherwise technologically dynamic, particularly as the growth from innovation tends to compound over time. However, such losses are not easy to estimate, and in the past the Commission has not attempted to incorporate the compounding factor into its estimates. Assessment has tended to be based on the following considerations:

- A consideration of the technological progressiveness (or innovative potential) of the industry in question, since industries vary widely in their scope for progressiveness, and hence in the potential for losses of innovative efficiency. The airline industry was assessed by the Commission as being relatively 'high tech' in the *Bodas* decision, and hence a productivity growth loss in the range of 1.0-2.5% was assumed.

- An evaluation of the past innovation performance of the companies which are parties to the acquisition, and what residual competitive pressures may encourage innovation post-acquisition.

- A separate assessment where feasible of the scope for 'product' and 'process' innovations.

- A recognition that innovations not developed or implemented result in a cost saving, which reduces the magnitude of the loss from innovative inefficiency.

678.NECG claimed to the contrary that dynamic efficiencies would be greater with the proposed Arrangement since the "gains of investment are more readily achieved by the investor" than would be the case under the "harsh" competition envisaged in the counterfactual. The latter is likely to result in the following effects: it would encourage a focus on survival and preservation of market share, rather than investment of capital in new equipment to expand services and in measures to reduce costs; it would reduce the resources available for innovation; and it would cause returns to be competed away, thereby reducing the incentives to innovate. Moreover, a major demand-side innovation has been the emergence of VBAs, the entry of which would be encouraged by the proposed Arrangement.

679.Even if this reasoning—that harsh competition discourages innovation—were to be accepted, the relevance of the argument would be reduced if NECG's counterfactual were to be changed to the one favoured by the Commission, which is for a less harsh form of competition.

680.NECG identified the most important innovations in the aviation industry worldwide as being the emergence of VBAs, and the low priced fares they bring, and the trend toward international alliances, which bring the benefit of greater network reach. It argued that Australasian consumers would not be denied these benefits by the proposed Arrangement. First, NECG regarded the proposed Arrangement as enhancing the entry prospects of a VBA into new markets relative to the counterfactual, because it would lead to higher prices. However, this ignores the fact that VBA entry is generally not focused on high priced markets. In North American and European markets VBA entry typically has not been on the highest priced or most profitable routes because of the expectation of significant retaliation by incumbent carriers should they enter there.

681.NECG claimed that the current benefits of network competition between Star Alliance and oneworld would not be lost in the medium-term through Air NZ joining Qantas in oneworld, as it expects Star Alliance to find new ways of connecting into the region through the initiatives of existing members such as United and Singapore Airlines. However, this view has been overtaken by the recent worsening of the financial plight of United Airlines. It also ignores the likelihood that any entry by another Star Alliance member would almost certainly be into Australia, and not necessarily to New Zealand. NECG asserts that frequent flyer credits would be honoured regardless of alliance changes, so that consumers would not suffer from alliance switching.

682.The Commission's preliminary view is that neither of these arguments advanced by NECG is persuasive. On VBA entry, it considers that the proposed Arrangement are more likely to impede entry than promote it. On the global alliance issue, the future looks uncertain given the financial difficulties being experienced by the two keystone members in each, United Airlines in Star Alliance and American Airlines in oneworld. However, the switching of Air NZ would seem likely to seriously weaken the Star Alliance in Australasian markets, and hence reduce the benefits of competition between the two, without the ready prospect of a replacement being available. Hence, on both counts the Commission considers that dynamic efficiency would be likely to be harmed by the proposed Alliance.

683.Estimates of the potential loss from dynamic inefficiency need to be made. In *Bodas* the Commission considered that the airline industry was a relatively dynamic industry, and that evidence from Air NZ suggested that it had made significant productivity gains in a recent period. It considered that loss of competition could possibly result in a loss of productivity growth of from 1% to 2.5%.

684.The various modelling work that has been undertaken as part of these Applications provides an alternative, more direct basis on which to assess the potential loss from diminished dynamic efficiency relative to the counterfactual. The lesser market penetration of the VBA entrant in the factual compared to the counterfactual would be expected to have a number of welfare-reducing effects. Economic efficiency would be expected to suffer in the following ways:

- for those passengers already flying on the incumbent airlines, but who would switch to the entrant, if one were present, there would be a decrease in the costs of supply;
- a VBA entrant would be likely to extend the market by its offering low fares, thereby creating additional consumers' surplus for those people who would not otherwise travel by air; and
- the benefits to consumers of various innovations that a VBA would be likely to introduce, and that incumbents would be pressured into imitating, including one-way fares, new service type, new destinations and new links.

685.Clearly, the extent of this potential loss would depend upon the extent to which Freedom Air and Air NZ's Express service have already pre-empted (and, in the factual, would operate and so continue to pre-empt) these low-cost-supply possibilities, and the extent of the market share not gained by the entrant in the factual relative to the counterfactual. As explained earlier, the Commission is of the view that VBA entry would not be likely in the factual (with the proposed Alliance), but would be likely in the counterfactual in an incremental form on the Tasman, but not on the New Zealand main trunk routes, within the five year timeframe used for the analysis. Hence the detriment calculations with respect to dynamic inefficiency must focus on the Tasman only.

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

- the size of the Tasman markets in total revenue terms of $1502.0 million estimated by Professor Gillen, which reflects the pre-Alliance position and ignores the presence of other airlines;
- the marginal costs of incumbents and entrants are 0.65 and 0.53 respectively for the Tasman, being those derived by Professor Gillen, and indexed to a price of one;

- the price elasticities of demand used by Professor Gillen of -1.33 for the Tasman;

- the welfare gain from entry comprises: (a) the productive efficiency gain where the entrant displaces existing supply with lower cost supply; and (b) for the new demand created the additional consumer and producer (for the entrant) surplus (and ignoring the impact on incumbents' supply of the transfer induced by lower prices); and

- a range of three alternative entry scenarios in the counterfactual are considered, namely those where the entrant secures different percentage shares of existing and of new demand respectively of 5%, 10% and 15% each. These imply market share gains by the entrant in the enlarged market of 9.5%, 18.2% and 26.1% respectively, which roughly accord with the range of outcomes in the United States, Canada and Europe when a VBA has entered a market.

687. The preliminary results are given in Table 7. These estimates suggest that the loss of dynamic efficiency from deterred VBA entry could be between about $43 million and $120 million, which give a range of between 2.9% and 8.0% of current market revenues.

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

Entrant market share	Existing demand – productive efficiency gain	New Demand		Totals	Percentage of total revenue
		Consumers surplus gain	Producers surplus gain		
5% + 5%	9.120	1.412	32.582	43.114	2.9%
10% + 10%	18.240	5.647	59.517	83.404	5.6%
15% + 15%	27.360	12.705	80.805	120.870	8.0%

688. On the basis of the above table, the potential loss of dynamic efficiency from the proposal might be of the order of $43 million to $120 million. However, in interpreting these estimates, a number of caveats have to be borne in mind:

- the use of the current (essentially status quo) market sizes and prices could be a conservative approach, as it overlooks the market contraction that would apply in the factual which, by allowing the entrant relatively greater scope to expand in the counterfactual, might tend to magnify the efficiency ('new demand') gains from entry;

- the estimates cover only the Tasman market, yet there are a number of other markets where competition from VBA entry could occur (e.g., South Pacific Island routes), especially if the Commission's timeframe were to be extended;

- mitigating factors are the presence of Freedom Air, which offers a VBA option on some Tasman routes already, and the possibility that Air NZ may introduce its Express service on the Tasman; and

- the estimates make no allowance for the loss of service quality for those existing passengers who are assumed to switch to the new no frills service of the entrant. However, this is because the switching passengers would be trading off lower fares for service quality, and switching would not occur if it were not welfare-enhancing. A possible counter to this is that if there were a general reduction in service offerings due to entry then there may be some loss in welfare, but this seems likely to be small.

689. In addition to loss of dynamic efficiency gains from blocked VBA entry just considered, no allowance has so far been made for two other potential sources of loss: the loss of benefits arising from the potential switch by Air NZ to the other global alliance (elements of which were discussed earlier); and the potential stunting of incentives to improve dynamic efficiency on the part of the partners in the proposed Alliance by virtue of the elimination of the competition between them.

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

Question 46

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

Question 47

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

Productive Efficiency

691.NECG considers that the productive inefficiencies resulting from the proposed Arrangement would not be material. Although it recognises that there will be one-off integration costs (costs which it has not attempted to quantify), NECG views these as being small, partly because they are one-off. However, this is questionable: integration is likely to occur progressively over a significant period of time (for example, codesharing could not begin for two years because of global alliance ramifications), and so transactions costs associated with the proposed Arrangement seem likely to be ongoing.

692.Experience from overseas, and with deregulation in New Zealand, across many industries suggests that dominant firms and monopolists are rarely as efficient as they could be if they were to face competition. A firm with a substantial degree of market power is under less pressure to minimise costs and to avoid waste than its counterparts in a competitive market. 'Slackness' creeps into its operations. In contrast, efficiency is likely to be a survival condition in competitive markets, where buyers are able to purchase elsewhere should a more efficient firm offer a lower price. Moreover, the presence of more than one substantial company in the market helps to facilitate benchmarking comparisons of production costs and efficiency, and provides management with a tool to lever cost savings within the organisation.

693.With respect to the airline industry, there is strong evidence from deregulation in a number of different markets that productive efficiency improved significantly when firms were exposed to competitive pressures. In Canada, for example, productive efficiency improved by 12-15%, and in the United States it improved by in excess of 25% for some carriers.

694.The extent to which costs are above the minimum necessary to produce a given output provides a measure of the welfare loss caused by productive inefficiency. This loss is real in the sense that the wasted inputs could be diverted to productive use elsewhere in the economy, where they could be used to produce outputs which are foregone because of their unproductive use by the dominant firm. NECG questioned this view by drawing the distinction between x-inefficiency and economic waste, arguing that much x-inefficiency simply involves transfers that do not result in economic waste. It seems to have in mind a situation where the supra-normal profits of a firm with market power are eroded by the rent-seeking behaviour of its labour force and other input suppliers, which are able to capture some of the profit in the form of higher remuneration.[74] However, NECG's argument ignores the problem that as rents are translated into costs, firms will choose different production technologies, which can be wasteful.[75]

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[74] If accepted, this would influence the calculation of the welfare impact of transfers in the section on allocative efficiency above.

[75] An example is provided by the use of smaller aircraft at highly congested airports, when an airline could and should shift to larger aircraft and consolidate flights. They do not shift because their costs would rise

695.NECG recognised that rent-seeking may introduce costs that do constitute an economic waste, regardless of the transfers actually effected. This waste is measured by the value of the resources devoted both by groups in rent-seeking activities, and by the company in attempting to combat such activities. However, it disputed that the proposed Alliance would result in greater rent-seeking than under the counterfactual. This seems questionable, given that the extra profits expected to be generated from the exercise of greater market power through the proposed Alliance would provide both the incentive and opportunity to engage in rent-seeking activities. Moreover, the rent-seeking literature leaves open the possibility that the rents potentially available could be absorbed completely by the resources devoted to obtaining them. Thus, all of the rent could become a cost and thus an economic waste.

696.NECG approached the productive efficiency argument by taking issue with a view ascribed to the ACCC that gains in efficiency from a proposed Alliance of the kind considered here, if not passed on to consumers, would be susceptible to erosion because of reduced competitive discipline. NECG considered that even if such inefficiency were likely, it would be a very small proportion (a figure of 0.5% is mentioned) of a relatively small amount. However, this is to miss the key point that the whole of the cost base of the entity concerned, not just the efficiency gains that may flow from the proposed Arrangement, would be susceptible to rising costs as competition diminishes.

697.NECG considered that any inefficiency resulting from the proposed Arrangement would be likely to be small for a number of reasons. First, inefficiencies would be contrary to profit-maximisation, and would not be in the interests of shareholders. To accept them as likely would be to imply either an unwillingness or inability of the firm to maximise profits, whereas the purpose of the proposed Alliance is to improve profitability. NECG argued that there is no reason to expect that the proposed Alliance would face fewer incentives to reduce costs than the firms in the counterfactual. This seems questionable given the experience of Air NZ, whose services improved dramatically once it began to face competition when Ansett entered the domestic New Zealand markets in 1987. Also, the term “legacy carrier” is often used of FSAs, the implication being that they carry a lot of legacy costs that they find difficult to shed, even in the face of competition from the new low cost carriers. The Australian Ansett operation provides a particularly good example.

698.Secondly, NECG pointed out that the Alliance agreement contains a provision for a subsidy margin to be paid by either airline if it were to insist on operating a flight that did not produce the highest margin available. This suggests that by introducing a mechanism to thwart it, the Alliance partners are aware of the potential for loss of competition to promote productive inefficiency. However, it seems doubtful that this provision would be rigorously enforced, given tolerances attached to comparative

due to higher pilot salaries with larger aircraft. The empirical example of this problem is United Airlines at LAX.

costings between airlines and because the Alliance agreement also provides for the pre-existing market shares of Air NZ and Qantas to be maintained.

699. Thirdly, NECG argued that the organisation would be under pressure from capital market disciplines, namely the threat of takeover. If performance were to slip, a company would expose itself to the risk of takeover, with existing management being replaced. However, there is a body of research that suggests that large firms are less constrained than small by the takeover threat, and history is replete with firms that failed (including airlines) without invoking capital market disciplines. In the present case, Air NZ could not be taken over during the future period in which the government retains majority ownership. In addition, the perception of an implicit 'government guarantee', given the fact that the government bailed out the company that would otherwise have failed, might erode incentives to preserve efficiency. Further, the "knocking it into shape" scenario posed by NECG (see footnote 156, page 129), which involves an acquirer splitting up and selling parts of the company, seems inconsistent with its views about the importance of network economies in the case of airlines, and with Air NZ's "Kiwi Share" obligations.

700. Fourthly, NECG pointed out that the proposed Alliance would continue to face competition on many routes, so that the entity would be informed about best practice from those routes. This may be correct to an extent, but the competitors may not be fully comparable with the proposed Alliance partners. For example, on the Auckland-Brisbane route cited, competition comes currently from Freedom Air (albeit that it is an Air NZ subsidiary), and could emerge from Virgin Blue, but these are both low cost VBA operators. The other current operators are fifth freedom ones—Thai and Malaysia—which only do so as an adjunct of their flights from Australia to home hub, and both are significantly government-owned and one at least has received significant government subsidies. These considerations would seem to muddy the determination of their costs and competitiveness. In addition, on many routes on the Tasman Air NZ and Qantas are the only operators. It would seem to be as easy to argue that 'slackness' that might emerge on those routes could undermine the efficiency across the wider operation, as to argue that competition on some routes would preserve efficiency on those threatened by slackness.

701. Fifthly, NECG argued that the general uniformity of markets would make it difficult for differing work practices to emerge in competitive and less competitive markets, and in any case, allowing system-wide inefficiencies would be financially disastrous. This seems to be an extension of the previous point. However, it is apparent that system-wide differences exist now. It was conceded by the Applicants that the labour unions tend to be stronger in Australia than in New Zealand, from which it could be inferred that labour costs are likely to be higher (or at least to be more resistant to being reduced) for Qantas than for Air NZ. Higher labour costs might be transferred to Air NZ through participation in the proposed Alliance.

702. Finally, NECG considered that any emerging inefficiencies would result in any cost slippage being very gradual. As the cost-reducing effect of the proposed

Arrangement would come sooner, and be larger, the net present value of the two combined would be heavily weighted in favour of the benefits. However, it will become apparent in the benefits section below that the achievement of any cost reducing benefits would also occur over a period of years.

703. On the basis of this preliminary analysis, the Commission is not convinced by NECG's arguments that productive inefficiencies flowing from the proposed Alliance would be immaterial. The proposed Alliance, in the Commission's preliminary view, would result in the two airlines no longer competing on a number of routes on which they are the major operators. The possible entry by Virgin Blue is uncertain, and may have a limited impact on competition even if it were to occur. Both airlines receive significant support from their respective governments of varying kinds. In all these circumstances, it seems likely that the proposed Alliance would have some deleterious impact on the productive efficiencies of the two airlines.[76]

704. In addition to the general literature on x-inefficiency,[77] a recent study published by the OECD supports the argument that there is a negative link between airline productive efficiency and market concentration (a proxy measure of market power).[78] This study analyses "the impact that different types of regulatory and market arrangements have on the efficiency of supply of scheduled air passenger travel services in the OECD area, controlling for 'framework conditions' such as airport dominance and the role of government-controlled flag carriers." A detailed set of summary indicators of regulation and market structure are used, which were constructed by means of factor analysis, along with two indicators of performance: air fares (broken down into business, standard economy and discount), and productive efficiency, measured by capital use efficiency and efficiency across all factor use. The former is measured by average aggregate load factors (or by its inverse, the inoccupancy rate), and the latter by Data Envelopment Analysis. The analysis is based on ordinary least squares regressions on a cross-section of 100 major international routes connecting the main hubs of the 12 largest OECD countries in or around the 1996/97 air travel season. A higher level view of the national industries supplying domestic and international services is also included.

705. Results are presented on the impact upon performance of regulation and market structure at both levels. Among the findings are the following: at both the national and route levels there is clear evidence that productive efficiency tends to improve, and all categories of fares tend to decline, as the regulatory and market environments become friendlier to competition; and productive efficiency is particularly sensitive to actual competitive pressures, as proxied by low market concentration, while fares appear to react to the threat of potential entry. The authors conclude that liberalisation

[76] An illustrative example is provided by the case of Air Canada, which faced substantially higher costs after it merged with Canadian Airlines. The higher costs were due to rent-seeking behaviour and the taking on of debt.

[77] R. S. Frantz (1997), *X-Efficiency: Theory, Evidence and Applications* (2nd edition), Dordrecht: Kluwer.

[78] R. Gonenc and G. Nicoletti, *Regulation, Market Structure and Performance in Air Passenger Transportation*, Economics Department Working Papers No. 254, Paris: OECD, 2000.

policies encourage efficiency and reduce price-cost margins, but to bear full fruit such policies must be accompanied by relaxation of constraints on airport access, and by checks on the strategic behaviour of incumbents through alliances and slot domination.

706. Similar findings emerged from a study by Oum and Yu of airlines in North America, Europe and Australasia.[79] Competition was found to be a significant factor explaining the differences in productive efficiency across carriers, measured by total factor productivity (where TFP is an index of productivity taking account of the growth in outputs and all inputs). Those carriers in more competitive markets had higher productivity or cost competitiveness, in that they were not only on a lower cost function, but also at a lower cost point on that cost function. The latter is achieved through innovative pricing and service strategies. Oum and Yu found that over the period 1986-93, three major European carriers improved their productive efficiency by 11 percent, and three Asian carriers improved their efficiency by 16 percent. In both cases these carriers were subject to increased competition in the markets they served.

707. In the *Bodas* decision (p. 99) studies of Canadian airline markets were cited in which inefficiencies in the range of 7-17% of the total costs of individual carriers were observed, apparently associated with markets in which there was an absence of full competitive pressures. The Commission recognised that no submission had attempted to quantify this detriment in respect of the domestic passenger air services markets in which dominance was expected to be acquired, but put forward the view that "possible orders of magnitude might conceivably fall in the range of 1% to 10% of current costs." This percentage range falls well within the efficiency gains found by Oum and Yu.

708. In the present case the modelling work on markets by the NECG and others has indicated that substantial transfers from consumers to the Applicants are likely to arise in the markets in which competition would be substantially lessened. The preceding discussion has suggested that the presence of such rents would be likely to provide the incentive and the opportunity for rent-seeking behaviour. This would have the effect of converting at least part of the transfers into costs, either from the resources used up by the behaviour itself, or from possible distortions in input use caused by differentially inflated resource costs through higher factor prices for labour, contacts or other inputs.

709. On this basis, the Commission has reached the preliminary view that the proposed Alliance would be expected to give rise to productive inefficiency in all markets in which there would be a substantial lessening of competition—namely the New Zealand main trunk and provincial routes, the Tasman, New Zealand to the Pacific Island and to the United States, and freight services and national wholesale travel distribution services —and the operations of both Applicants would be equally

[79] Tae Oum and Chunyan Yu*, Winning Airlines: Productivity and Cost Competitiveness of the World's Major Airlines,* Dordrecht: Kluwer, 1998.

exposed. However, given the New Zealand focus of the Act with respect to public benefit assessment, the productive inefficiency expected to arise in respect of Qantas's operations in these markets would only be relevant to the extent that the resources it uses are New Zealand-owned.

710. Some preliminary estimates can be made using the revenue and marginal cost data derived by Professor Gillen and used above in the assessment of dynamic efficiency (but extended to include the New Zealand main trunk market), and applying the Commission's 1-10% range used in the *Bodas* decision. These preliminary calculations are presented in Table 8.

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

Item	NZ main trunk	Tasman
Total revenue	433.166	1502.026
Variable costs (assuming MC = 0.65)	281.558	976.317
Productive inefficiency (1-10% of variable costs)	2.816 – 28.156	9.763 – 97.632

711. The projections are imprecise, but point to annual detriments in the range from about $12 million to about $126 million for the two market areas combined. However, these are subject to the following qualifications:

- it is assumed that productive inefficiency would impact only on variable costs, but fixed costs could be unaffected, too;
- whatever the appropriate costs might be, the relevant cost base would tend to be smaller with the expected output reduction in the factual;
- the coverage is only of two markets—New Zealand main trunk and the Tasman—whereas other markets and areas of the companies' businesses are likely to be affected, particularly as costs affected would be company-wide rather than route-specific;
- the airline efficiency studies quoted above suggest that limited competition is associated with loss of productive efficiency that could easily exceed 10%;
- a possible off-setting factor would arise if the entrant in the counterfactual were to gain significant market share from the incumbents, and they were not able to maintain volumes through market growth, such that they would experience a loss of economies of density that would be avoided in the factual

(although output reductions might prevent them from keeping such economies in the factual, too);

- the detriments would not arise to the levels projected immediately, but would be expected to mount gradually over time (although the force of this point is weakened by the fact that this also applies to the claimed benefits); and

- given the New Zealand focus of the public benefits test in the Act, the productive inefficiency is only of concern where New Zealand-owned resources are being wasted or used inefficiently, whereas the figures in the table include Australian-owned resources to some degree, both those used by Air NZ and by Qantas.

712. On the basis of the calculations and the evaluation of the various qualitative factors, the Commission is inclined to widen the range within which productive inefficiency flowing from the proposed Alliance is likely to fall to between \$20 million and \$150 million per annum. Its preliminary assessment is that the outcome is most likely to be in the middle of this range.

Question 48

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

Question 49

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

Conclusions on Detriments

713. The Commission's preliminary conclusions on likely annual detriments are set out, and contrasted with NECG's claims, in Table 9. The detriments from the Commission's perspective arise as the difference in performance in the various markets in the counterfactual, where competition between Air NZ and Qantas would be preserved and would likely be augmented on the Tasman by the entry of a VBA, and market performance in the factual with the proposed Alliance and without significant VBA entry, where competition would be substantially lessened in a number of markets.

TABLE 10
Summary of Annual Detriments ($M)

Item	NECG's View*	Commission's Preliminary View	
		Range	Most likely
Allocative inefficiency and transfers	10.3	132	132
Productive inefficiency	Very small	20 - 150	80
Dynamic inefficiency	Nil	50 - 150	90
Totals	>10.3	202 - 432	302

*Year 3 estimate.

714. The summary of the Commission's preliminary assessment of productive efficiency indicates that losses are thought likely to fall in the range from $202 million to $432 million per annum, with the most likely outcome being around $300 million per annum. It is accepted that these losses would not apply immediately, but would tend to build up over a time period.

Question 50

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

PUBLIC BENEFITS

Introduction

715. While the Applicants acknowledged that the proposed Alliance would likely generate competitive detriments, they argued that these are outweighed by benefits to New Zealand. They mentioned a large number of potential benefits, but the Application is supported by estimates of benefits in six broad categories:

- cost savings;
- new direct flights;
- better scheduling;
- increased inbound tourism;
- maintenance of existing levels of New Zealand-based engineering and maintenance contracts; and
- the freight market.

716. The Applicants mentioned, but did not attempt to quantify, certain other benefits.

717. The purpose of this section is to assess the benefits that the proposed Alliance will afford the New Zealand public. The argument proceeds, in general, as follows: first, the Applicants' and NECG's claims and estimates are presented; second, comments from interested parties, submissions and relevant experts are discussed; and third, the Commission's position is discussed and preliminary conclusions are drawn, including dollar value estimates where possible and appropriate.

718. Many of the effects discussed below are difficult to quantify with any certainty. Where precise quantification is difficult and assumptions necessarily arbitrary, the Commission has opted for conservative assumptions and values. NECG's assumptions and values are used by the Commission when there are no superior assumptions or values apparent.

Cost Savings

The Applicants' Claim

719. According to NECG's analysis, cost efficiencies from reduced excess capacity would represent nearly one third of total claimed public benefits. (The present value of cost savings in year 3 of the proposed Alliance is estimated by NECG to be around $75

million, compared with total benefits in year 3 of around \$236 million). Under the proposed Alliance, the airlines would singly produce much of that which was duplicated. NECG stated that lounges, computer systems, baggage-handling and check- in services are subject to some economies of scale: the more of them produced, the lower is the average cost of their production. On the other hand, the Applicants and NECG conceded that integration costs could be substantial, in particular, the cost of integrating computer systems. Given the difficulty of estimating the potential gains from economies of scale and the likely costs of achieving them, the Applicants have assumed that the benefits and detriments are balanced for the purpose of the Applications. The Commission agrees with this approach, especially given the uncertain costs of exiting the Alliance and how that ought to be imputed in integration costs.

720.Cost savings are also claimed to result from better aircraft selection and use. For example, where Air NZ and Qantas might each fly a 100 seat aircraft on a route, the proposed Alliance will allow one airline (the airline with lower costs) to serve the route using a 200 seat aircraft. NECG has estimated the potential gains from such cost savings by identifying the different costs incurred by Air NZ and Qantas according to three cost drivers: passenger numbers, block hours (the sum of flight time and time spent on the ground between flights) and the number of departures. NECG infered operating costs from financial accounts and used these to estimate total costs according to the cost drivers implied in the factual and counterfactual scenarios. The Applicants supplied factual and counterfactual departure numbers, the model of competitive detriments provided passenger numbers, and block hours are standard values supplied by the Applicants. Capital costs were estimated according to the types of aircraft assumed to be used to meet the factual and counterfactual schedules based on confidential figures disclosed by the Applicants. Annualised capital costs were based on a straight-line depreciation using a cost of capital of 8%.

721.NECG explained that the resulting efficiency gains of the proposed Alliance can be explained by the fact that the "counterfactual schedule involves significant under-utilised capacity compared with the factual schedule". This referred to the "war of attrition" counterfactual where Air NZ and Qantas competitors both present the market with unused capacity and the factual where the Alliance partners avoid this waste. Savings from the reductions in passengers travelling because of higher fares were deducted from the total cost savings to avoid double counting. The cost of providing services on new direct routes was subtracted from the total.

Other Views Received

722.Submissions have commented on the fact that the Applicants did not claim cost savings from economies of scale, and on the Applicants' claim of savings from aircraft selection and use.

723.Frontier Economics and Professor Hazledine noted that NECG has estimated no economies of scale, which are normally the basis for public benefit claims in merger applications. Frontier Economics noted further that it is not improved aircraft selection that drives NECG's estimates but savings from avoiding wasteful competition.

724. According to Frontier Economics, NECG's argument depends on a counterfactual where "Qantas is threatening that, if it is not allowed to proceed with the proposed alliance, it will embark on a vigorous increase in capacity".

The Commission's View

725. The Commission has assessed cost savings to be much lower because it does not accept the counterfactual proposed by the Applicants. The Applicants' counterfactual is characterised by a great amount of resources being spent by both airlines in mutually detrimental competition, and this situation is compared to a factual in which the Alliance partners would agree to allocate their resources more rationally. The Commission's counterfactual sees the airlines competing relatively efficiently. Consequently, cost reductions in the Commission's view would be smaller.

726. The Commission agrees that some economies of scale would be difficult to quantify because implementation costs may be high. The Commission acknowledges, however, that they would likely only be undertaken where expected gains exceeded expected costs. On the other hand, economies of scale relating to the costs of serving particular routes (referred to as "economies of density" to distinguish them from network-wide economies of scale) are amenable to quantification.

727. There are two effects working against each other. On the one hand, the price rises and quantity reductions in the factual means that the average cost per passenger of supplying flights would be higher (a shift up the average cost curve, in economic terminology). On the other hand, if there are significant economies of density, the airlines ought to be able to serve the combined market (though it would, as said, diminished by anticompetitive effects) at a lower average cost (the applicable cost curve would shift rightwards). Specifically, without the Alliance, average costs on a route would be the sum of Qantas' total costs and Air NZ's total costs, divided by the total number of passengers flying that route. With the Alliance, the airlines claim they would choose whichever operator could provide the service more cheaply. (The Commission has not tested the airlines' ability to rationalise costs in this way with their stated intentions to maintain market shares). Average costs would then be the cheaper carrier's total costs divided by the (diminished) number of passengers who fly on that route. The cost savings per route would depend on how much the market had contracted as a result of higher fares, the share of each airline and the difference in their costs.

728. The Commission's preliminary estimate of cost savings implicitly accepts the cost parameters used by NECG, but the final number is assumed to be a proportion of NECG's estimate, reflecting the Commission's and NECG's different views of the counterfactual and the competitive effects of the proposed Alliance. Whatever cost

savings are available will be a function of the change in traffic between the factual and counterfactual scenarios and the cost of supplying capacity to carry that traffic. The following relationship has been used to estimate cost savings:

$$\text{Cost savings} = \text{NECG cost savings} \times \frac{\text{NECG change in passengers}}{\text{Commission change in passengers}} \times \frac{\text{NECG load factor}}{\text{Base case load factor}}$$

729.The formula above adjusts the NECG estimate once to reflect the Commission's view on the supply of capacity in the counterfactual and again to reflect the Commission's estimate of the contraction in passenger numbers (and, implicitly, flights). The "change in passengers" parameters are the difference between factual and counterfactual passenger numbers modelled by NECG and the Commission. This ratio reflects the fact that available cost savings will be a function of traffic levels. The ratio of "NECG (counterfactual) load factor" and "Base case load factor" reflects the Commission's view that the most likely counterfactual is characterised by the kind of capacity supply functions that are currently observed rather than the "war of attrition" envisaged by NECG.

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

$$\text{Cost savings} = \$74.625 \text{ million} \times 0.77 \times 0.57 = \$32.405 \text{ million}$$

731.This preliminary calculation is based on a simple aggregation of load factors and passenger numbers across markets. It is the Commission's intention to develop more comprehensive estimates that take into account traffic levels, market shares and aircraft types on different routes.

Question 51

The Commission seeks comments on its estimation of cost savings?

Tourism Benefits

Introduction

732.Inbound and outbound tourism in New Zealand depend on the cost and availability of air transport to access the destinations and activities that tourists demand. Tourism exports generate jobs and income for New Zealanders, and a large number of New Zealanders derive enjoyment from overseas travel and tourism. The net public benefits of the proposed Alliance ought therefore to take into account its effect on tourism.

733.The Applicants submit that New Zealand will benefit from increased inbound tourism as a result of the proposed Alliance. More than half the present value of benefits to New Zealand in the first five years of the proposed Alliance is projected to occur as a consequence of increased inbound tourism, according to the NECG model. NECG proceeds first by identifying how the proposed Alliance would affect tourist numbers, and then by estimating the effect on tourist numbers. They convert these numbers into dollar amounts for the purpose of calculating public benefits and detriments.

734.This section assesses the claimed effects of the proposed Alliance on the benefits to New Zealand of inbound tourism. The section answers the following questions:

- Are the sources of tourism benefits identified in the alliance proposal legitimate and credible? Are any tourism effects omitted?
- Are the tourism effects identified in the Applications correctly estimated?
- Have the expected strategic responses of destinations that lose tourists to NZ been fairly considered?
- Are the welfare effects of tourism effects correctly estimated?
- Have the estimates correctly considered risk factors that may affect tourism such as political stability or other exogenous effects?
- What is the Commission's estimate of welfare effects of the proposed Alliance on inbound tourism?

Sources of Tourism Benefits

<u>The Applicants' Claim</u>

735.The Applicants claimed that the proposed Alliance could provide tourism benefits to New Zealand. The benefits occur from Qantas Holidays' increased incentive to market New Zealand products and from the proposed Alliance improving the promotional effectiveness of Tourism New Zealand and the airlines themselves. Qantas Holidays is described in Qantas's 2002 annual report as a wholly-owned subsidiary of Qantas and is "Australia's largest travel wholesaler of both international and domestic holidays designed for independent travellers and small groups".

736.Furthermore, the Applicants claimed additional tourists are also attracted by the creation of new products and better scheduling. The benefits are partly diminished by a negative response to higher fares. NECG estimated the New Zealand tourism effects in year 3 of the proposed Alliance as set out in Table 10:

TABLE 11
NECG Estimates of Effects on Numbers of Inbound Tourists in Year 3

Qantas Holidays	Improved promotion effectiveness	New fares and products	Total
50,000	13,277	-10,333	52,944

737.The Applicants claim that these additional 53,000 tourists would not be attracted to New Zealand in the absence of the proposed Alliance.

<u>Qantas Holidays</u>

738.Qantas Holidays' increased promotional activities in New Zealand would, according to the NECG Report (p. 148), include:

- promoting New Zealand as a major holiday destination in all QH's promotional material available through its overseas network;
- expanding QH's product portfolio in New Zealand;
- introducing NZ/Australia combined trips/packages;
- specifically targeting the 'events' market in New Zealand; and
- increasing access to air capacity through a combined network of Air NZ and QF establishing a local presence and delivery capability (e.g.., Inbound Tour Operator).

739.These activities are estimated to cost $14 million per year. According to the Applicants, Qantas Holidays would promote New Zealand tourism because Qantas would receive a share of the additional Air NZ profits via its equity holdings, and because increased tourist numbers would make New Zealand more profitable for Qantas.

740.Qantas Holidays' "Marketing and Sales Plan for Growing NZ Inbound Market under the Alliance" summarises its strategies in both the factual and counterfactual scenarios as shown in Table 11.

TABLE 12
Qantas Holidays' Approaches to Marketing Inbound Tourism to New Zealand

No Alliance – counterfactual	Alliance – factual
• QH forms a major distribution channel for QF and will not sell seats on Air NZ due to competitive reasons. • Qantas' limited network to, and within NZ, makes many NZ related itineraries from most inbound markets uneconomical (especially mono NZ), and combined Australia/NZ itineraries often too expensive. • Qantas brand is strongly associated with Australia, making it difficult for QH to push mono NZ itineraries in overseas source countries. • For these reasons, NZ is currently only promoted and sold by QH overseas as an add-on destination to Australian itineraries.	• Alliance allows QH to also sell Air NZ seats. • Alliance offers QH an improved air product in the region, with a larger network, better connections, and new mono NZ, and multi-destinational itineraries. • Access to Air NZ (Holidays) brand enables QH to promote NZ as an inbound destination in its own right. • Opportunity significantly enhances QH's inbound growth strategy by combining two well-aligned inbound markets (Aus, NZ). • Leveraging QH's global distribution footprint delivers a step-change in the number of distribution outlets of NZ product, considering Air NZ Holidays' limited overseas infrastructure. • Growing leisure business is in line with overall group objectives of two carriers QF and Air NZ.

741.The Applicants argued that these opportunities would allow Qantas Holidays to bring to New Zealand an additional 50,000 tourists annually, of which 14,000 would come from Australia and 36,000 from elsewhere. Of the 36,000, 19,000 are expected from Asia, 7,000 from North America and 9,500 from Europe. The figure of 50,000 is Qantas Holidays' own estimate, though one that is supported by a report from Tourism Futures International (TFI).[80] The Applicants, Qantas Holidays and TFI have all suggested that these targets are likely to be modest, and that many more tourists would be brought to New Zealand were Qantas Holidays able to repeat the success that it has had in Australia.

742.TFI explained why Qantas Holidays' actions will increase inbound tourism to New Zealand. TFI compare the examples of four tourists whose spending on travel to New Zealand is based on the average expenditure by visitors to New Zealand. Seventy per cent of their expenditure (an assumption based on the proportion in Australia) is spent

[80] TFI, 'Australasian Tourism Review', submission to the Commerce Commission, 11 February 2003.

before arrival on airfares, accommodation, transport within New Zealand and activities. The four tourists types buy from Qantas Holidays a land-based package (i.e., services within New Zealand) and fly to New Zealand using any of four alternatives:

- with Qantas, which earns the Qantas Group [ ] profit per passenger;
- with Air NZ, Qantas appropriating one-third of Air NZ's margins from the sale, which earns the Qantas group [ ] profit per passenger;
- with a third-party airline booked through Qantas Holidays, which earns the Qantas Group [ ] per passenger; or
- the fourth type of tourist buys a land package only from Qantas Holidays (arranging their travel to New Zealand separately), which earns the Qantas Group [ ] per passenger.

743.TFI suggested that because the Qantas brand is identified strongly with Australia and because the Qantas network in New Zealand is limited, "it is … unlikely that this avenue (i.e., a package including Qantas airfares) could produce significant additional overseas visitors to New Zealand". In other words, the most profitable and practicable way for Qantas Holidays to make money by increasing tourism to New Zealand is by selling packages that include an Air NZ airfare, the proceeds of which will be partly appropriable by Qantas. TFI endorsed Qantas Holidays' claim that it will promote New Zealand products with greater zeal as a result of these incentives.

<u>Other Views Received</u>

744.The tourism estimate has received considerable criticism from industry sources. Some have dismissed the number as very unrealistic. Others have agreed that Qantas Holidays could sell 50,000 New Zealand holidays, but that these tourists would not be in addition to those already arriving, but would be diverted from other providers. It may also be the case that current travellers to New Zealand would switch to Qantas Holidays and simply stay longer. Gullivers Pacific Group's submission, for example, interprets the NECG Report's statement, "Qantas Holidays will have an incentive to market its products in New Zealand under the Alliance," to be a declaration that under the proposed Alliance Qantas Holidays can and will "exert anti-competitive behaviour (on) the New Zealand travel wholesale market". Gullivers Pacific stated that Qantas Holidays "will be able to effectively undercut all the inbound travel wholesalers in the New Zealand marketplace", and that without the ability of other wholesalers to acquire rival products from Air NZ, the competitors of Qantas Holidays will be at a disadvantage. Noting the statement in the NECG Report that Qantas Holidays achieved a 7.3% share of the inbound holiday passenger market to Australia, Gullivers observed that this was in a period of decline in Australian inbound tourism. The conclusion they draw from this is that "airlines have little influence in the overall quantum of demand for a destination but can influence the choice of customers by price and promotion".

745. Tourism New Zealand acknowledged that the proposed Alliance "would provide for a broader range of Australia/New Zealand itinerary options for global travellers than the status quo because of the combined domestic network strengths of each carrier". Tourism New Zealand notes Qantas's preference for brand-based promotion rather than promoting destinations. It stated that to the extent that Qantas does promote destinations, it generally does so "when it sees a tactical (short-term commercial) need to do so during periods of seasonal weakness in demand".

746. Tourism New Zealand described the market in which Qantas Holidays operates as "cluttered and highly competitive," and pointed out that Qantas Holidays is not a New Zealand specialist. Consequently, Qantas Holidays' investing in New Zealand promotion would likely have an impact on market share rather than adding to tourist numbers.

747. Various tourism industry participants told the Commission that projected increases in dual destination tourism to New Zealand ignore the current preferences for mono destination tourism. Professor Hazledine's submission asks what is the "source of market failure that currently prevents" thousands of "people realising their latent desire to be tourists in New Zealand", and why the proposed Alliance would correct this market failure.

748. Frontier Economics, in support of Virgin Blue's submission, made the point in its analysis that the market failure might be a "free-rider" problem. In other words, why would Qantas Holidays sell New Zealand products if other airlines gain from the promotion without bearing its costs? And, asks Frontier Economics, why would an entrant such as Virgin Blue not also benefit from Qantas Holidays' efforts were the proposed Alliance to proceed and Qantas Holidays to launch its New Zealand campaign?

749. In its March 2003 "Response to Submissions in Relation to NECG's Report", NECG noted the general criticism that the tourism benefits projected as a result of the proposed Alliance could be obtained without it. NECG claimed the submissions fail to appreciate the new opportunities that the proposed Alliance provides Qantas Holidays. These include:

- greater connectivity between major tourist source countries and destinations;
- greater connectivity to tourist destinations within New Zealand and Australia;
- greater flight frequency on major tourist routes, such as Japan; and
- the improved scheduling of flights per day on core markets.

750.Qantas Holidays would exploit these new opportunities under the factual, according to the Applicants. In this argument, the Applicants appear to be referring to the kind of responses described by NECG in relation to the "quantitative service index" (QSI) approach[81] (see, for example, the NECG report (pp. 154-55) and TFI's report (pp. 41-42)). But neither NECG nor TFI has estimated a complete set of QSIs that would be relevant to inbound tourism to New Zealand. The projected number of additional tourists appears to be based on information from Qantas Holidays. Indeed, it is not clear where the estimate came from: TFI called it an NECG estimate, NECG referred to Qantas Holidays' information, while Qantas Holidays' "Marketing and Sales Plan" attributed the detailed projections in each market to "QF/Air NZ, QH management information". The numbers appear to be based on past experience of promotion expenditure, and are said to be significantly less than a simple extrapolation based on inbound tourist capacity utilisation would suggest.

The Commission's View

751.The Commission accepts that the proposed Alliance would offer Qantas Holidays a slightly increased incentive to sell packages that include Air NZ products. However, the incentive to promote tourism to New Zealand should remain largely unchanged. The Commission does not accept that the added incentives in the factual case are necessarily as great as those argued by the Applicants, NECG, Qantas Holidays and TFI. For example, it is not clear why Qantas would be entitled to claim one-third of the profits from Air NZ airfares.

752.The Commission also notes that TFI's examples are based on spending by the average tourist to New Zealand. Submissions and advice from industry participants have pointed out that the Applicants propose to increase the marginal growth of tourism to New Zealand, implying that it may be better to perform the calculations based on the spending of the marginal tourist to New Zealand. The marginal tourist might spend considerably less than the average tourist, according to advice received by the Commission. This might especially be true where the additional tourists stay for a shorter period of time, as the dual destination tourist might be expected to do. The Commission acknowledges that any addition to tourist numbers achieved by Qantas Holidays could well consist of tourists with atypical expenditure, however it is not certain that these additional tourists would necessarily spend less than the average tourists, nor is it possible to project how different their spending would be.

Question 52

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

[81] A measure used by airlines to assess the viability of routes: its arguments include connectivity and frequency.

753.Part of the tourism benefits come from stimulating dual destination tourism. However, Tourism New Zealand's submission advised that mono-destination tourists stay longer, spend more and travel more broadly within New Zealand. It is also not clear that such promotion would lead to new tourists, as distinct from having current tourists increase their length of stay.

754.Under the proposed Alliance Qantas could claim some part of the airfare component of packages where Air NZ was the carrier. (Currently, as mentioned above, Qantas Holidays does not sell products that include Air NZ travel.) The proposed Alliance would therefore increase the number of seats that Qantas Holidays could fill, and do so in a way more profitable to Qantas than if the packages involved another, third party carrier. However, the Commission believes that it makes greater commercial sense for Qantas Holidays to sell Qantas seats, and that means that New Zealand will remain a secondary focus. By Qantas Holidays' and TFI's own admission, the Qantas brand is strongly identified with Australia, and Qantas Holidays is quite obviously a Qantas brand. However, given the greater profitability of packages including Qantas airfares, it might also make commercial sense for Qantas to invest in repositioning its brand such that it becomes identified also with New Zealand. The costs of doing so would need to be added.

755.In the absence of the proposed Alliance, Qantas is projected to increase its capacity to New Zealand in competition with Air NZ. If that were so, the Commission expects that Qantas Holidays would be marshalled to help fill these seats. Given the cost of additional capacity and the profit advantage of selling packages that include Qantas travel, the Commission expects that promoting New Zealand as a tourist destination would become an urgent objective under the counterfactual too, thereby diminishing the gap between benefits available in the factual and counterfactual scenarios.

756.The objective of Qantas Holidays under the proposed Alliance would be to expand the market, to encourage new tourists who otherwise would not have travelled. If Qantas Holidays could sell packages to these tourists, there would be a gain to Qantas, regardless of what airline the tourists use. In discussion with Commission staff, Qantas Holidays suggested that it would not be permitted by its parent company to exploit this latent market without the proposed Alliance. An Air NZ spokesman explained that this may be attributed to Qantas' reluctance to offer Air NZ any commercial opportunities in the current competitive environment. Qantas is therefore willing to forgo a market expansion that offers Qantas and Air NZ mutual advantages. The Commission takes the view that, were the proposed Alliance not to proceed, the advantage to Qantas of Qantas Holidays' selling packages that include Air NZ products, where Qantas products could not be substituted, would generally outweigh the disadvantage of referring business to a competitor. The Commission is supported in this view by a [

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Question 53

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

757. As stated above, the Commission accepts that the proposed Alliance would increase the incentive for Qantas Holidays to sell Air NZ products, though it does not accept that the incentives to promote New Zealand tourism are as great as those proposed, nor would packages involving Air NZ necessarily be much more saleable than those involving Qantas. However, even accepting the Applicants' proposal that Qantas Holidays will act as a New Zealand advocate in the factual but not the counterfactual, the question remains of how effective it might be. The proposal includes an estimate of Qantas Holidays' effectiveness as a New Zealand tourism promoter. The suggested additional $14 million spend per year is projected to attract an additional 50,000 tourists to New Zealand and 18,000 to Australia.

758. To put this estimate in perspective, Qantas Holidays attracts 165,000 inbound tourists to Australia annually. An additional 50,000 tourists to New Zealand would increase projected inbound tourism by about 5% of the one million total number of visitors whose purpose in coming to New Zealand is described as 'holiday', equivalent to 2.6% of the total number of international visitor arrivals.[82] According to figures supplied by TFI, the annual growth in international visitor arrivals to New Zealand in the three years from 1999 to 2001 was 8.3%, 11.2% and 6.9%, while the average annual growth in arrivals projected over 2001 to 2008 is 6%.

759. As cited above, Qantas Holidays estimated a profit of [ ] per tourist from packages that include a competing airline. Yet if these 50,000 tourists are in addition to those already travelling, the extra packages could be sold with no immediate disadvantage to Qantas at a total profit of [ ] to the Qantas Group. When asked why Qantas Holidays would not attempt to exploit the gains, the Applicants suggested that Qantas would not allow its subsidiary to develop markets on behalf of its New Zealand rival. To do otherwise would strengthen Air NZ over time and allow it to resist Qantas' competitive strategy on other routes and in regard to other products. The Commission accepts that this explanation accords with how Qantas Holidays has behaved in the past. However, this past behaviour also indicates why Qantas Holidays' might want to continue to direct its focus towards increasing its parent company's revenue rather than becoming an advocate for Air NZ. And, as noted above, if Qantas Holidays can make [ ] profit for the Qantas group in the counterfactual, the Commission would expect it to do so, even where the package included Air NZ flights.

[82] See Tourism Research Council, *International Visitor Arrivals Report*, http://www.trcnz.govt.nz/Surveys/International+Visitor+Arrivals/Reports+and+Analysis/default.htm, December 2002 (accessed 26 March 2003).

760.The Commission accepts that were Qantas Holidays to attempt to attract additional tourists to New Zealand, it would succeed in doing so to some extent. However, it does not accept that the proposed Alliance would provide Qantas Holidays with the opportunity to attract 50,000 additional tourists. The analysis submitted by Qantas Holidays and TFI describes various markets that might be targeted and the strategies that could be employed to appeal to these markets, but there is no demonstration of a link between these strategies and expanding the markets by the target amounts. Strategies described by Qantas Holidays might conceivably succeed only in taking business away from other providers. The Commission also notes that undertakings given to the ACCC commit the airlines to spending only an additional A$5.4 million "in the one year following' the effective date of the proposed Alliance," rather than the full $14 million per year by Qantas Holidays anticipated in the NECG Report.

761.To the extent that Qantas Holidays can offer better products, in terms of connectivity, network coverage and other benefits of co-ordination, the Commission considers that the effort will contribute to an already competitive market for inbound tourism. The question is not only if the strategy proposed by Qantas Holidays of increased expenditure, new products and additional sales outlets can profitably expand the market, why they are not doing it already, but if there are these untapped sales opportunities, why is no one else doing it already?

Improved Promotion Effectiveness

<u>The Applicants' Claim</u>

762.According to NECG , the proposed Alliance will "provide opportunities for significant improvement in the effectiveness of existing promotion activities". Qantas and Air NZ could engage in co-operative advertising, making for cost savings and a greater focus on increasing the market rather than attempting to take passengers away from each other. Qantas' and Air NZ's co-operation with their national tourism bodies could be extended into a concerted effort to promote Australia and New Zealand as a dual destination. Qantas Holidays and Air NZ (Holidays) have told the Commission that this co-ordinated effort would not result in a reduced effort to market their own home markets but would be supplemental.

763.NECG explained a model of airline demand with which they estimate an "elasticity of RPKs (revenue passenger kilometres) on Air NZ with respect to promotion". That is, they estimate how much further Air NZ ticket-holders travel as a response to promotion effectiveness. The resulting elasticities for promotion in the Australian and North American markets are 0.13 and 0.17. In other words, NECG's model suggested that increasing promotion effectiveness by 10% would increase tourist arrivals by 1.7% (holding distance travelled constant). Overall, NECG assumed that promotion effectiveness would increase by 10%, 5% from joining forces rather than competing for market share and another 5% as a result of efficiency improvements.

The Commission's View

764.The Commission is cautious about accepting the promotion effectiveness elasticities and doubtful of the assumed increase in promotional effectiveness. NECG cites one study by Crouch, Schultz and Valerio of promotional elasticities in support of the model's result.[84] The Commission's investigations have suggested that promotion elasticities ranging from 0.15 to 0.25 are commonly reported by national tourism organisations and incorporated into formal models of tourism demand.

765.On the estimate of promotion elasticities, the Commission notes that NECG's model has RPKs as its dependent variable, the variable whose value depends on the other parts of the model. The more relevant variable would seem to be the number of tourists. Since NECG compares its results with those obtained by Crouch, Schultz and Valerio, who use a model specified with tourist numbers as the dependent variable, it is curious that the NECG model is estimated for RPKs. The Commission has some reservations about the Crouch, Schultz and Valerio study, and about information on promotion elasticities gathered by NECG from industry sources. First, that study's results are not as confident as the Commission would like. For example, the USA to Australia marketing elasticity is reported as 0.11, but the 95% confidence interval is 0 to 0.23. Second, while tourism authorities may be expert in the effectiveness of tourism promotions, using independent estimates of elasticities would avoid the perception of bias. Finally, it is not obvious that the NECG model includes the kind of lags that the Commission would expect to see in a model of international tourism marketing. Foreigners who see a persuasive advertisement for adventure in New Zealand might not respond straight away, as they might need to arrange leave from work or to save money. It is not clear how the NECG model estimates the delayed effect of promotion.

Question 54

How effective are national tourism organisations' promotions? Can airlines promote national tourism as effectively?

766.The estimate of a 10% increase in promotion "effectiveness", if effectiveness means effect on tourist numbers rather than on profits, seems arbitrary and contrary to how the Commission assesses competition. If Qantas and Air NZ were to compete for business, their different products and prices may encourage fewer tourists than in the case where they combined their message. The Commission would normally expect duopoly advertisers to differentiate and to expand into parts of the market where they

[84] G. Crouch, L. Schultz and P. Valerio, "Marketing international tourism to Australia, a regression analysis", *Tourism Management*, June 1992, pp. 196-208. Schultz and Valerio disclose that they were Australian Tourist Commission (ATC) employees in 1992. The results of their research "contributed to the (Australian) government's decision to boost funding to the ATC by an additional A$23 million, an increase of over 50%." The decision followed "a period of considerable debate between industry bodies and government about the value of the ATC's marketing activities" (Crouch, Schultz and Valerio 1992, p. 208).

can exploit a particular advantage, and so increase the overall size of the market size. In the NECG view, the single voice in marketing is supposed to appeal to more people.

767. The Commission's initial view is that combining and co-ordinating marketing by the airlines would not result in increased tourist numbers. The opportunities for increased dual destination tourism also appear to be limited by current preferences for mono destination tourism. Gullivers' submission makes the point that an attempt to market Australia and New Zealand as a dual destination product would encourage Australian States to react with regional campaigns. Previous attempts at dual destination marketing by Australia and New Zealand have not been successful. A campaign to increase tourism would not be ignored by other competing destinations or activities. The NECG numbers assume, incorrectly in the Commission's view, that there would be no strategic response from competitors.

New Fares and Products

The Applicants' Claim

768. NECG estimated that some tourists will be lost because of higher fares and reduced capacity in the factual case. However, NECG argued that the negative effects will be partly offset by the airlines' enhanced connectivity and attention to dual destination markets.

769. The QSI approach is invoked to justify (but not quantify) the benefits in this category. The opportunities for benefits from new routes and better scheduling are considered in greater detail below.

The Commission's View

770. The Commission's initial analysis of competitive detriments suggests that the negative effects on tourism resulting from increased fares and reduced capacity have been significantly underestimated.

The Star Alliance

The Applicants' Claim

771. NECG considered that the proposed Alliance would most likely result in Air NZ leaving the Star Alliance and joining the oneworld Alliance. However, it does not expect lower tourist numbers as a result. [ ] In its Data Handbook 2001, Air NZ quotes a Merrill Lynch study in 2000 that describes the Star Alliance as the "strongest alliance based on the relative rankings of airline alliances in five categories

measuring the network, regulatory and financial characteristics of each alliance". Air NZ also quotes a University of Illinois study in 2000 that "credited the Star Alliance with saving customers US$100 million annually, as a result of … code-sharing and antitrust immunity".

Other Views Received

772. Industry experts and submissions have suggested that Air NZ's departure from the Star Alliance would have significant effects on tourism to New Zealand. Qantas and Air NZ argued that the effect on tourism would be minimal, Star Alliance and oneworld offering more to the business traveller than to tourists. How significant the impact of the loss of Star Alliance would be would depend on whether another Star Alliance partner would enter the New Zealand market. The NECG analysis did not estimate the impact of the loss of Star Alliance representation on tourism to New Zealand.

773. The Ministry of Tourism considered feed from both the Star Alliance and oneworld to be one reason why New Zealand tourism growth has exceeded growth in the Australian market. If New Zealand lost the Star Alliance, it could have a negative impact on tourist numbers, in the same way that growth in the Australian market was affected by the loss of the Star Alliance partner, Ansett. According to Tourism New Zealand, the benefits of Air NZ's membership of the Star Alliance are as follows:

- Access to network feed from 11 other airlines provides the broadest global reach of any airline proposed Alliance. "This passenger feed onto Air New Zealand enables Air New Zealand to sustain direct air services that might not otherwise be viable if the airline were forced to rely solely on its own and Qantas' sales and marketing resources.

- Travel agents' and consumers' access to a wider range of competing products.

- Access to frequent flyer redemption opportunities. New Zealand "currently benefits substantially from inbound visitor frequent flyer redemption for 'holiday' purposes and the direct marketing associated with this". Lufthansa's and United Airlines' programmes "generate very high yield visitors for New Zealand's tourism industry".

- Distribution and interline access with Thai Airways, Singapore Airlines and United Airlines which decrease the cost of travel and attract frequent flyer customers from these airlines' home markets.

The Commission's View

774. The Commission has not yet formed a view on the likelihood of another Star Alliance airline flying to New Zealand, from where it might fly, how frequently or when it might start. It may be that were the Qantas-Air NZ alliance to provide

oneworld with a dominant position in the region, Star Alliance carriers may consider other strategies than expansion into New Zealand. In the present environment, it may be that international carriers will be looking closer to home rather than seeking opportunities in far parts of the Pacific.

775. The tourism effects modelled by NECG do not include any effects of a loss of the Star Alliance. According to the Commission expects that the loss of Star Alliance would diminish total benefits attributable to the proposed Alliance, especially if the loss were prolonged. It would adversely affect:

- the marketing effectiveness of Air NZ (Holidays) which has sold products as part of the Star Alliance network;
- the ability of members of other Star Alliance airlines' rewards schemes to redeem their points in flights to New Zealand;
- the promotion effectiveness of the airlines and Tourism New Zealand;
- the convenience of travel to New Zealand;
- the range of products available to tourists seeking to travel to New Zealand; and
- the ability of travel agents to find competitive deals for their customers.

776. In other words, the loss of the Star Alliance has the potential to diminish virtually every projected tourism benefit of the proposed Alliance, though the total effect might not be large. On the other hand, were Air NZ to join oneworld, the benefits to New Zealand could be expected to be much smaller than the loss of Star Alliance benefits, since Qantas already brings a certain amount of oneworld traffic to New Zealand.

777. If other Star Alliance partners were able and willing to provide sufficient capacity to New Zealand, losses attributable to Air NZ leaving the Star Alliance might be minimal. The Commission has, however, been unable to identify any Star Alliance members planning to enter New Zealand markets.

Capacity Issues: Aircraft Seats and Tourism Infrastructure

<u>Views Received</u>

778. Various submissions have pointed out that the proposed Alliance would mean fewer available seats to New Zealand. This loss of capacity would make it more difficult to travel to New Zealand. The Commission has also been told that existing tourism facilities might not be able to accommodate an addition to total tourist numbers of the size projected by the Applicants.

The Commission's View

779. The Commission considers that if sufficient demand were to exist, then resources would be diverted to supply services to meet it. To the extent that these resources were scarce, they would be likely to cost more per additional tourist, and this would be likely to diminish overall benefits. This is another justification for valuing the contribution of additional tourists to public benefits as being less than the Applicants suggest.

Risk

780. The Commission notes that the numbers suggested by Qantas Holidays seem to be independent of the general volatility of the international tourist market. Currently, for example, there are local problems in Asia and elsewhere that are globally affecting people's willingness to travel long distances. The effects of war, disease, fuel price increases and other shocks have not played out, and there is no certainty that other events will not in the meantime contribute to travellers' apprehension. Recessions, exchange rate fluctuations, accidents involving airliners and many other factors can significantly affect the demand for international tourism. The risk of these events will be the same in the factual scenario as in the counterfactual, however a factual scenario that assumes a growth in tourism must include these risks in any projections. A projection of increasing tourist numbers by 53,000 per annum does not have the same value in a risky world as it would in a risk-free world.

781. Consequently, a strategy that seeks to effect an increase in tourist numbers has to be given less credence unless it specifically accommodates risk in the target numbers. Leisure travellers in general and tourists in particular could be expected to react to emergencies and adverse economic events by deferring travel, or by substituting local tourism consumption. According to Qantas Holidays' plan, they anticipate being able to discover untapped markets among some of the world's increasingly anxious populations. But however safe New Zealand may be as a destination, the Commission cannot accept that even Qantas Holidays' most earnest efforts will produce results as reliable and confident as those projected in the Application.

The Welfare Effects of the Proposed Alliance

The Applicants' Claim

782. Having estimated the number of additional tourists that the proposed Alliance would attract to New Zealand, NECG estimates the economic effect they would have. Three alternative estimates are presented. The first two employ a general equilibrium model,[85] and the third (the one used in the final calculation of benefits and detriments) is based on tourist expenditure.

[85] General equilibrium models are economic models that attempt to show the effects of a change in one market (in the present case, tourism) on all other markets in the economy. The sum of effects, therefore,

783.NECG used a model developed by the Australian Bureau of Agricultural and Resource Economics called the "Global Trade and Environment Model (GTEM)," a computerised member of the "Walrasian" family of general equilibrium models.[86] It is related also to the widely used Australian general equilibrium models, MONASH and ORANI, but differs from these in two ways: in its modelling of greenhouse gas emissions, and in its inclusion of a New Zealand sector. Its outputs include, among other things, employment, national income, and welfare measures.

784.GTEM does not include a defined tourism sector. NECG simulates an increase in tourism by increasing three export sectors – services, other manufacturing and trade, and transport – by $105 million, $20 million and $20 million respectively, or by $145 million in total. The assumption is that tourists consume services, manufactures, trade and transport in these proportions. Solving the model involves assuming something about the availability of resources. Two alternatives were modelled. First, real wages were fixed (i.e., additional labour was available to industry at the prevailing wage rate). Second, employment was fixed (i.e., the economy was assumed to be characterised by full employment, so expanding industries bid for additional workers who were then diverted from other sectors of the economy).

785.The results indicated that gross national product rose by 96% of tourism expenditure under the assumption of fixed real wages. Under the assumption of fixed employment, GNP rose by around 40% of tourism expenditure. The fixed real wages result is used to justify the third approach adopted by NECG, the valuation by expenditure per tourist. The fixed real wages results "lend support to setting the value of benefits generated by the proposed Alliance approximately equal to the initial effects indicated" (i.e., to the dollar value of tourism expenditure). In other words, a dollar spent by foreign tourists in New Zealand is a dollar's benefit to New Zealand.

<u>Other Views Received</u>

786.Professor Hazledine believed that NECG's tourism expenditure-based estimate of benefits are incompatible with the welfare measures used elsewhere in the report. The expenditure-based method does not represent the true impact on public benefits, he says. He provides the following illustration (p. 9):

> A flight attendant loses their job as a result of efficiencies resulting from the cartel. NECG (correctly) would count the salary saved as a benefit (in the cost savings category of benefits.) Then suppose that the ex-flight attendant walks down the airport concourse and gets a job at one of the expanded car rental outlets needed to service the additional tourists. NECG now count (this) new salary as another benefit. That is, they double-count the effect of the resource allocation.

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represents the impact of a change in one market on the economy as a whole. In the present case, for example, an increase in tourism implies increased spending on restaurants, hotels and transport, which in turn implies increased purchases for the inputs these industries use, and so on.

[86] H. Pant, "Global Trade and Environment Model (GTEM): A computable general equilibrium model of the global economy and environment" (document in progress), ABARE, Canberra, 2002.

787.NECG in its March 2003 response to submissions argued that Hazledine's characterisation is mistaken. According to their MONASH modelling, a dollar of tourism expenditure increases welfare by between $1.07 and $1.50. NECG seemed to argue that the welfare effects estimated in the Applications are substantial underestimates, since the New Zealand results are derived from the more modest results of GTEM.

The Commission's View

788.The Commission does not accept the equation of dollars spent by tourists with benefits to New Zealand. A gross figure, such as this, does not represent the net welfare gain to New Zealand of additional tourists. It counts the gross amount spent on resources to meet tourist demand as a bonus, ignoring the fact that those resources will be unavailable for an alternative use in which benefits will be forgone.

789.TFI provided data on tourist numbers by home market and average tourist expenditure by home market, where available. NECG's calculations of benefits then becomes a simple matter of multiplying tourism numbers by how much they spend to arrive at a measure of public benefit.

790.The Commission does not agree with either the methods used to estimate benefits, or the estimates themselves. Concerns with the approach include the following:

- NECG adopts the expenditure-based approach following the results of the fixed real wage scenario of the GTEM, yet the fixed employment scenario (the results of which are much more modest) may be a more valid representation of the New Zealand economy and a more conventional assumption in a social cost-benefit analysis.

- Both the GTEM results show large terms of trade effects. Given that GTEM does not include a specific tourism sector, it is important to understand these effects. For example, if resources are in reality diverted more from domestic production, the public benefit would be lower.

- If improved connectivity and scheduling attracts inbound tourists, it ought also to encourage outbound tourism. However, there is no modelling of increased NZ imports corresponding to the model of inbound tourism.

- There is no general equilibrium model of other consequences of the proposed Alliance-for example, of the maintenance contracting, of the increased cost of transport from increased airfares or of the effects in the freight market.

- Why is the supply of capital assumed to be fixed, rather than somewhat responsive to price?

- Why are GDP and GNP results reported, but not welfare results? The Commission understands that GTEM can generate welfare results-consumer and producer surplus-so why not report these rather than measures of gross income? Other parts of the NECG analysis-for example, the detriments–and the test that the Commission uses in granting authorisations–public benefits–are denominated in terms of welfare, so why not tourism benefits?

791.The Commission accepts that general equilibrium models are useful for estimating the effects of tourism on public benefits. However, these models are only as useful as their specifications and interpretation. NECG has used the GTEM to estimate gross income effects rather than welfare effects. Moreover, NECG's final tourism benefit estimate is equated with the GTEM results under the assumption of fixed real wages rather than fixed employment. Fixed employment is often a required assumption for assessing public benefits.[87] The New Zealand Treasury requires a full employment assumption, except in unusual circumstances (Bollard 1999, p. 13).[88] The Treasury memo states that any departure from the basic assumption of a fully employed open economy "should be clearly stated and justified".

792.The full employment assumption is not only desirable on public policy grounds, but in the current economic climate in New Zealand it may be a more realistic assumption. Currently New Zealand's unemployment rate is around 5% and is projected to remain between 5 and 5.5% for the next several years.[89] This is a low level of unemployment meaning that the benefits of increased tourism employment would be offset by labour scarcity in other sectors of the economy. The assumption recognises that the resources used to serve tourists are taken from some other employment; they are not idly waiting to be given a job to do by a sudden incursion of tourists. The diversion of these workers and equipment therefore has a real cost as well as a benefit.

793.A paper by Dwyer, Forsyth, Spurr and Ho (2003) describes how tourism benefits ought to be estimated.90 First, they distinguish measures of impact from measures of benefit. According to the paper: "The change in GDP is a gross exaggeration of how much better off the country, and, more precisely, its residents, are" (p. 4). "Some policies or projects may increase GDP yet yield overall negative net benefits" (p. 5).

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[87] For example, see US Office of Management and Budget, Memorandum for Heads of Executive Departments and Establishments: Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs, Circular No. A-94, Revised (Transmittal Memo No. 64) October 29, 1992, http://www.whitehouse.gov/omb/circulars/a094/a094.html, accessed 17 March 2003; Australian Department of Finance and Administration 1991, *Handbook of Cost-Benefit Analysis*, AGPS, Canberra. See also Bureau of Transport Economics 1999, *Facts and Furphies in Benefit-Cost Analysis: Transport*, Report 100, Bureau of Transport Economics, Canberra, chapter 5 for a discussion of the costs and benefits of including employment effects in a transport cost-benefit analysis.

[88] A. Bollard, "Guidelines for costing policy proposals", Office minute 1999/B41, 21 December 1999.

[89] Treasury, *2002 December Economic and Fiscal Update*, Treasury, Wellington, p. 24.

[90] L. Dwyer, P. Forsyth, R. Spurr and T. Ho, "Measuring the benefits of tourism", Draft paper prepared for the CAUTHE conference, Coffs Harbour, Australia, February 2003.

794.According to Dwyer et al. (pp. 10f), using a general equilibrium model to estimate benefits correctly involves identifying tourists' spending patterns, relevant taxes, subsidies, price elasticities, costs of capital, effects on wages, externalities and other issues. It is a simple matter (p. 12) to adjust GNP or GDP outputs to produce net benefit measures. To do so, "one subtracts the cost of additional inputs used to produce the increase in activity. Thus the cost of additional labour used (wage by quantity), the cost of additional capital services and cost of additional natural resources must be taken from the change in the value of the increased economic activity, as measured by the change in GNP or National Income".

Conclusion on Tourism Benefits

795.The Commission's preliminary view is to discount the estimate of tourism benefits on the following grounds:

- The Commission is not convinced that the proposed Alliance will itself provide sufficient incentive for Qantas Holidays to focus on products that bring benefits to New Zealand. To the extent that Qantas Holidays can profitably increase its advocacy of New Zealand tourism, some opportunities exist already, and the Commission expects that, to some extent, Qantas Holidays could and would be able to offer Air New Zealand products in the absence of the Alliance. To the extent that Qantas Holidays can attract more business, resources used to supply additional tourism services may have a higher marginal cost..

- The Commission doubts that Qantas Holidays' efforts will result in additional inbound tourists to the extent suggested. It is more likely that there will be some encroachment on other providers' market shares, a diversion from mono to dual destination business and competitive reactions from Australian state government tourism bodies.

- The Commission does not accept that combining the efforts of Qantas Holidays and Air NZ (Holidays) will necessarily lead to more effective promotion, where "effective" means increasing tourist numbers rather than making marketing more profitable. Instead, it is possible that the combination will reduce the variety and range of appeals to different parts of the market.

- The Commission believes that the negative effects on tourism arising from increased fares and reduced capacity have been significantly underestimated.

- The Commission believes that negative effects could follow the loss of a local Star Alliance airline. These have not been included in the calculation of tourism benefits by NECG.

- The Commission believes that the methods used to convert the tourism effects into benefits are inappropriate for the present purposes. A measure of impact (tourist expenditure) rather than welfare is used, the model assumes fixed wages rather than fixed employment and the results do not seem to be corrected or checked for exaggerated terms of trade effects.

796. Each of these concerns about the tourism benefits implies that the Commission considers a lower estimate than that offered by NECG to be appropriate. However, it accepts that several of the steps involved in estimating benefits are highly uncertain, if not impossible to quantify. The sum of positive effects (welfare gains from increases in tourism from increased promotion and the benefits of improved scheduling and additional products) and negative effects (responses to higher fares, the contraction of capacity and the loss of the Star Alliance) depends on the values given to each effect.

797. The Commission's preliminary view is that a range of conservative values ought to be considered. The bounds of the range could begin at a substantial negative impact on tourist numbers (where competitive detriments and the loss of the Star Alliance dominate the result) to an upper bound closer to the Applicants' projections. The Commission considers it appropriate to value the change in tourist numbers using welfare measures, rather than the gross effects suggested by NECG's tourist spending approach and changes to GNP produced by the GTEM.

798. The Commission considers that a reduction in tourist numbers of 10,333 provides an appropriate lower bound for estimating the net impact on tourism. This number is NECG's estimate of the reduction in tourist numbers to New Zealand in year 3 of the proposed Alliance resulting from higher fares and including a positive response to new products. The lower bound therefore assumes that the net impact of Qantas Holidays' strategies and projected increases in promotional effectiveness between the factual and counterfactual is negligible. If the proposed Alliance were to produce the lower bound change, or any net reduction in tourist numbers, then the tourism effect is more properly regarded as a detriment than as a benefit.

799. The upper bound of the Commission's estimates assumes that the impact on tourism of the proposed Alliance is greater than the number expected in the consensus of advice that the Commission has received from tourism industry experts and Government bodies. The upper bound suggests that Qantas Holidays could succeed in its stated ambitions and achieve its targets, and it might continue to deny itself profits in the counterfactual by not selling packages that include Air NZ products. In this case, it might be appropriate to estimate tourism benefits based on the numbers projected by the Applicants, though the Commission retains doubts about these targets for reasons given above. The upper bound is therefore 52,944 additional tourists to New Zealand in year 3 of the proposed Alliance.

800. The Commission has not modelled the impact of changes in tourism on New Zealand, but it is aware of general equilibrium models developed in New Zealand that might be suitable for this purpose. The Commission is satisfied that, given that there is no tourism sector defined in GTEM, NECG's approach to simulating an increase in

tourism by increasing a number of related export sectors is reasonable. However, the Commission does not accept that the changes in GDP or GNP produced by the model, under either the fixed employment or fixed real wages assumptions, are appropriate measures of the impact on public benefits. It follows that the Commission does not accept that tourism expenditure is an appropriate value with which to measure tourism benefits because of its similarity to the GTEM results under the assumption of fixed real wages.

801. At the time of this draft decision, the Applicants had not supplied the Commission with the results obtained from GTEM that showed changes in welfare as calculated by NECG. The results in Table X are therefore only approximates based on the GTEM calculations of GDP (i.e., GNP excluding terms of trade effects) presented in the NECG Report (p. 159). Under the assumption of fixed employment, GDP is projected to increase by $13.49 million. Dividing by the number of tourists suggests that, on average, tourists contribute around $255 each to GDP growth. Public benefit estimates in the Table are simply the number of additional tourists multiplied by $255.

TABLE 13
Estimates of Annual Tourism Benefits

	NECG year 3	Lower bound	Mid point	Higher bound
Tourist numbers	52,944	-10,333	25,956	52,944
Net public benefit ($ m)	120.259	-2.633	6.614	13.490

802. The range of public benefits inferred from the GTEM results and from different assumptions about changes to tourist numbers suggest that the welfare effects of the impact on tourism will be much smaller in magnitude than that projected by NECG. In fact, the range suggests that the impact on tourism may be detrimental if the proposed Alliance were to have a negative impact on tourist numbers, and positive but relatively small even if Qantas Holidays' and the Applicants' confidence in their projections were to be fully realised.

Question 55

The Commission seeks comments on its estimation of tourism benefits?

Question 56

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

Scheduling Efficiencies

The Applicants' Claim

803.The Applicants submitted that the proposed Alliance would result in scheduling benefits arising from improved flight frequency, enhanced connectivity and additional direct services. In short, the airlines under the proposed Alliance would stop scheduling services at the same time, and instead schedule their flights more evenly throughout the day at times more suitable to a significant number of travellers. It is claimed these travellers would benefit from being able to travel at times more suitable to them rather than at times suitable to airline rivalry.

804.Scheduling benefits to New Zealand are estimated to be around $10.5 million per year. Hypothesised schedules under the proposed Alliance are compared to current schedules. This is the only estimate that is not a comparison of the factual to counterfactual cases. The reason for the departure from the usual practice is that schedules under the counterfactual are not known. Benefits are calculated from savings in waiting time using values of time of $115 per hour for business travellers and $23 per hour for leisure travellers.

Other Views Received

805.The NECG model has attracted three main criticisms from industry sources. First, benefits are said to be overstated since, in a counterfactual case involving greater capacity, it is reasonable to assume that this added capacity would be distributed at times other than those provided in current schedules. Therefore, the counterfactual promises some scheduling benefits, too, relative to the present. Second, the use of $115 per hour and $23 per hour time saving values is criticised because it assumes that those waiting for aircraft or in the air have no alternative uses of their time. Third, the values of time themselves are high.

806.NECG, in its response to submissions, defended the use of current schedules since counterfactual schedules were unavailable (though the number of flights in the counterfactual was used). NECG claimed travel time values were conservative when compared with some overseas estimates, and are also conservative considering Austroads' recommendation to set travel time values equal to the hourly wage rate plus ongoing costs.[91]

The Commission's View

807.The Austroads recommendation (which relates to passenger car travel where the time spent travelling can rarely be used in alternative ways) is included in a broader discussion of valuing travel time. The Bureau of Transport Economics (1999)

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[91] NECG cite Austroads' (1997) view as reported in Bureau of Transport Economics (1999).

suggests that travel time values are contextual and sensitive to driving conditions, the purpose of travel, the time of day and other factors.

808.NECG's values of time are high compared to similar measures used overseas and in New Zealand. The Austroads study,[92] for example, recommended values that are lower than the business figure used by NECG. In 1995 dollars, Austroads estimated that the value of travel time saved is A$21.80 per hour for paid private travel and A$6.81 per hour for unpaid private travel. America's Federal Aviation Administration (FAA) uses (in 1995) US$19 for leisure, US$34.50 for business and US$26.70 for all purposes.93 Transfund New Zealand recommends the following values (in 2001) for evaluating projects: for car drivers, $23.85 during work time, $7.80 while commuting and $6.90 for other non-work time; and for car passengers, $21.70 during work time, $5.85 while commuting and $5.20 for other non-work time. Similar values were estimated for corresponding travellers on public transport, in commercial vehicles, pedestrians and cyclists.[94]

809.The Commission's preliminary view is that scheduling benefits are overstated. While it is reasonable to assume that the hourly wage rate used to estimate values of time might be higher than that used by Transfund New Zealand (based on the assumption that air travellers earn higher incomes than other travellers), it is not reasonable to assume that the benefits of more convenient scheduling are best represented by a full hourly value of travel time saved. The reason is that, when schedules are known and reliable, those who travel at less convenient times will not be idle between their preferred travel time and when they are forced to travel. Moreover, given that New Zealand incomes are, on average, lower than those in Australia and the United States, it seems unlikely that $115 is a reasonable representation of the air traveller's hourly wage and ongoing costs.

TABLE 14
Annual Benefits from Scheduling ($ million)

NECG year 3	Commission
1.80	0.36

810.The estimate of $0.36 million might itself greatly exaggerate scheduling benefits. The calculation takes no account of passengers substituting between other flights, so the benefits in time savings will be overestimated. Given that they treat each link as independent, NECG's modelling has not taken account of network effects, nor has it considered inter-temporal substitution.

[92] Austroads 1997, *Value of Travel Time Savings*, AP 119, Austroads, Haymarket. See especially pp. 910, 12.
[93] S. Hoffer, F. Berardino, J. Smith and S. Rubin, *Economic Values for Evaluation of Federal Aviation Administration Investment and Regulatory Decisions*, FAA-APO-98-8, US Federal Aviation Administration, June 1998, p. E-2.
[94] I. Melsom, *Review of the Benefit Parameters Used in Transfund New Zealand's Project Evaluation Procedures*, Information Paper, Transfund New Zealand, February, 2003, pp. 13-14.

Question 57

The Commission seeks comments on its estimation of scheduling benefits?

Benefits from New Direct Flights

The Applicants' Claim

811.NECG estimated the benefits of time savings by being able to travel to particular destinations directly, rather than indirectly, under the counterfactual. Benefits of direct flights are projected to be around $13 million per year. New direct flights are anticipated (and declared in the Applicants' undertakings) to include flights between Auckland and Adelaide, by Air NZ, while Qantas would fly between Auckland and Hobart, Auckland and Canberra, and Wellington and Canberra. Time savings valued at $115 per hour and $23 per hour for business and leisure passengers respectively, and expected patronage on these services were the basis of benefit estimates.

Other Views Received

812.Critics of direct flight benefits from industry sources have asked the question: if these flights are profitable, why are they not now available? Current competition should allow the more efficient airline to serve these markets if it were possible to do so under the proposed Alliance. NECG answered that, under competition and where there are fixed costs, neither airline could "bind the other to act in such a way as to assure it of fixed cost coverage once it extends its product range". So the routes are profitable for a single airline, but not for one of two competitors. This assumes there is a business stealing effect of having two competitors, or that the market does not respond to lower fares and higher service levels. However, this market reaction is well documented and is implied by other parts of the NECG report. Other criticisms of these benefits concern travel time values and the assumed traffic levels on the new routes, both of which the critics argue are exaggerated.

The Commission's View

813.NECG appealed to QSI increases resulting from improved connectivity, marketing and sharing frequent flyer points in order to make the routes profitable under the proposed Alliance. Even so, the viability of the routes will depend both on how much demand can really be stimulated this way, and by the response of Virgin Blue, which has shown that it is willing to contest markets that the larger airlines are hesitant to enter. Furthermore, the proportion of the market sensitive to these non-fare service factors in the QSI is low and currently shrinking.

814.In the estimates of the benefits there is no consideration given to passengers who would shift from current indirect to direct flights, and what the distribution between business and leisure passengers might be. If there were direct services with no fare differences one might expect a pure transfer. But the gains to passengers may well be offset by the higher costs to airlines. Based on the uncertainty of the relationship between the proposed Alliance and the economic viability of these new direct services, the Commission's preliminary view is to estimate the public benefits of direct flights as being nil.

Question 58

The Commission seeks comments on its estimation of direct flight benefits?

Engineering and Maintenance

The Applicants' Claim

815.NECG stated that under the proposed Alliance, Qantas would "have an incentive to direct up to 80% of its subcontracted external heavy maintenance to Air New Zealand". Without the proposed Alliance, Qantas would seek out the "most cost-effective heavy maintenance agreements available in the region". [

] Only 10% of Qantas' heavy maintenance business might be available to Air NZ without the proposed Alliance. In 2001-02, Qantas directed 43% of business to Air NZ. In 2002-03 it will increase to 78% (NECG Report, p. 160).

816.The difference in gross expenditure on Air NZ's heavy maintenance services under the factual and counterfactual is $39 million, which is also the claimed annual benefit. As with the estimate of tourism benefits, engineering and maintenance gross export revenue is treated as a benefit.

The Commission's View

817.The Commission's preliminary view is to discount entirely the benefits from engineering and maintenance for several reasons. The estimate of only 10% of business going to Air NZ in the counterfactual would involve a great reduction in the amount of business currently directed to Air NZ. Qantas would seek the most cost-effective arrangements were the proposed Alliance not to proceed, implying that it is not already doing so and would not do so under the proposed Alliance. There is no justification for Qantas' Air NZ equity-holdings providing it with the incentive to engage Air NZ for up to 80% of heavy maintenance, especially given that it already purchases 78% of its requirements without an equity incentive. Finally, the claimed benefit is, like the tourism benefits, a measure of gross expenditure rather than welfare. As mentioned in the discussion of tourism, the correct measure is the change in welfare resulting from the purchase of engineering and maintenance services that is attributable to the proposed Alliance.

Question 59

The Commission seeks comments on its estimation of engineering and maintenance benefits?

Freight Benefits

The Applicants' Claim

818.Improved freight operations are projected to provide a relatively small stream of benefits to New Zealand. These benefits result from proposed additional freight services along with improved scheduling, cost savings and "the possibility that the two airlines could operate joint freighter services". Proposed additional freight services include "back of the clock" flights of 767 aircraft. The additional freight capacity on Tasman and Asian routes was valued at [ ] per tonne kilometre, an average yield figure. This is a gross figure, similar to the figures used by NECG to estimate tourism and engineering services benefits. The correct measure is the change to welfare in the air cargo market that is attributable to the proposed Alliance.

The Commission's View

819.The Commission's preliminary view is to discount freight benefits, as there may be significant detriments in the freight market resulting from reduced competition (see the discussion of the freight markets in the section on competition analysis). It is not clear that additional capacity projected on certain routes is guaranteed and were it to be realised, it is not clear how reduced competition may affect freight rates. The reduction in capacity under the factual may result in significant detriments to time-sensitive freight markets, for example flowers, fresh food and seafood. In cargo, three factors affect demand: uplift capacity (including frequency), destinations served and the number of carriers. Under the factual, two out of the three factors decline, so freight markets are likely to suffer.

820.NECG suggested that the barriers to entry in the market for freight services are low. It claims that in particular, dedicated freight carriers can enter the market and compete with freight services provided by passenger airlines. Regulatory barriers are low for entry to the freight market, as are sunk costs.

821.Operating costs are not low, however. For a dedicated freighter to fly profitably, it must carry a greater quantity of cargo than that carried in passenger aircraft belly holds. In contrast, passenger airlines' first imperative is to fill seats. They can operate profitably without carrying any freight. Consequently, while passenger airlines can profitably charge marginal cost freight rates, cargo airlines need to recover average costs. Scheduled cargo services are the exception rather than the rule, while belly hold space is available on most scheduled passenger services. Various industry participants have told the Commission that cargo airlines do not attempt to compete with the freight services offered by passenger airlines. Rather, they discover and develop niche markets. New Zealand is not enroute to major markets so therefore must rely more heavily on belly hold capacity. Also, "back of the clock" flights would be unlikely to be profitable.

822.On this basis, the Commission's preliminary view is that on a net basis, freight benefits flowing from the proposed Alliance are likely to be nil.

Question 60

The Commission seeks comments on its estimation of freight benefits?

Other Benefits

The Applicants' Claim

823.The NECG Report discussed but did not quantify a further range of benefits of the proposed Alliance. These included:

- improved governance;
- lower opportunity cost of capital;
- avoidance of deadweight cost of taxation;
- global competitiveness; and
- the preservation of the national flag carrier.

824.According to NECG, the proposed Alliance is expected to allow the New Zealand Government "to sell down its stake in Air New Zealand and/or avoid contributing further capital to the firm". NECG stated that benefits occur from the increased commercial incentives of the Air NZ board and management, and to the extent that government capital has a higher opportunity cost than private capital, society is better off.

825.Global competitiveness benefits are claimed to occur from having "a more robust and viable international airline" in the region. A final claimed intangible benefit is the preservation of a national carrier, whose viability is assumed to be affected by the proposed Alliance.

The Commission's View

826.The Commission believes that the cost of capital point is not correct. With government as a shareholder, the cost of capital should be low due to risk-spreading. If NECG is referring to profit, the opportunity cost is the same with or without the proposed Alliance since there are forgone opportunities, though under the proposed Alliance there is more profit. It is also not clear what the difference would be under the factual and counterfactual in the Government's requirement to hold Air NZ shares.

827.Additional benefits would occur because the proposed Alliance may avoid the need for the Government to use tax revenue to finance Air NZ. The use of taxes that fall on consumption and investment generates deadweight losses. Assessing this benefit would require an estimate of the probability and extent of future commitment of Government funds. It also assumes that taxes would decrease in the absence of the Government investment. The proper measure is the opportunity cost (in terms of forgone welfare) of using tax money in this endeavour rather than somewhere else.

828.There is some reason to credit the arguments concerning Air NZ's global competitiveness and its value as the national flag carrier.[95] But, as NECG pointed out, the benefits of these effects are difficult, if not impossible, to quantify.

829.In addition to the benefits raised by NECG, the Commission notes that public benefits could include the effect of the proposed Alliance on externalities. To the extent that the proposed Alliance would result in a reduced number of flights and different aircraft, then noise, safety and security externalities could be affected.

Question 61

The Commission seeks comments on its assessment of other benefits?

Question 62

Has the Commission omitted any significant benefits from its analysis?

Conclusion on Public Benefits

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

Source of benefit	NECG	Commerce Commission

[95] See, for example, J. Clougherty, 1996, "North American Airlines Mergers: Strategic Responses to Imperfectly Competitive International Markets", *Transportation Research Record*, No. 1517, Transportation Research Board, pp. 10-16. He suggests that anticompetitive airline mergers were permitted by North American governments in the late 1980s because they offered an increase in international competitiveness.

	Year 3	Present value of 5-year cash flows	Average annual estimate
Cost savings	74.6	332.8	32.4
Tourism	120.3	549.1	-2.6 to 13.5
Scheduling	1.8	19.7	0.36
New direct flights	7.1	26.3	0
Engineering and maintenance	30.3	151.8	0
Freight benefits	2.2	2.6	0
Total	236.3	1,082.3	30.2 to 46.3

830. The Commission's preliminary assumptions and estimates suggest that the annual public benefits attributable to the proposed Alliance would be in the order of $30.2 to $46.3 million, According to the Commission's calculations, the greatest potential source of benefits would be cost savings, and even these would be considerably less than the benefits projected by NECG.

831. The difference between the Commission's benefit assessment and that of NECG is attributable to three main factors:

- Cost savings are lower. As explained in sections on the counterfactual and detriments, the Commission rejects the Applicant's preferred counterfactual, and secondly, because the Commission's model of competitive detriments generates different fares, passenger numbers and capacity from those modelled by NECG. In the Commission's preferred counterfactual, Air NZ and Qantas allocate capacity on a more cost-efficient basis and do not sustain a mutually detrimental "war of attrition".

- The Commission uses a measure of the economic effects of tourism that expresses the impact as a welfare measure rather than using gross expenditure. The latter approach relied on by NECG suggests much larger benefits because it does not subtract the value that resources used in the activity might have generated were they not employed to supply tourism services.

- The Commission discounts various other benefits because it could not be confident in the assumptions on which they were based, and could not find that they were available only as a consequence of the proposed Alliance.

Question 63

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

Question 64

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

Question 65

Should the Commission consider any other issues in its assessment of public benefits?

BALANCING

832.The determination of the Applications involves a balancing of the public benefits and the detriments. Only where the detriments are outweighed by the public benefits can the Commission be satisfied that the proposed Alliance could be authorised.

833.The benefits and detriments resulting from the proposed Alliance might, and probably will, be realised from different times. Some effects will require investment, investigation and adjustment. Others could feasibly occur almost immediately following authorisation.

834.In general, the Commission expects that detriments will be generated more quickly than benefits. Airlines can and do change fare structures with great facility. Once co-ordination of fares were possible, it ought to be a simple matter to publish an updated schedule of fares. On the other hand, it might take a long period of research before overseas tourists respond to a Qantas Holidays promotion. Similarly, cost savings could be expected to lag well behind new fares as the airlines feel their way along their new, combined demand curve. Scheduling efficiencies could be a matter of trial and error while investing in serving new direct routes might be slower yet.

835.In this draft, the Commission has estimated single-period benefits and detriments, but has not discussed, in general, how quickly these effects take hold or how quickly they might grow to their expected annual value. The Commission has not attempted to adjust estimates to account for different timing. NECG, on the other hand, does adjust certain benefits in the first year or two. So, according to NECG, in year 1 there are no direct flight benefits, tourism benefits are less than half what they are projected to be in year 2, cost savings are smaller and there are projected detriments in the freight market, rather than the benefits that NECG estimate will occur from year 3. Despite the modesty of NECG's benefits estimates in the first two years, the Alliance is projected to offer significant public benefits in all five years modelled. Part of this may be attributed to the estimates suggesting that, while deadweight loss will be $49 million in year 1, it will only be $19 million in year 2 and around $30 million in the three years following. This variation can be partly attributed to NECG's assumptions about the timing, scale and scope of VBA entry.

836.Without adjusting for the different timing of benefits and detriments (an exercise which would, given the Commission's estimates and assumptions regarding VBA entry, weigh against the Application), the implications for public benefits, according to the Commission's estimates, are clear, as the following table shows. The Commission considers that the proposed Alliance would, most likely, generate negative public benefits in the order of $-264 million per annum. Even considering the highly unlikely scenario of detriments being at the low end of the range of estimates and benefits being at the high end, net public benefits would still be $-156 million. The least favourable estimates suggest net public benefits of $-402 million.

Even some of the elements of the least favourable estimates, as mentioned in the body of this draft, could in all likelihood overstate benefits and understate detriments.

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

	Applicants	**Commission**
Detriments	-10.3	-202m to -432
Benefits	236.3	30.2m to 46.3
Net Benefits	226	-155.7 to -401.8

837.On the basis of the information currently available to it, the Commission has formed the preliminary view that the benefits to the public likely to result directly from the proposed Alliance will not outweigh the detriments.

UNDERTAKINGS AND CONDITIONS

838.In granting an authorisation under s 67(3) of the Act, the Commission may accept written undertakings to dispose of assets or shares. The Commission can also grant an authorisation under s 61(6) of the Act subject to conditions not inconsistent with the Act and for such period as it thinks fit. A discussion of the relevant issues raised by the Applications is set out below.

Undertakings in Respect of Proposed Acquisition

839.Section 69A of the Act states:

> (1) In giving a clearance or granting an authorisation under section 66 or section 67 of this Act, the Commission may accept a written undertaking given by or on behalf of the person who gave a notice under section 66(1) or section 67(1) of this Act, as the case may be, to dispose of assets or shares specified in the undertaking.
>
> (2) The Commission shall not accept an undertaking in relation to the giving of a clearance or the granting of an authorisation under section 66 or section 67 of this Act, other than an undertaking given under subsection (1) of this section.
>
> (3) An undertaking given to the Commission under subsection (1) of this section is deemed to form part of the clearance given or the authorisation granted in relation to the acquisition to which the undertaking relates.

840.The Commission has the ability, in relation to authorisation applications, to accept written undertakings from Applicants to dispose of shares or assets. Such an undertaking would, if accepted, form part of the authorisation.

841.Section 69A(2) prohibits the Commission from accepting behavioural undertakings; for example relating to price, quality, capacity or service measures.

842.An acquisition that would receive authorisation without a divestment undertaking would not generally be made subject to such an undertaking. However, undertakings may be offered by Applicants if it were felt that a divestment would lessen or remove competition concerns so as to change the balance of detriment and benefit to enable an authorisation to be granted.

843.The Commission's Practice Note on divestment undertakings[96] notes that such undertakings must as a minimum specify:

- the particular assets or shares to be divested;
- the time period within which the divestment will occur;

[96] Practice Note 1 "Divestment Undertakings and Business Acquisitions: Practice and Procedures" (June 1997)

- the identity of any proposed purchaser, or if no particular purchaser is proposed, the mechanism for divestment and an assurance that the purchaser will not be interconnected or associated with the vendor; and

- any other relevant conditions relating to the disposal of the assets or shares subject to the undertaking.

844. The Applicants have indicated they would be prepared to enter into a number of conditions which are described in more detail below. None of the suggested conditions amount to structural undertakings.

845. The Commission's approach to authorisation applications is to consider the application on the basis of the terms submitted to the Commission. As the Applicants have not offered the Commission any specific structural undertakings, the Commission has not given substantive consideration to undertakings to divest assets or shares.

846. A number of submitters have, however, suggested that Air NZ dispose of Freedom Air[97]. The Commission notes that it does not have jurisdiction to insist upon structural undertakings such as the disposal of a subsidiary company. Further, Air NZ is on record as saying that Freedom Air is vital to the company's future success[98] and the Commission understands that such a divestment is not contemplated by Air NZ.

847. Given the submissions received, however, further submissions as to whether a third party acquisition of Freedom Air would assist to lessen competition concerns and alter the balance of detriment and benefit to enable authorisation to be granted would assist the Commission.

848. A third party acquisition of Freedom Air, which operates on certain Tasman routes (and has in the past flown on New Zealand main trunk routes), would appear to be likely to bring about the early entry of a value based airline to the Tasman market. That in turn might serve as a platform to enable further entry or expansion into the domestic New Zealand market.

849. The Commission notes, however, that the transfer of Freedom Air would not of itself constrain the Applicants from entering into price and/or capacity conduct in competition to Freedom Air. For example, Air NZ through an extension of the Express class offering to Tasman flights and/or Qantas, which owns two value based airlines, would be free, absent any restraint of trade provisions, to compete directly with Freedom Air.

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[97] The divestment of the wholesale and retail travel distribution businesses in New Zealand and the disposal of terminal services were also suggested by some submitters.

[98] Air NZ "Highpoints" Magazine, March – April 2003

850.The Commission also notes that Air NZ has suggested that were Virgin Blue to acquire Freedom Air that would, in effect, create a "dominant player" in the VBA market.

Conditions in Respect of the Proposed Arrangement

851.Section 61(2) of the Act states:

> "Any authorisation granted pursuant to section 58 of this Act may be granted subject to such conditions not inconsistent with this Act and for such period as the Commission thinks fit."

852.The Applicants noted in their section 58 Application that conditions might assist the Commission's consideration of the Application. They indicated that any conditions proffered should be designed to achieve the following objectives:

- to facilitate and protect new entry on trans-Tasman routes, including (if necessary) access to terminals, ground services and engineering facilities;
- to ensure that the Alliance will not take unreasonable actions relating to capacity and prices on routes where the Applicants will be the sole operators; and
- to ensure delivery of certain of the public benefits identified in the Application.

853.The Applicants have supplied the Commission with an outline of a suggested scheme of conditions to apply to certain trans-Tasman and New Zealand services ("Outline Undertakings")[99]. These conditions have been proposed to the Australian Competition and Consumer Commission ("ACCC") in the form of undertakings and the Applicants have indicated to the Commerce Commission that these undertakings, formulated as conditions, would be an appropriate starting point for discussion if the Commission considers conditions are necessary in order to meet the test for Authorisation.

854.The Applicants acknowledged that the Outline Conditions offered do not limit the Commission's ability under s61(2) to propose such conditions as may be considered appropriate.

855.The following points are relevant in considering when and what sort of conditions the Commission should impose[100]:

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[99] As proposed the undertakings would apply to city pairs between Australia and New Zealand and the city pairs between Auckland, Christchurch and Wellington in both cases where Qantas and Air NZ both operate flights but no other airline operates flights.

[100] *Re NZ Kiwifruit Exporters Assn (Inc)/NZ Kiwifruit Coolstores Assn (Inc)* (1989) 2 NZBLC 104, 485, 104,510-104,512; paras 7.4 and 7.10).

- the discretion given to the Commission appears to be wide, subject only to the important qualification of consistency with the Act;
- conditions designed to enhance competition or to remove detriments following from the absence of competition could be appropriate;
- conditions designed to help ensure the continuation or effectiveness of public benefit found to exist in respect of any application could also be considered;
- the enforceability of the conditions is important, particularly if used to "tip the balance" in favour of authorisation;
- the Commission will take into account considerations such as compliance costs for the parties, enforceability, precision, monitoring, etc when imposing such conditions; and
- it is important that any authorisation not hinder or stand in the way of an industry review or organisation. In such cases it may be necessary to grant the authorisation for a limited period only.

856.It is generally only where the Commission's preliminary view is that the benefits, absent conditions, do not outweigh the lessening of competition likely to result from the Alliance, that it is necessary for the Commission to give consideration as to whether conditions should be sought. Further, the Commission has discretion to impose conditions that are not inconsistent with the Act, it will normally only seek to impose conditions, after consultation, where the existence of such conditions would make the difference between granting and declining the authorisation.

Entry Facilitation and Protection

<u>Facilities</u>

857.The first suggested condition relates to facilitating and protecting new entry on the Tasman routes or New Zealand routes ("Facilities Condition"). The Facilities Condition is intended remove what might be seen as the barriers to entry for an airline entering the Tasman or main trunk markets.[101] The Applicants are willing to undertake to provide to a new entrant to these markets access to the following facilities and services at airports in Australia and New Zealand:

- airport gates;
- airport counter facilities;
- line maintenance services (including spares and parts as part of those services); and
- ground handling services.

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[101] See footnote 98 above. New Zealand routes means the city pairs between Auckland, Christchurch and Wellington.

858.These facilities and services would be provided for a maximum period of one year at each airport.

859.The proposed terms on which the facilities and services will be provided are as follows:

- at an equivalent rate and on similar conditions to those offered by the Applicants at the relevant airport to the other airlines with similar requirements (but disregarding terms attributable to global alliance membership and reciprocity); or
- where the facility or service is not provided by one of the Applicants to another airline at the relevant airport, on reasonable commercial terms.

860.The facilities and services do not include facilities or services:

- that are not necessary for the purposes of operating or maintaining the new entrant's flights Tasman or main trunk markets, as the case may be;
- that can reasonably or practicably be purchased or acquired by a New Zealand entrant;
- that are not effectively controlled by one of the Applicants at the relevant airport; or
- that cannot reasonably be provided by either of the Applicants, having regard to their capability based on current aircraft types in their fleets, their actual and reasonably anticipated schedules, operational or safety considerations, or legitimate business interests (for example, the necessity to incur capital costs in excess of NZ$100,000).

861. Where the Applicants and a new entrant are unable to agree on terms, the dispute will be referred to an independent arbitrator.

862.The Facilities Condition, and the provision of any facilities or services under it, would terminate two years after the date of satisfaction of the conditions precedent in the Alliance agreement (including grant of authorisation by the ACCC and the Commission and Air NZ shareholder approval) ("Effective Date").

<u>Capacity Ceiling Condition</u>

863.The Applicants are willing to undertake, in respect of those trans-Tasman city pairs and New Zealand city pairs on which, on the Effective Date, Air NZ and Qantas both operate flights and no other airline operates flights ("Regulated City Pair"), not to increase the Applicants' combined capacity on that city pair during the period of one year following the date on which a new entrant announces its intention to commence operating flights on that city pair, except as set out below ("Capacity Ceiling Condition").

864.The Capacity Ceiling Condition will be suspended in respect of any city pair:

- if the new entrant does not accept bookings within one month of announcing its intention to commence operating flights on that city pair;
- during periods of abnormal demand (for example, sporting or cultural events); or
- if the new entrant ceases to operate flights on that city pair.

865. The condition will not apply to:

- temporary increases in capacity for periods not greater than 14 days (for example, changing aircraft type to cover operational requirements such as planned and unplanned maintenance and engineering);
- increases in capacity announced by either Applicant prior to the new entrant's announcement of its intention to commence operating flights;
- increases in the combined capacity of the Applicants not exceeding 5% per scheduling season;
- the addition of one return flight per week; and
- increases in capacity made following the commencement of operation of flights by a new entrant and not exceeding 25% of the capacity operated on that city pair by the new entrant.

866. The following will not be treated as an increase in capacity on any city pair:

- for Air NZ, the replacement of B737 with A320 aircraft; and
- for each Applicant, the replacement of any aircraft series (for example B737-300) with another aircraft of the same type (for example B737-800).

867. The Capacity Ceiling Confition, and the restrictions, would terminate two years after the Effective Date.

Removal of Threat of Misuse of Market Power

<u>Capacity Floor Condition</u>

868. The following condition is designed to prevent the Applicants from restricting output and increasing prices in respect of routes on which the Applicants will be the sole operators as a result of the proposed Alliance.

869. The Applicants have suggested a condition, in respect of each Regulated City Pair, during the period of two years following the Effective Date, not to reduce the Applicants' combined capacity on that city pair, except as permitted below ("Capacity Floor Condition").

870. The Capacity Floor Condition would terminate in respect of any city pair immediately upon another airline commencing operating flights on that city pair.

871.The Applicants may reduce capacity on a city pair where load factors for a rolling three month period on that city pair are below historic load factors by 10% or more, but under no circumstances may the Applicants' remaining capacity be less than the capacity on the Effective Date.

872.The Applicants may reduce capacity, or cease operating, on a city pair for any period where there is a material reduction as a result of external shocks (for example terrorism or war).

Public Benefits

<u>New Services</u>

873.The Applicants have suggested the following conditions regarding the commencement of operations:

- eight weekly flights (four return services) between Auckland and Adelaide within one year of the Effective Date; and
- two weekly flights (one return service) on each of the following city pairs within one year of the Effective Date:
  - Auckland-Hobart;
  - Wellington-Canberra; and
  - Auckland-Canberra,

("New Services Condition")

874.The Applicants must continue operating flights on these city pairs for a period of one year.

875.The New Services Condition is subject to the negotiation of commercially acceptable agreements with the relevant airports (including on terms substantially the same as those currently provided to the Applicants).

876.The Applicants may reduce capacity, or cease operating, on a city pair set out above, for any period where there is a material adverse change to the financial returns earned by the Applicants on the relevant city pair.

877.The New Services Condition would terminate in respect of a city pair immediately upon another airline commencing operating flights on that city pair.

<u>Tourism Condition</u>

878.This proposed condition is intended to ensure that the Alliance results in a substantial increase in overseas tourists visiting Australia and New Zealand.

879.The Applicants have suggested a condition to be imposed that they spend an additional A$5.4 million in the one year following the Effective Date on costs directly associated with the implementation of the Qantas Holidays' business plan and designed to stimulate an additional 50,000 tourists to New Zealand (including 18,000 dual destination tourists) which includes A$1.75 million on direct sales and marketing ("Tourism Condition").

880.The A$5.4 million would be spent in conjunction with national and state tourism bodies where that was likely to maximise tourism flow.

<u>Freight Condition</u>

881.The Applicants have suggested a condition be imposed that they add two weekly return Tasman wide-bodied "back of the clock" services specifically for freight to each of Auckland and Christchurch within one year of the Effective Date ("Freight Condition").

882.The Applicants would be able to reduce capacity, or cease operating, the additional freight services to Auckland and Christchurch for any period where there was a material adverse change to the financial returns earned by the Applicants on that service.

Analysis of the Outline Undertakings (Conditions)

883.The Commissions preliminary view is that the Outline Undertakings (Conditions) would not as currently proposed ensure that the entering into, or the giving effect to the provisions of the Alliance, would in all the circumstances result, or be likely to result, in a benefit to the public which would outweigh the lessening in competition that would result, or be likely to result or be deemed to result from the Alliance.

884.However, the fact that they have been offered, indicates that the Applicants recognise there may need to be certainty as to the public benefits if the Application is to succeed.

885.The Commission notes the following matters in relation to the Outline Undertakings (Conditions).

<u>Facilities Condition</u>

886.The Facilities Condition:

- only applies to facilities not being used by the Applicants i.e. there is no implicit requirement to relinquish capacity, particularly at Sydney and Auckland where space at peak periods may be at a premium;
- may mean that the terms of licence fees are greater for a new entrant than the Applicants who it is suggested in submissions receive a margin;
- gives no guide to the quality of the facilities is given;

- is limited to a term of one year; and
- may represent no more than is currently required under "make available' requirements already in place at some airports.

Capacity Ceiling Condition

887.The condition:

- only applies to city pairs on which the Applicants are the sole operators e.g. Auckland - Sydney and Auckland - Brisbane are excluded as are any new routes not currently flown by any airline and on which an entrant might wish to commence service;
- permits increases in capacity following the commencement of operation of flights by a new entrant including up to 5% capacity per Scheduling Season, the addition of one return flight per week and up to 25% of the capacity operated on that city pair by the new entrant. This potential response to new entry is to be juxtaposed with the Applicants contention that they wish to reduce inefficient capacity; and
- is for a term of two years but is suspended in certain circumstances including if the new entrant ceases to operate flights on a city pair.

Capacity Floor Condition

888.The Capacity Floor Condition would:

- terminate in respect of any city pair immediately upon another airline commencing operating flights on that city pair and presumably would not be reinstated if the other airline abandoned service within the time period; and
- allow the Applicants to reduce capacity on a city pair where load factors for a rolling three month period on that city pair are below historic load factors by 10% or more, provided that the Applicants' remaining capacity is not less than the capacity on the Effective Date.

New Services

889.This is subject to:

- negotiation of commercially acceptable agreements with the relevant airports (including on terms substantially the same as those currently provided to the Applicants);
- the Applicants may reduce capacity, or cease operating, on a city pair for any period where there is a material adverse change (undefined) to the financial returns earned by the Applicants on the relevant city pair; and
- termination in respect of a city pair immediately upon another airline commencing operating flights on that city pair.

Tourism

890.The undertaking stops short of guaranteeing that the Alliance will result in an increase of 50,000 additional overseas tourists visiting New Zealand.

Freight

891.The Applicants have a very broad ability to reduce capacity, or cease operating, the additional freight services to Auckland and Christchurch for any period where there was a material adverse change to the financial returns earned by the Applicants on that service.

892.The Commission also queries what effect this will have on current trans-Tasman freighter competition and the impact of Air NZ's move from 767's, which can accommodate containerised loading of freight to A320's which must be loaded by hand.

Practical Considerations

893.Aside from detail specific concerns, a number of practical considerations also need to be taken into account by the Commission in considering whether conditions (based on the Outline Conditionsor otherwise) might be appropriate. In this regard the Commission notes:

- to be effective in a complex and dynamic market (such as the airline industry) they may need to be so intrusive as to likely stifle competition and competitive processes[102];
- enforcement of conditions can be difficult and of necessity will only occur after a breach;
- they require frequent monitoring; and
- by their nature, they are inflexible and unresponsive to market changes.

Question 65

The Commission seeks comment on the likely effectiveness of the conditions suggested by the Applicants.

Question 66

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

[102] Similar concerns are identified in the ACCC Merger Guidelines in relation to undertakings

DRAFT DETERMINATION

894. The Commission's preliminary conclusion is that it is not satisfied that the proposed Acquisition would not have, or would not be likely to have the effect of substantially lessening competition in a range of affected markets, and is not satisfied that the proposed Acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted. In considering the proposed Acquisition, the Commission has taken account of the interdependent proposed Arrangement.

895. The Commission preliminary conclusion is that it is not satisfied that the proposed Arrangement would, in all the circumstances, result or be likely to result, in a benefit to the public that would outweigh the lessening in competition that would result or be likely to result. In considering the proposed Arrangement, the Commission has taken account of the interdependent proposed Acquisition.

896. If these two conclusions are confirmed, following consideration of submissions on this draft determination, the Commission would decline to grant an authorisation to either Application under ss 67(3)(c) and 61(6) of the Act.

APPENDIX 1

International Airlines – Routes and Rights under International Air Services Licences and ASAs Summarised

Airline	Country	Current Routes	International > Tasman Frequency	Basis of Operations	Potential Routes based on Unused Air Rights
Aerolineas Argentina	Argentina	Sydney – AKL – Buenos Aires	Twice weekly	Own aircraft	▪ Not limited under IASL to Buenos Aires – AKL, can operate from any point in Argentina. ▪ ASA does not limit operations in NZ to AKL. ▪ IASL allows operations from Buenos Aires – AKL to be via intermediate points in South America the South Pacific. ▪ ASA allows for operations to 2 points in Australia. ▪ Unlimited capacity under IASL and ASA.
Air Caledonie International	France (New Caledonia)	AKL – Noumea	3-4 times a week	Own aircraft	▪ Not limited under IASL to Noumea – AKL, can operate from any point in New Caledonie. ▪ IASL does not limit operations in NZ to AKL, can also operate to/from CHC. ▪ IASL allows for services from AKL to operate beyond to Papeete (Tahiti) on a code-share basis with a designated airline of France, NZ or Chile. ▪ Capacity under IASL and ASA all presently being used. ▪ ASA provides for 5th freedom rights.
Air Canada (Star Alliance)	Canada	Los Angeles-AKL	LAX-AKL twice daily	Code-share on Air NZ and United Airlines	▪ IASL provides for unlimited code-share services with airlines having a NZ IASL and the necessary capacity from Canada to NZ (optionally via intermediate points) and beyond. ▪ ASA allows for own aircraft operations from Vancouver or Toronto to NZ, up to 4 return services a week. ▪ ASA provides for intermediate points and exercise of 5th freedom rights in a number of points in the South Pacific and Australia

Airline	Country	Current Routes	International > Tasman Frequency	Basis of Operations	Potential Routes based on Unused Air Rights
Air NZ (Star Alliance)	NZ	NZ Domestic Trans-Tasman (SYD, MEL, BNE, PTH, CNS) Pacific Islands ▪ AKL-Apia ▪ AKL-Nadi ▪ AKL-Tahiti Asia ▪ AKL-Nagoya ▪ AKL-Osaka ▪ AKL-Osaka-Toyko ▪ AKL-HK ▪ AKL-Taipei ▪ AKL-Singapore Los Angeles-AKL, SYD Los Angeles -Tahiti-Rarotonga-AKL London-Los Angeles	Daily except as follows: LAX-AKL twice daily AKL-Singapore twice daily AKL-Osaka twice daily AKL-Taipei twice daily AKL-Tahiti twice daily	1 Singapore flight code-share SIA 1 Taipei flight code-share EVA Air	*Not analysed in detail for each route – rights not fully utilised overall.*
Air Pacific (46.32% owned by Qantas)	Fiji	Pacific Islands ▪ AKL-Nadi ▪ AKL-Suva ▪ SYD, MEL-Nadi	Daily	Own aircraft	▪ Not limited under IASL to Nadi and Suva – AKL, can operate from any point in Fiji. ▪ IASL does not limit operations in NZ to AKL, can also operate at CHC and WLG. ▪ IASL allows operations Fiji – AKL to be via 1 intermediate point in the South Pacific. ▪ Unlimited capacity under IASL. ▪ ASA provides for services to operate beyond to a number of points in Asia, the south Pacific and west coast USA. ▪ ASA provides for 5th freedom rights.

Airline	Country	Current Routes	International > Tasman Frequency	Basis of Operations	Potential Routes based on Unused Air Rights
Air Tahiti Nui	Tahiti	Trans-Tasman Pacific Islands ▪ AKL-Tahiti (Papeete)	Weekly to Tahiti	Code-share trans-Tasman on Qantas	▪ IASL allows services Tahiti – AKL to operate beyond to Sydney on own aircraft (not just by code-share). ▪ Extra capacity under IASL Tahiti – AKL – 2 return A340 per week own aircraft and 2 return code-share services per week. ▪ ASA provides for services to operate beyond to a number of points in Asia, the south Pacific and west coast USA. ▪ Capacity under IASL not presently being fully used. ASA provides for more capacity on top of IASL capacity.
Air Vanuatu	Vanuatu	Pacific Islands ▪ AKL-Vanuatu	Twice weekly	Own aircraft	▪ ASA allows services Vanuatu – AKL to operate beyond to 1 point in South Pacific, and also allows for 1 intermediate point. ▪ Capacity under IASL and ASA all presently being used. ▪ ASA provides for 5th freedom rights.
American Airlines (**oneworld**)	USA	Trans-Tasman Los Angeles	Daily	Code-share on Qantas	▪ IASL provides for unlimited code-share services from USA to NZ (optionally via intermediate points) and beyond. ▪ ASA allows for unlimited own aircraft operations. ▪ ASA provides for 5th freedom rights.
Asian Express (Australian owned SAM airline – working for DHL)	Australia	Trans-Tasman ▪ AKL-Sydney AKL-Samoa-Honolulu	Daily trans-Tasman	Own aircraft	▪ IASL provides for unlimited services from any points in NZ to any points in Australia. ▪ IASL provides cabotage rights.
British Airways (**oneworld**)	UK	Trans-Tasman Los Angeles Asia ▪ AKL-HK	Daily	Code-share trans-Tasman and to LAX on Qantas; AKL-HK on Cathay Pacific	▪ IASL provides for largely unlimited code-share services UK to NZ (optionally via intermediate points) and beyond; but exercise of 5th freedom rights is limited to 7 services a week. ▪ ASA allows for own aircraft operations.
Cargolux	Luxembourg	MEL-AKL-LAX Asia ▪ AKL-HK	Weekly	Own aircraft	▪ IASL and ASA allow for unlimited operations NZ – Luxembourg (via intermediate points) and beyond. ▪ ASA provides for 5th freedom rights.

Airline	Country	Current Routes	International > Tasman Frequency	Basis of Operations	Potential Routes based on Unused Air Rights
Cathay Pacific (**oneworld**)	Hong Kong	Asia ▪ AKL-HK	Daily	Own aircraft	▪ Not limited under IASL to Hong Kong – AKL, can operate to any point in NZ. ▪ ASA allows operations from Hong Kong – NZ to be via Melbourne. ▪ Capacity with own aircraft under IASL and ASA all presently being used; unlimited capacity available on code-share basis. ▪ ASA provides for 5^{th} freedom rights.
EVA Air	China	Asia ▪ AKL-Taipei ▪ CHC-Taipei	Twice weekly out of AKL, 3-4 times a month out of CHC	Own aircraft	▪ IASL allows operations from Taiwan – NZ to be via unlimited intermediate points. ▪ Agreement with Taiwan provides for unlimited beyond points. ▪ Capacity under IASL and Agreement with Taiwan not all presently being used. ▪ Agreement with Taiwan provides for 5^{th} freedom rights.
Freedom Air (100% owned by Air NZ)	NZ	Trans-Tasman	Daily	Own aircraft	▪ Unlimited capacity—not fully utilised. ▪ Can operate to any destination in Australia.
Garuda Indonesia	Indonesia	Trans-Tasman Asia ▪ AKL-SYD-Bali	Twice weekly	Own aircraft	▪ Capacity under IASL and ASA not all presently being used – ability to operate one further service return a week. ▪ Agreement with Taiwan provides for unlimited beyond points.
Japan Airlines	Japan	Asia ▪ AKL-CHC- Osaka	Daily	Code-share on Air NZ	▪ Only operating services on 1 of 4 routes available under IASL (and ASA); routes also available to Tokyo (optionally via Nadi), Nagoya and Fukouka. ▪ Capacity under IASL and ASA not all presently being used. ▪ ASA provides for own aircraft services. ▪ Other intermediate and beyond points are available under ASA. ▪ ASA provides for 5^{th} freedom rights.

Airline	Country	Current Routes	International > Tasman Frequency	Basis of Operations	Potential Routes based on Unused Air Rights
KLM Royal Dutch Airlines (KLM/ Northwest)	Netherlands	Trans-Tasman Europe		Code-share on Malaysian Airlines	▪ IASL provides for up to 7 code-share services a week from the Netherlands to AKL via Kuala Lumpur. ASA soon to be signed will provide for the same number of own aircraft services and code-share services via London. ▪ ASA provides for 5th freedom rights.
Korean Air (Sky Team)	Korea	Pacific Islands ▪ AKL-Nadi Asia ▪ AKL-Incheon	Twice weekly to Fiji, twice daily to Korea	Own aircraft	▪ Not limited under IASL to Incheon – AKL, can operate from any point in Korea. ▪ IASL does not limit operations in NZ to AKL, can also operate at WLG and CHC. ▪ IASL allows operations Korea – NZ to be via intermediate 2 points in Australia and 1 point in Oceania. ASA provides for unrestricted intermediate points and beyond points ▪ Capacity under IASL and ASA all presently being used. ▪ ASA provides for 5th freedom rights.
Lan Chile (**oneworld**)	Chile	Trans-Tasman Sth America ▪ SYD-AKL-Santiago	Daily	Code-share trans-Tasman on Qantas	▪ IASL provides for optionally flying via Tahiti. ASA provides unrestricted intermediate and beyond points. ▪ Capacity under IASL and ASA not all presently being used—unlimited capacity available. ▪ ASA provides for 5th and 7th freedom rights, as well as cabotage rights.
Lufthansa (Star Alliance)	Germany	Trans-Tasman Asia ▪ AKL-HK ▪ AKL-Singapore ▪ AKL-SYD-Bangkok ▪ AKL-BNE-Bangkok Los Angeles MEL-AKL-Honolulu	Daily except as follows: LAX-AKL twice daily 2-3 times weekly MEL-AKL-Honolulu	HK and Singapore Code-share Air NZ SYD, BNE and Bangkok code-share Thai Airways	▪ None of rights and capacity for own aircraft services being utilised – up to 5 return services a week under IASL, unlimited under ASA. ▪ Unlimited code-share capacity available. ▪ Unlimited intermediate and beyond points. ▪ Can operate to/from any point in NZ, not just AKL. ▪ ASA provides for 5th freedom rights, as well as 7th freedom cargo rights. ▪ MOT advise that Lufthansa Cargo has applied for an IASL (currently code-share Air NZ).

Airline	Country	Current Routes	International > Tasman Frequency	Basis of Operations	Potential Routes based on Unused Air Rights
Malaysia Airlines (KLM/ Northwest)	Malaysia	Trans-Tasman Asia ▪ AKL-Kuala Lumpur ▪ AKL-Brisbane-Kuala Lumpur	5 times a week via BNE, 2 times a week direct ex AKL	Own aircraft	▪ Unlimited capacity—not fully utilised. ▪ Unlimited intermediate and beyond points. ▪ ASA provides for 5^{th} freedom rights.
Mexicana (Star Alliance)	Mexico	Los Angeles-AKL	LAX-AKL twice daily	Code-share Air NZ	▪ IASL provides for unlimited code-share services from Mexico to NZ (optionally via intermediate points) and beyond. ▪ ASA allows for unlimited own aircraft operations.
Polynesian Airlines	Samoa	Trans-Tasman Pacific Islands ▪ AKL-Tonga-Samoa ▪ AKL-Samoa-Niue ▪ SYD-AKL-Tahiti ▪ SYD-AKL-Tonga ▪ SYD-AKL-Niue ▪ SYD-Tonga	Daily services to varying destinations out of AKL, SYD services less frequent	Own aircraft	▪ Unlimited capacity—not fully utilised. ▪ Unlimited intermediate and beyond points. ▪ ASA provides for 5^{th} – 9^{th} freedom rights.
Qantas Airways (**oneworld**)	Australia	Aust Domestic Trans-Tasman Pacific Islands ▪ AKL-Tahiti Asia (ex Aust) Los Angeles-AKL, SYD Other USA (ex Aust) London-Los Angeles Europe (ex Aust) Sth America (ex Aust) Sth Africa (ex Aust)	Daily	AKL-Tahiti code-share with Air Tahiti AKL-Sth America (Santiago) code-share Lan Chile	▪ Unlimited capacity—not fully utilised. ▪ Unlimited intermediate and beyond points. ▪ ASA provides for 5^{th} freedom rights, plus cabotage rights.
Royal Tongan Airlines	Tonga	Pacific Islands ▪ AKL-Tonga	Twice daily	Own aircraft	▪ Unlimited capacity—not fully utilised. ▪ Unlimited intermediate and beyond points. ▪ ASA provides for 5^{th} freedom rights.

Airline	Country	Current Routes	International > Tasman Frequency	Basis of Operations	Potential Routes based on Unused Air Rights
Singapore Airlines (Star Alliance)	Sinapore	Asia ▪ AKL-Singapore ▪ CHC-Singapore	AKL-Singapore twice daily, CHC daily	1 ex AKL flight code-share Air NZ	▪ Unlimited capacity—not fully utilised. ▪ Unlimited intermediate and beyond points. ▪ ASA provides for 5th freedom rights, plus cabotage rights.
Thai Airways (Star Alliance)	Thailand	Trans-Tasman Asia ▪ AKL-SYD-Bangkok ▪ AKL-BNE-Bangkok	Daily via SYD, 5 times a week via BNE	Own aircraft	▪ Can operate to/from any point in NZ, not just AKL. ▪ Capacity under IASL fully utilised, more capacity available under ASA. ▪ IASL and ASA provide for unrestricted intermediate points. ▪ ASA provides for beyond 2 points in South Pacific. ▪ 3rd – 5th freedom rights available under ASA. ▪ Unlimited code-share capacity under ASA.
United Airlines (Star Alliance)	USA	Trans-Tasman Pacific Islands ▪ AKL-Apia ▪ AKL-Nadi Los Angeles-AKL,SYD Los Angeles -Tahiti-Rarotonga-AKL Other USA ▪ AKL-LAX-Chicago ▪ SYD-San Francisco	Daily except as follows: LAX-AKL twice daily SYD-San Francisco 4 times a week	Nadi, trans-Tasman, Apia and LAX code-share Air NZ	▪ Unlimited capacity—not fully utilised. ▪ Unlimited intermediate and beyond points. ▪ ASA provides for 5th freedom rights.

The following airlines have IASL but are presently not operating any services (own aircraft or code-share) to/from NZ:

- Air China
- China Airlines
- Delta Air Lines
- Evergreen International Airlines
- Federal Express
- Solomon Airways
- World Airways

APPENDIX 2
MODELLING THE MERGER OF MULTIPLE PRICE FIRMS

INTRODUCTION

1. A key feature of the markets for passenger air services is the range of prices available for similar service offerings. For a given flight, airlines typically offer a variety of prices to prospective travellers, with the highest prices often exceeding the lowest by several hundred percent. Airlines practice this price discrimination by attaching conditions (known as "fences") to cheaper flights to discourage those who are price insensitive from purchasing their travel more cheaply. For example, a requirement for a weekend stay with a low priced return flight makes this option unattractive to business people, despite offering a relatively low price.

2. A single pricing firm with a substantial degree of market power would be expected to earn an above-normal return by setting its price above the competitive level. Where that firm is able also to price discriminate, it would be able to earn more profit by raising price for those buyers who are price insensitive, and lowering price for those who are price sensitive. In this way it is able to earn more of the surplus that would otherwise accrue to consumers.

3. Price discrimination need not necessarily lead to a firm earning excessive profits. In industries characterised by high fixed costs and low marginal costs, a price set at the competitive level of marginal cost would leave the firm unable to recoup its fixed costs. If such a firm were able to price discriminate, it might be able to set its lowest price equal to marginal cost, so that total output would equal that produced in competitive conditions, yet set progressively higher prices for those buyers falling higher up its demand curve. To do so would require it to be able to identify different classes of customers with differing propensities to pay, and to prevent those who would pay a higher price from buying at a lower. Overall, if the firm's total revenue, over all prices, were equal to the sum of fixed and variable costs, then it would be making only normal profits.

4. Price discrimination is most often analysed with respect to a monopolist, which sets a schedule of prices and, if fences are effective, sells the quantity at each price as determined by the market demand curve. In like manner, one of a small group of price discriminating oligopolists sets a schedule of prices, but its quantity sold at each price is determined by its *residual* demand curve. A firm's residual demand curve determines what quantity that firm can sell at a given price, given the market demand, the supply (real and anticipated) of other price discriminating firms and any product differentiation. The firm's residual demand curve implicitly incorporates all of these factors.

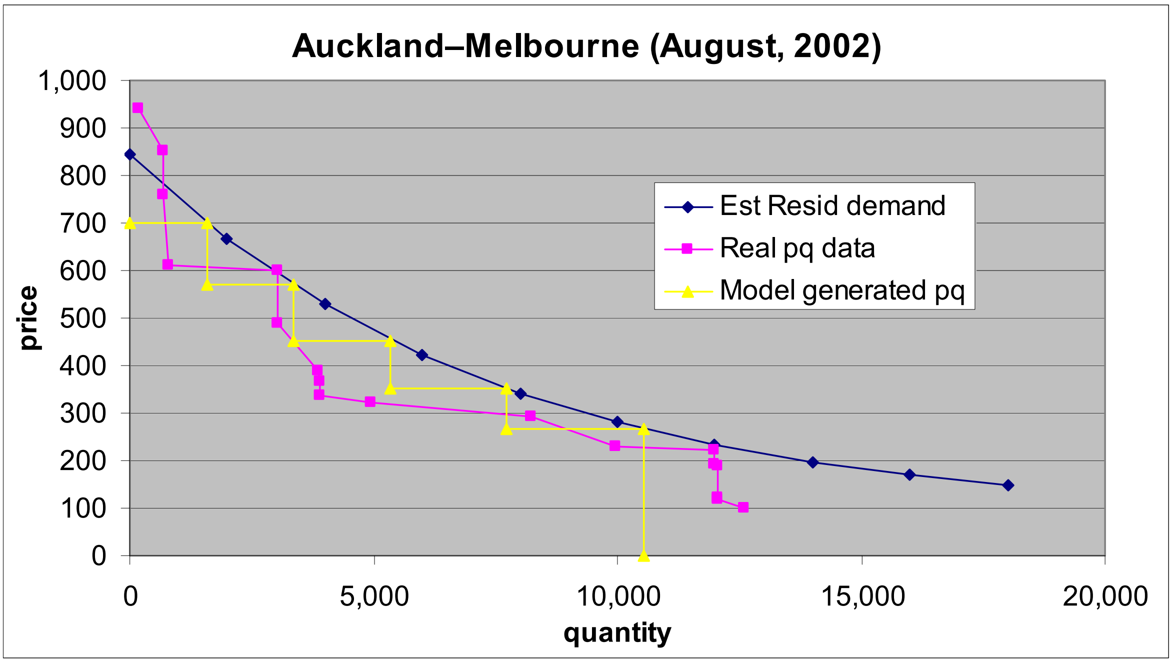
ALLIANCE BETWEEN PRICE DISCRIMINATING AIRLINES

5. If the incumbents' residual demand curves could be estimated directly, they could provide a short-cut route for modelling the impact of the proposed Alliance, and would avoid the need to make possibly arbitrary assumptions about market demand price elasticity and the nature of the rivalrous interaction between the firms. Then in the factual, and absent entry, the likely price discriminating behaviour of the allied entity can be inferred. In this way, the impact of the proposed Alliance on prices and quantities can be modelled.

6. In response to a request by the Commission, the two Applicants have made a significant amount of price / quantity data available on the various routes they fly. Modelling work using this data has been undertaken in an effort to better understand the effects a merger might have in a multi-price market.

7. Data on what quantities a price discriminating firm has sold at what prices enables the residual demand curve to be constructed. Estimated residual demand curves for a number of routes pertinent to the Application were able to be generated in software for both parties for each month over the last three years. An example is shown in Figure 1 for Air NZ on the Auckland–Melbourne route for August, 2002. The route currently has Air NZ with a 45% share (Qantas has the remaining 55%). The real price / quantity data line provides clear evidence of price discrimination on this route. The residual demand curve was estimated using the following functional form: $p = b(m^q) + c$ where b and m are estimated for each route-period using Excel's LOGEST function, which gives a "best-fit" curve for the real price quantity points. However the firms' true residual demand forms an upper envelope, rather than a best-fit, curve for the price quantity points and so c, a "lift" parameter, has been calculated. c has been set at a value such that the profit maximising price quantity points generated within the model against the estimated residual demand are those that provide a revenue equal (plus or minus 1%) to actual revenue.

FIGURE 1



8. Simulating the choice of optimal price / quantity pairs is done in code by using Excel's numerical optimiser, Solver. Given an estimated residual demand curve determined as above, and a measure of marginal cost (taken as the lowest substantial – in terms of quantity sold – discount fare) the computer code generates quantities that the airline should sell at each of a set number of different prices in order to maximise profit. (The model was separately run with three and five different price bands) The profit maximising quantities were generated against the (route-period specific) objective function:

$$\max_{q_1,\ldots q_5} \pi = \sum_i p_i q_i - \sum_i c q_i$$

where the p_is are a function of q as determined by the residual demand function as described above, that is:

$$p = b(m^q) + c$$

9. The next step in the analysis of detriments is to construct a residual demand curve for the Alliance. This has been modelled by postulating one of the parties to the Alliance exiting that route but leaving their capacity – i.e. exit does not cause capacity shortages. The approach in the literature[103] is to shift the residual demand curve of the remaining player by the amount previously supplied by the exiting player[104]. Treating supply as fixed in this way encapsulates the Cournot player's perspective of taking the supply of others in the market as given; it leaves the slope of the residual demand curve unchanged. This might be regarded as conservative; it could be argued that are should rather add the supply *function* of the exiting firm to the remaining firm's residual demand. This would make the slope of the aggregated residual demand curve steeper, since supply is typically increasing in price.

10. Where the supply of other firms is price elastic—which would be the case if an airline were already flying that route—and in the segment for price-insensitive passengers, the parallel outward shift of the residual demand by the amount previously supplied by the "exiting" party is likely to overstate the effect of the Alliance. However on routes where the parties currently supply most of the market, and entry or expansion is difficult, it will be a reasonable characterisation. Further, it is worth noting that price-insensitive passengers are by definition relatively more impressed by branding and other forms of horizontal product differentiation, and so are likely to be more difficult to woo by a non-Alliance airline.

11. While the approach is novel it has the following advantages:

    - It is built from detailed data supplied by the parties.
    - It addresses the multiplicity of prices in the market.
    - Post-transaction supply is determined within the model.

12. Table 1 shows the results of this modelling for those routes that have sufficient data. For this run the number of price levels has been set at 5. The figures assume a counterfactual of the status quo, and are based on monthly data for the 2000, 2001 and 2002 calendar years. Dead weight loss figures are annual.

TABLE 1

Route	Reduction in output	Net Deadweight loss $NZ
AKL-APW	0.4%	2,756
AKL-BNE	11.0%	2,606,518
AKL-CHC	15.3%	5,140,614
AKL-LAX	24.0%	4,127,813
AKL-MEL	21.6%	3,400,220
AKL-NAN	2.3%	19,763
AKL-PPT	8.2%	217,919
AKL-SYD	14.7%	4,456,386
AKL-TBU	0.2%	1,472

[103] See for example Carlton and Perloff, Modern Industrial Organization 2nd Ed pp235, Tirole, The Theory of Industrial Organization pp213.
[104] Staff deliberated on whether this is appropriate for price discriminating firms and several other possibilities were explored. The final view of staff is that this approach is applicable to multiple price markets although the resulting weighted average price rise is more sensitive to where the combined residual demand is estimated to be under multiple prices.

Route	Reduction in output	Net Deadweight loss $NZ
AKL-WLG	17.1%	7,304,344
BNE-CHC	15.5%	394,204
BNE-WLG	14.2%	208,180
CHC-MEL	16.4%	536,651
CHC-SYD	12.6%	777,979
CHC-WLG	5.9%	476,493
CHC-ZQN	18.4%	706,993
MEL-WLG	20.4%	640,623
SYD-WLG	19.1%	1,376,058
SYD-ZQN	18.1%	90,531
Total		**32,485,517**

Comments:

- Deadweight losses were calculated against the estimated combined residual demand curve using model-generated quantities for total factual and counterfactual output. As a result, dead weight losses for routes where other carriers currently have substantial capacity will be underestimated although this may be cancelled out by the tendency of the model to over estimate quantity reductions on those routes.
- The argument might be made that the output shrinkage is arbitrary and that firms might put in another price band nearer to marginal cost so increasing output and reducing welfare losses. It is true that the models inbuilt restriction to a number of price bands under both scenarios may induce the result of a loss of output however there is a significant body of literature, both theoretical and empirical, that finds the spread of prices under price discrimination is reducing in market concentration and, in particular, that the lowest fares are higher in more concentrated markets[105].
- The intuition for some routes having larger losses than others is consistent with the greater competitive constraint provided by the parties to each other on these routes under the status quo.
- DWL figures shown do not include transfers.
- Inspection of the data suggests that 5 price levels may be too many. When the model was configured to run with 3 price levels, predicted dead weight losses were greater than those shown in Table 1. They were approximately $85m under that setting.

[105] See James D. Dana Jr, "Equilibrium price dispersion under demand uncertainty: the roles of costly capacity and market structure", *RAND Journal of Economics*, Vol 30 No 4 Winter 1999 and Joanna Stavins, "Price discrimination in the airline market: the effect of market concentration", *Review of Economics & Statistics*, Feb2001, Vol. 83 Issue 1

APPENDIX 3

Technical Specification of the Gillen Model

Consider a Cournot model in which there are three firms, two FSAs and one VBA. The firms are indexed 1 for Qantas, 2 for Air NZ and 3 for a VBA. The two FSAs can be considered to be incumbent firms that may compete to varying degrees ranging from highly competitive to alliance (effective cartel). These firms may have different costs, and the differences can arise in either fixed entry costs (f) or variable cost, c_i components. The demand function is linear but there is product heterogeneity. The price functions for the three firms can be written, in general form as:

$$P_1=a_1 - b_1[\qquad] + e_{12}q_2 + e_{13}q_3 \qquad (1)$$
$$P_2=a_2 - b_2[\qquad] + e_{21}q_1 + e_{23}q_3 \qquad (2)$$
$$P_3=a_3 - b_3[\qquad] + e_{31}q_1 + e_{132}q_2 \qquad (3)$$

Equations 1 through 3 indicate that the prices faced by the three airlines depend on their output and the e_{ij} parameters, which measure the degree of <u>horizontal</u> product differentiation. If $e_{ij}=b_i$ the products of the all firms are completely independent of each other; they are not substitutes since a change in q_j will have no impact on P_i.[106] If $e_{ij} = 0$ it implies the products are perfect substitutes. <u>Vertical</u> product differentiation would be considered as a different value of a, the demand intercept term. Given the demand by firm, i, for example, the residual demand curve for firm j would have a particular value for a, a_j, and this will reflect an assessment by the market of any amount of vertical product differentiation. If this differentiation should change, a_j would shift up or down to reflect a different residual demand.
The cost functions can be written as:

$$C_i = f_i + c_i q_i \qquad i= \text{QF, TE and VBA} \qquad (4)$$

where f is the fixed cost of entry and c_i is the incremental cost of output, which could be further divided into flight costs and passenger costs.
The profit function for each firm can be written as:

$$\Pi_i = P_i q_i - C_i$$

or

$$\Pi_i = q_i[\qquad\qquad] - f_i - c_i q_i \qquad (5)$$

The profit maximizing level of firm i's output is:

$$\frac{d\Pi_i}{dq_i} = a_i - 2b_i q_i - (b_i - e_{ij})q_j - (b_i - e_{ij})q_i \frac{dq_j}{dq_i} - (b_i - e_k)q_k - (b_i - e_{ik})q_i \frac{dq_k}{dq_i} - c_i = 0 \qquad (6)$$

The conjectural responses of the firms with respect to rivals' output changes are indicated by dq_i/dq_j. We can write these as:

[106] This is a more general version of the Haugh-Hazledine (1998) model in which they treat two incumbents who offer identical products and a third entrant airline with a differentiated product.

$$\frac{dq_2}{dq_1} = (1+\lambda_1) = \frac{dq_1}{dq_2} \qquad 7a$$

$$\frac{dq_3}{dq_1} = \lambda_e = \frac{dq_3}{dq_2} \qquad 7b$$

$$\frac{dq_1}{dq_3} = \lambda_E = \frac{dq_2}{dq_3} \qquad 7c$$

These conjectures assume that firm 1 and 2 treat themselves as equals and would respond in the same way to a change in the output of the other. The reason for this is that the outputs are assumed to be identical. Equation 7b indicates that firm 3 will respond in the same way should either firm 1 or 2 enter the market, and 7c indicates that firms 1 and 2 will respond in the same way should firm 3 enter the market. We would expect $\lambda_E > \lambda_e$ by a large amount; which could be written as $\lambda_E = \theta\ \lambda_e$ where $0 < \theta < 1$. This implies that the incumbent FSAs would respond in a vigorous manner should a VBA enter, but the VBA would be less vigorous in its response should a FSA enter its market.

The profit maximizing equations can be simplified if we make some assumptions regarding the cross-price effects, i.e., what happens to customers lost to an airline should the other airline match its (*quality adjusted*) fare increase. We make the following assumptions to reduce the number of parameters required to solve the model:

$$Let\ A = b_1 - e_{12} = b_2 - e_{21} \qquad or \qquad \frac{dP_1}{dq_2} = \frac{dP_2}{dq_1}$$

$$Let\ B = b_2 - e_{23} = b_1 - e_{13} \qquad or \qquad \frac{dP_2}{dq_3} = \frac{dP_1}{dq_3}$$

$$Let\ D = b_3 - e_{32} = b_3 - e_{31} \qquad or \qquad \frac{dP_3}{dq_1} = \frac{dP_3}{dq_2}$$

which mean that the small cross-price effects cancel out for the incumbent firms when they change prices. If a firm changes price a customer will be lost, but if the other carrier responds with the same price change the customer would return, provided conditions are the same. This means that changes in the prices of full service airlines, like TE and QF, have the same effect on one another. If they were perfect substitutes the value of A would be a in the demand function. However, various factors including national preference will mean something less than perfect substitution.

B indicates the cross-price effects of a change in the entrant's price is the same for both incumbent firms, and D means the cross-price effects of a change by either incumbent firm on the entrant is the same. However, note that $A \neq B \neq D$. This means some horizontal product differentiation can be introduced into the model. The profit maximizing conditions can therefore be written as:

$$\Pi_1^* : a_1 - 2b_1q_1 - Aq_2 - Aq_1(1+\lambda_1) - Bq_3 - Bq_1\lambda_e = c_1 \qquad 8a$$

$$\Pi_2^* : a_2 - 2b_2q_2 - Aq_1 - Aq_2(1+\lambda_1) - Bq_3 - Bq_2\lambda_e = c_2 \qquad 8b$$

$$\Pi_3^* : a_3 - 2b_3q_3 - Dq_1 - Dq_3\lambda_E - Dq_2 - Dq_3\lambda_E = c_3 \qquad 8c$$

Equations 8a-8c indicate that the profits of each firm are dependent on the output decisions of rivals. However, it is also clear that other objective functions would reflect the same interdependence.[107] The Cournot model is robust for objectives such as sales or revenue maximization.

The total revenue for firm i can be written as:

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[107] See Steven Sklivas, "The Strategic Choice of Incentives", *Rand Journal of Economics*, Vol. 18, No. 3. (Autumn, 1987), pp. 452-458; and Chaim Fershtman and Kenneth L. Judd, "Ownership Incentives in Oligopoly", *American Economic Review*, Vol. 77, No. 5. (Dec., 1987), pp. 927-940.

$$TR_i = P_iq_i = aq_i - b_iq_i^2 - (b_i\text{-}e_{ij})q_iq_j - (b_i\text{-}e_{ik})q_iq_k \qquad (9)$$

from which marginal revenue can be derived. Letting $\lambda_E = \theta\,\lambda_e$ we can solve for the profit maximizing Cournot outputs of the firms, q_i^C. These are as follows:

$$q_1^C = \frac{a_1 - Aq_2 - Bq_3 - c_1}{\left[2b_1 + B\lambda_e + A(1+\lambda_1)\right]} \qquad 10a$$

$$q_2^C = \frac{a_2 - Aq_1 - Bq_3 - c_2}{\left[2b_1 + B\lambda_e + A(1+\lambda_1)\right]} \qquad 10b$$

$$q_3^C = \frac{a_3 - Dq_1 - Dq_2 - c_3}{\left[2b_3 + 2D\theta\lambda_e\right]} \qquad 10c$$

This represents three equations in three unknowns provided we have full information on the demand and cost functions.
Using this framework we can also solve for the competitive reactions:

$$\lambda_1 = (a_1 - c_1)\frac{1}{Aq_1} - \frac{1}{A}\left(2b_1 + B\frac{q_3}{q_1} - B\lambda_e\right) - \frac{q_2}{q_1} \qquad 11a$$

$$\lambda_e = (a_2 - c_2)\frac{1}{Bq_2} - \frac{1}{B}\left(2b_2 + A\frac{q_1}{q_2} + A(1+\lambda_1)\right) - \frac{q_3}{q_2} \qquad 11b$$

The change in price resulting when moving from a Cournot market to an alliance market is:

$$\frac{P_i^A - P_i^C}{P_i^C} = \frac{\varepsilon_{ji}\left(\varepsilon_{ij} + \varepsilon_{ii}\right)^{s_j}\!\big/_{s_i}}{\varepsilon_{ii}\left[\varepsilon_{jj}\left(\varepsilon_{ii} - 1\right) - \varepsilon_{ji}\left({}^{s_j}\!\big/_{s_i} + \varepsilon_{ij}\right)\right]} \qquad 12$$

We can also solve for the profit-maximizing values of output and price if the firms are sales or revenue maximizers.

$$q_1^R = \frac{a_1 - Aq_2 - Bq_3}{\left[2b_1 + B\lambda_e + A(1+\lambda_1)\right]} \qquad 13a$$

$$q_2^R = \frac{a_2 - Aq_1 - Bq_3}{\left[2b_1 + B\lambda_e + A(1+\lambda_1)\right]} \qquad 13b$$

$$q_3^R = \frac{a_3 - Dq_1 - Dq_2}{\left[2b_3 + 2D\theta\lambda_e\right]} \qquad 13c$$

Comparing equations 13a–c with equations 11a–c, it is evident that a sales- or revenue-maximizing firm will produce more output than a profit-maximizing firm in Cournot competition, and will therefore also have lower prices than profit-maximizing ones. However, sales maximizers will have lower output and higher prices than a highly [ ] competitive firm.
If we were to solve for the values of conjectures as in equations 11a and 11b, the values would differ between profit-maximizing and revenue-maximizing firms; the marginal cost would not be included. This implies, and can be shown, that the competitive reactions would be 'more aggressive' under revenue- than

profit-maximization. The magnitude of the substitution terms would be an important factor in influencing these conjecture values as well.