Air New Zealand Limited/Qantas Airways Limited

UPDATED EXECUTIVE SUMMARY

On 9 December 2002, Qantas and Air New Zealand ("the parties") lodged applications for authorisation of an Alliance with the New Zealand Commerce Commission and the Australian Competition and Consumer Commission (the "NZCC" and "ACCC" respectively). Since that date, the parties have had extensive interactions with the Commissions; the Commissions have received submissions in respect of the applications from a wide range of interested parties; the issues raised by the applications have been the subject of considerable media attention; and of course, international aviation and the context in which the parties operate have not stood still. It is therefore appropriate for the parties to restate and update the key arguments they put to the Commissions at the time of initial filing.

In doing so, the parties start from the fact that both the Australian and New Zealand Governments have for some time been, and now plainly are, strongly committed to economic integration. The important initiatives they have adopted – including the Closer Economic Relations agreement, and the Single Aviation Market – have brought the Australian and New Zealand economies together in ways that create an ever greater commonality of interests in which our long term economic prospects are effectively intertwined.

But while markets are integrated across the two sides of the Tasman, the competition policy process is not. This creates a risk that the Commissions may not recognise the commonality of interests that a Single Aviation Market has encouraged.

The reality, as will be clear from the discussion below, is that the future of Air New Zealand is at the heart of this authorisation. The Alliance creates a framework in which Air New Zealand will not merely survive but also maximise its contribution to the welfare of New Zealand and the region. In contrast, without the Alliance, Air New Zealand's long term prospects are uncertain at best.

An outcome in which Air New Zealand was not viable would not be in the long term interests of either economy. It would undermine the aviation infrastructure of the two economies and harm New Zealand's economic prospects. The parties believe the ACCC should take this into account in considering whether authorisation should be granted.

That said, the parties are confident that the Alliance is, and has been shown in their submissions to be, clearly in the interests of both economies, just as it is very much in the interests of both airlines. Given this, the parties believe that they have every right to expect the Alliance to be authorised.

Authorisation is intended to provide a means for allowing conduct that meets the wider interests of the community to go ahead, even though that conduct might otherwise be in breach of the competition laws. It would be inconsistent with the proper role of the Commissions, with the substance and purpose of the statutes, and with the wider interest of the two economies, to convert the requirements for authorisation set out in the statutes into a test that imposes an onus that could not be

practically met. Rather, where there are convincing grounds for believing that the conduct will likely generate benefits that outweigh its detriments, then authorisation can and should be granted.

The parties believe that developments since they submitted their initial applications confirm the substantial net benefits the Alliance will bring to both Australia and New Zealand. In reviewing those developments – including questions put by the Commissions and the views expressed in third party submissions – since filing, five factors stand out:

1. the commercial basis for the transaction is even clearer and more compelling now than it was originally;

2. VBA expansion onto Tasman and domestic New Zealand routes, which was considered to be highly likely in the parties' initial analysis, can now be taken to be certain, reducing even further the limited competitive detriment from the Alliance;

3. the benefits of the Alliance to both economies have been underscored and confirmed by further analysis carried out by the parties. This economic outcome is also evidenced by the support received from both the New Zealand and Australian Governments;

4. the credibility of the parties' modelling of the net gains the Alliance brings – net gains which, in the parties' submission, clearly warrant the grant of authorisation – has been tested in and highlighted by the process of public scrutiny; and

5. the parties have offered enforceable commitments that are sufficient to meet any residual concerns.

Subsequent sections of this overview cover each of these.

The Commercial Basis for the Alliance

Since the parties' applications were filed, it has become even more apparent that global aviation is undergoing far-reaching change. United Airlines' move into Chapter 11 bankruptcy protection reflects a range of factors specific to its situation; importantly, however, it also highlights the difficulties Full Service Airlines ("FSAs" or "network carriers") have in adjusting to increasingly intense competition from their Value Based Airline ("VBAs", also often referred to as "low cost carriers") rivals. It is estimated that in liberalised markets such as New Zealand and Australia, VBAs, even in their current business model, could claim large shares of the short haul airline market, with the scope to expand beyond that as they move to offer some features (such as loyalty programs) previously associated primarily with network carriers.

The success of VBAs reflects the fact that only a relatively small share of the potential market values those features closely associated with FSAs – such as full interlining, reservation systems capable of handling complex itineraries, additional leg room, in-flight catering, loyalty programs and frequent flyer lounges – sufficiently highly to bear the costs they entail. As a result, the impact of VBA competition is to erode the

revenue base available to sustain the FSA model, even in its most efficient forms. In a market where there is a VBA, the scope for that market to support overlapping FSAs is therefore far smaller than it has ever been in the past.

These developments are not prospective – they are fully at work in today's markets. In effect, the rise of VBAs has already irreversibly affected both the carriers' and the public's perceptions of acceptable fare levels. In markets where VBA competition is well entrenched, as is the case in Australia, expectations of fare levels have moved sharply down, with consumers coming to expect and demand fares that only a few years ago would have been thought unsustainable. In other markets, where VBA competition is imminent, it has become plain that carriers that do not adjust fares down risk being punished by the travelling public when lower cost alternatives come into the market. While this brings clear gains to the travelling public, it means that the yield levels that may once have sustained high costs in aviation markets are well and truly gone.

FSAs, if they are to survive, must therefore act now both to reduce costs and to refine and better target the service offerings which make them distinctive. In particular, in the competitive landscape FSAs face, they must seek to make the best use of the connectivity and other advantages their extensive networks provide.

However, it is not only the challenge from VBA competition that is relevant. Faced with recurrent crises in global aviation, ever-closer alliances have been forged between major carriers worldwide. Competition authorities have recognised the benefits these alliances can offer in terms of wider network reach, enhanced convenience and lower costs, and – though at times imposing conditions on their operation – have largely allowed the alliances to proceed. The result is that world aviation is being reshaped, with the emergence of close integrated alliances between network carriers that – in contrast to the marketing alliances such as Star and **one**world – potentially could evolve into global players. This process will only develop in the years ahead.

Here too, the implications for FSAs are clear. As aviation markets become more integrated internationally, the rewards will go to those carriers who can use a strong position in their home markets to best project their competitive assets into other parts of the world.

It is against this backdrop that the alternatives the parties face need to be considered. It is unrealistic to think that Qantas can simply withdraw from New Zealand to its historical home market, all the more so as Virgin Blue expands its operations across the Tasman. Rather, absent the Alliance, each party will want to secure as great a share as it can of the contestable customer base in the Single Aviation Market of both Australia and New Zealand, so as to reduce its costs, preserve and enhance the value of its long haul operations, and increase its distinctiveness relative to what a VBA can offer.

In practice, this means that absent the Alliance, at the same time as they are being pressured from below by Virgin Blue, the parties will increasingly target exactly the same base of customers – a base that, as the results of market surveys made available to the Commissions clearly show, places great value on frequency in selecting among

competing carriers. Inexorably, this will lead to a continuation of the growth in the capacity the parties offer into the markets in which they compete.

Just how wasteful this process is has been highlighted by the parties' analysis – an analysis discussed in more detail below. However, to say it is wasteful does not mean it will not occur. Rather, the reality is that the parties have competed on this basis for some time, and absent the Alliance will do so for as long as they can into the future.

This competition is free neither of costs nor of risks.

Faced with strong and growing VBA competition in its home market and the susceptibility of its long haul routes to severe competitive pressure, Qantas faces a clear need to strengthen its regional position in its longer term interests. A prolonged battle with Air New Zealand would do little to enhance Qantas' ability to meet the challenge of the very difficult markets in which it operates.

That said, it is a matter of commercial reality that the costs and risks inherent in the current situation are greatest for Air New Zealand. Air New Zealand has engaged in a range of initiatives aimed at enhancing its competitiveness. Some of the fruits of these initiatives are now apparent. However, it is important to neither overstate the outcomes achieved nor understate the remaining vulnerabilities.

The fact of the matter is that the gains made to date, and manifested in Air New Zealand's most recent financial reports, are heavily influenced by one-off factors that may not be durable and certainly will not continue to improve.

To begin with, a not insignificant part of the recent improvement reflects conjunctural developments – the strengthening of the New Zealand dollar, some weakening of effective fuel prices, and the cyclical pattern of major maintenance expenses[1]. As the very high volatility of airline net income surely confirms, these factors cannot be expected to remain positive into the medium term.[2] The possibility of serious disruption to world aviation markets as a result of an escalation of conflict in the Middle East only underscores this assessment.

At the same time, the gains secured from competitive developments are also essentially short-term. In particular, the move to the Air New Zealand Express service in domestic New Zealand has allowed costs to be reduced without any loss, as yet, of share in the higher yield market segments. However, these gains will not persist once Qantas scales up its competitive presence in those segments, including by providing capacity and thereby frequencies that more closely match Air New Zealand's. So too, the imminent withdrawal of United from New Zealand has resulted in substantial gains in revenues, and allows the shift of capacity from Air New Zealand's

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[1] Maintenance expenses fell by NZ$ 41 million between the latest half-year result and the corresponding prior period. With regard to fuel prices, each 1% reduction in fuel price increases Air New Zealand's Net Profit Before Tax by approximately 2%. Although fuel prices increased in the most recent period, the higher nominal prices were more than offset by favourable exchange rates and gain on hedging. A stronger NZ$ also helped to reduce Lease and Interest costs.

[2] While the global airline industry's average annual earnings between 1980 and 1998 were US$ 1.1 billion, the average change in Net Income from year-to-year was US$ 2.2 billion. Simply put, the volatility of industry earnings, as measured by the Standard Deviation as a percentage of average earnings, was 416% over this period. This is a very high degree of income volatility by any standard.

unprofitable services to the US out of Sydney to the now more profitable flights between the US and New Zealand. But here too these gains will be subject to erosion as Qantas matches the increased Air New Zealand capacity.[3] Adding to these pressures, Virgin Blue's expansion across the Tasman and into domestic New Zealand – with the intention, confirmed in Virgin Blue's submission, of contesting all segments of the travelling public – will reduce margins from serving these routes, which are of obvious significance to Air New Zealand's overall financial position. And, as these competitive developments play themselves out, marketing expenses, which have been declining,[4] will need to rise to attract and retain customers, so that costs are likely to increase as yields fall.

The medium term outlook for Air New Zealand is therefore still substantially adverse – far more so than a focus on short term outcomes might suggest. As confidential material provided to the Commissions makes clear, Air New Zealand's prospects outside the Alliance involve a "war of attrition" that it will fight if it must, but which it is poorly placed to win.

What is important here is that Air New Zealand faces a substantially greater challenge than it ever has in the past. Until now, Air New Zealand's domestic competitors were substantially weaker than it was. Both Ansett New Zealand and then Tasman Pacific operated a poorer fleet than Air New Zealand's, had higher costs and offered substantially lower connectivity. The inroads they could make into domestic revenues were therefore very limited and Air New Zealand could rely on those revenues to fund its substantially less profitable overseas operations.

This is plainly no longer the case. The impending expansion of Virgin Blue into Air New Zealand's markets means that competition at the discount end of the market will become substantially more intense. At the same time, Qantas, operating directly on the domestic New Zealand routes, is obviously a more formidable competitor than its predecessors ever were.

Whether domestic New Zealand could ever sustain two FSAs is perhaps an interesting question; but what is surely plain is that the aviation revenues it generates cannot sustain **three** airlines competing head to head. Some market consolidation is therefore inevitable.

In considering Air New Zealand's prospects in that consolidation process, the central fact is that there is a substantial asymmetry between Air New Zealand's position and that of Qantas. What matters here is not only that Qantas is some six times the scale of Air New Zealand, or that the Australian domestic sector is both larger and growing at a higher trend rate; rather, it is that that there are few obstacles, if any, to Qantas' continued expansion in New Zealand while there are no realistic options for Air New Zealand to establish a viable presence in Australia.

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3 Additionally, there is every reason to expect a US carrier to enter or re-enter the route. There are very few major routes, if any, out of the US on which a US carrier does not offer service. There is therefore no reason to expect US-New Zealand to remain served entirely by carriers from this part of the world.

4 Reduced commission rates, greater direct bookings and favourable exchange rates have helped reduce Air New Zealand's Sales & Marketing expenditures. These diminished by some NZ$41 million in the most recent period compared to the prior period.

Qantas can therefore draw on far greater resources – not only financially, but also and especially of network depth and breadth – in competing for Air New Zealand's traditionally profitable customer base. Additionally, the constraints on Air New Zealand will become all the tighter as Virgin Blue expands across the Tasman and into domestic New Zealand, effectively "squeezing" Air New Zealand between the expected growth of Virgin Blue and Qantas. The revenue base on which Air New Zealand can rely to fund its survival will consequently become ever smaller than that available to its rivals as the "war of attrition" proceeds.

There are clear parallels here to the dynamics that ultimately destroyed Ansett, both in Australia and New Zealand.

Viewed with the benefit of hindsight, it is of course easy to suggest that management decisions, made over a long period of years, contributed to Ansett's demise, as did the instability of Ansett's shareholding structure. However, it would be a serious error to overlook or downplay the structural causes of Ansett's predicament and the substantial limits these imposed on the range of actions that management could have taken.

Central to these market structural causes of weakness was the asymmetry of position between the carriers contesting domestic Australia – with Ansett seeking to compete on a full service basis with a rival whose network entirely enveloped its own. Thus, even before Virgin Blue entered domestic Australia, Ansett, lacking any serious international revenue base, could not profitably compete with a stronger player capable of contesting every segment of its customer base and with the added advantage of substantial international connections. Reflecting this, Ansett's earnings, although fluctuating over the years, were never sufficient post-deregulation to cover its cost of capital. It was this which forced Ansett to rely on an outdated and increasingly unreliable fleet, driving its operating costs up and precipitating the grounding it suffered. Ansett's position – despite at times successful attempts at cost cutting and at launching new services – was therefore structurally precarious when VBA entry occurred in the second half of 2000.

That VBA entry, while increasing the industry's cost base, left aggregate revenues virtually unchanged (the increase in volumes being just matched by the fall in fares, as is usually the case in aviation); the margins which had previously allowed Ansett to operate on a cash-positive basis were therefore no longer there. Squeezed between a lower cost carrier at the discount end of the market, and a carrier with substantially greater network reach at the other, Ansett's situation, despite a strong brand and a large and seemingly loyal customer base, quickly became unsustainable.

Air New Zealand is all too aware of the risks inherent in situations such as these. Indeed, over a period of many years, successive attempts have been made at establishing a viable base in Australia – a base which is ultimately indispensable for profitable survival in the Single Aviation Market. Those attempts have repeatedly failed.

The dangers this lack of a viable base in Australia now creates must be seen against the backdrop of a prolonged period in which Air New Zealand has failed to recover its

cost of capital. Indeed, even on current financial performance, earnings are still well short of full, economic, cost recovery, and the gap has tended to widen since the mid-1990s. As a result, even if the current gains were not reversed, Air New Zealand's shareholders would eventually have to underwrite its operations, covering the gap between the earnings the airline can achieve and what private capital markets demand and expect. As Air New Zealand's situation deteriorated, as it would were a 'war of attrition' to play itself out, the call on shareholders' funds would become all the greater. In that event, absent substantial capital injections, retrenchment would ultimately be inevitable.

It is true that Air New Zealand enters into this process with some advantages relative to Ansett. Its costs are lower, as is the cost penalty it suffers relative to Virgin Blue. Its fleet is more modern and well maintained, and its revenue base is broader than was Ansett's. However, it too faces sharp constraints both on how much further it can cut costs while retaining an attractive product and on its ability to finance outlays that are needed to secure its future.

That these constraints impose hard choices is obvious even now. For example, Qantas is upgrading its long-haul business class product and its in-flight entertainment systems in all cabin classes; Air New Zealand must finance the investments this requires, and failure to do so would affect the yield and share it can secure on its long haul operations. In an industry in which small losses in yields and in market share can lead to large deteriorations in financial performance, it is important to be realistic about the long run consequences of disparities such as these.

There is no certainty that these consequences will eventuate, but it would be foolish to understate the risks they involve. The role these risks have played in the decisions taken both by the Board of Air New Zealand and by the New Zealand Government, in its role as majority shareholder, attests to their significance and makes it incumbent on the Commissions to give them weight in considering the alternatives to the Alliance.

That the Alliance materially eases these risks is obvious. What is important, however, is that it also brings a wide range of other benefits to the parties. In particular, by combining their forces, the parties will be able to reduce their costs, enhance the reach of their networks and offer better service to customers both in our region and globally. The Alliance offers, in other words, a framework in which both airlines can stand their best chance of being competitive domestically and internationally.

Air New Zealand, for example, will obtain from the Alliance significantly better scope for services from and to Europe via Asia,[5] as well as increased connectivity to Qantas' domestic network. Qantas too will gain by having full access to Air New Zealand's domestic network and to its greater international connectivity out of Auckland, while the carriage of Air New Zealand passengers through the Kangaroo Route will strengthen Qantas' crucial hub at Singapore. At the same time, the

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[5] Air New Zealand currently transfers passengers primarily onto Singapore Airlines for flights out of Singapore to Europe and other destinations. Although Singapore Airlines offers very substantial connectivity out of Singapore, schedules are not closely aligned, leading to situations where effective transit times for Air New Zealand passengers can be long. In contrast, under the Alliance, there would be mechanisms and incentives for close alignment of schedules – as has occurred under the Qantas-BA Joint Services Agreement.

combined passenger base will make possible new direct flights, both within the region and likely more widely, increasing the value of the parties' networks overall. These changes in turn will make it easier for the two airlines to develop new fares and services and to attract new customers, most notably tourists, thereby helping to cover the very high fixed costs of their long haul networks. Working together, the parties will thus be more competitive, efficient and sustainable participants in global aviation markets.

VBA Entry and the Competitive Detriment

It is the prospect of these commercial gains that underpins the Alliance. The parties have always accepted, however, that the tests for authorisation would centre not on the commercial motivations for the Alliance, but on an assessment of whether any competitive detriment it causes is outweighed by public benefit.

At the time of filing, the parties, in analysing the competitive detriment, considered it highly likely that Virgin Blue would move relatively quickly to contest at least the Tasman, and if the Alliance went ahead, domestic New Zealand. Since then, Virgin Blue has confirmed that that it intends to contest all these routes "with or without the Proposed Alliance".

The parties have no reason to believe that a player such as Virgin Blue would compete on the routes at issue on any scale other than one likely to have a material effect. The low level of any barriers it may face to continued expansion – all the more so given the enforceable commitments the parties are willing to make – means that even if its initial presence is modest, which is unlikely, the competitive pressure it exercises will not be. Rather, experience internationally confirms the very substantial effect that the presence of VBA competition in a market has on that market's dynamics, forcing prices down and outputs up.

Inevitably, there have been comments that the parties themselves could, by their strategic conduct, obstruct this process. More specifically, it has been said that it would be more difficult for a VBA to successfully enter a market served by a single player.

These claims are simply wrong as a factual matter. In effect, the bulk of successful VBA entry worldwide has been into markets served by a small number of players, and most often, a single incumbent FSA.[6] Indeed, it is precisely in these markets that the VBA entrant can benefit most greatly by offering customers a choice. There is no reason to believe, or evidence to show, that incumbents can anti-competitively prevent VBA entry or expansion from occurring. The enforceable commitments the parties have offered – commitments aimed at facilitating entry on what would otherwise be sole-supply sectors – make it even less plausible that such anti-competitive obstacles to VBA entry or expansion could arise in the areas affected by the Alliance.

This is not to say that entry or expansion are ever riskless. However, as has been confirmed time and time again, VBAs go into this process with decided advantages –

[6] This also applies to Virgin Blue which has expanded its route structure greatly since Ansett's collapse, generally into sectors served only by Qantas.

most obviously, a significantly lower cost base and a more carefully focussed product and business model, free of the legacy constraints that affect their FSA rivals. These advantages are such that properly managed VBAs have repeatedly succeeded in securing substantial revenue shares even in the face of opposition from strong incumbent carriers.

This obviously does not mean that the parties will in any way withdraw from those segments of the market in which Virgin Blue will have the greatest competitive advantages – far from it. Both the parties long have been and remain fully committed to contesting all segments of the market; and they believe that it is in the interests of the travelling public for them to do so.

The future with the Alliance will therefore be one in which competition will intensify in all segments of the market. This can and must frame the Commissions' consideration of the Alliance's competitive effects. Richardson J. stressed this point, in the AMPS-A decision, when he emphasised that though BellSouth had not yet entered the relevant market, the fact that it was going to do so, offering a more efficient product, meant that:

> *But for the interconnection question it might even be argued that if anyone is in a dominant position it is BellSouth, that is taking a reasonable time frame within which competitive activity will be taking place. In any event the reality of BellSouth's entry must constrain Telecom as the incumbent in its present pricing and other market policies.*[7]

The competitive detriments caused by the Alliance must, in other words, be assessed taking fully into account Virgin Blue's now confirmed intention to contest the market.

Seen in that light, the competitive detriments estimated in the NECG Report are extremely conservative, as even with the Alliance, the market will remain effectively competitive. Rather, absent the Alliance, it is likely that Air New Zealand will become progressively less effective as an element in the competitive process, since it will be squeezed between Virgin Blue's aggressive expansion and Qantas' need to provide a sustainable level of frequency and service. The resulting erosion of Air New Zealand's position is not an enhancement of the competitive process but rather would cause harm to consumers, to competition and to the long term health of the region's aviation infrastructure.

The Benefits from the Alliance

While the competitive detriments are slight, the parties believe that the benefits to both economies from the Alliance are substantial.

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[7] Telecom Corporation of New Zealand Ltd v Commerce Commission (3 NZLR 1992) at 445 per Richardson J. Richardson J also notes, at 443 (emphasis added), that in assessing market power (in that case for the purpose of a dominance test, but nothing turns on the height of the threshold) "... a prospective development [BellSouth's effective entry] should not be disregarded *merely because it entailed looking two years into the future*." Equally Cooke P notes that allowance has to be made "for the quite intense competition which Telecom is likely to face *before long*." (at 439 per Cooke P, emphasis added).

Cost savings

An important part of these benefits arises from cost savings relative to the counterfactual.

Inevitably, there have been changes to the counterfactual since the time of filing. United Airlines' announced withdrawal from New Zealand, which is obviously a development beyond the parties' control, is by far the most important. Its effects are magnified by the fact that it has also resulted in Air New Zealand's redeploying the aircraft it used to fly between Australia and the United States to replace the capacity United is withdrawing. These changes, significant though they are, do not alter the basic result that the Alliance permits substantial cost efficiencies to be obtained.

Understandably, the Commissions, as well as a number of submitters, have probed the issue of how much confidence can be placed in the counterfactual. From the parties' perspective, it is a fact of life that aviation markets are highly uncertain. That said, the parties have made their best efforts to develop separate counterfactuals that are plausible in the light of experience, that are consistent with the methods they use to determine route capacity and frequency and that closely reflect the advice each party has provided to its Board in considering the commercial desirability of the Alliance. While outcomes will undoubtedly differ from expectations, there is no reason to believe there is any bias in the way the counterfactuals have been framed.

Additionally, the parties completely reject any suggestion that the counterfactuals they have developed, and which form the basis for the main counterfactual used in NECG's modelling, involve conduct that is in any way predatory or extreme.

Rather, it is apparent from a consideration of the historical record that the capacity trends built into the counterfactual are fully consistent with recent trends – indeed, the capacity growth they involve on the Tasman is only slightly greater than that suggested by historical experience. Moreover, those capacity decisions reflect sound commercial considerations consistent with ordinary airline practice. Finally, it would be absurd to say that decisions that – even on the most conservative modelling – result in price falls and output increases of some 4 to 5 percent could be predatory or extreme.

As well as being fully credible, the cost savings identified by the parties are achievable and sustainable. The parties will face strong and indeed intensifying competition across their networks, including from a VBA that has already secured a high share of revenues on the routes it contests. Enjoying the benefits of a 'quiet life' is simply not an option the parties have open to them. Nor could the parties afford to dissipate the savings – say in providing too generous conditions to input suppliers – without threatening their continuing viability. Rather, the parties have, and will continue to have, every incentive to pursue and achieve the greatest cost savings and productivity gains they can.

What is true is that the Alliance minimises the risks of Air New Zealand facing a "death spiral" that could lead it, like Ansett, to collapse or significant retrenchment. However, avoiding the high social costs such collapses entail is a benefit to society, not a cost.

Finally, the Alliance will not in any way blunt the incentives to innovate. In fact, the parties, faced with growing VBA competition, will have to offer customers better value for money, including by developing new fares, providing a wider range of destinations and emphasising the connectivity and reach their networks offer. The need to remain competitive on long haul routes, where the parties face some of the industry's strongest and most innovative players, will make the pressures to remain at the forefront of new service development all the greater. By also allowing the parties to better benchmark their own services and operations against those of their Alliance partner, and to pool their investment in new product and process development, the Alliance will facilitate the parties' response to this challenge rather than retard it.

As a result, there is no valid basis for discounting in any way the cost efficiencies the parties have submitted for the Commissions' considerations.

Scheduling and direct services

As well as cost efficiencies, the Alliance will provide other, substantial, benefits.

Improved scheduling and more direct flights are of obvious importance in this regard. There is little doubt that FSAs, when they compete head-to-head, schedule flights so as to each secure a share of the high yield segments of the market. The result is wing-tip scheduling using smaller aircraft, which reduces the availability of discount fares and the convenience of travel for the public. Consolidating the parties' customer bases will allow flights to be better distributed over the day, producing a closer alignment between flight schedules and customers' preferences about departure times. In turn, a wider spread of departure times and the combined management of inventory will make it possible to offer more low yield fares at the off-peak times.[8]

Exactly the same competitive forces that lead to inefficient wing-tip flying impede the parties, in the absence of the Alliance, from offering a wider range of direct routes. It is the parties' experience that even when only one carrier offers a direct service, that carrier secures only a share of the customers travelling between the points the direct service links. Rather, a substantial number of customers, because they prefer to fly on the other carrier, accept the inconvenience of using an indirect service, eroding the viability of the direct flight. Here too, the Alliance, by combining the parties' customer bases, will increase the number of routes that are served directly.

Overall, the Alliance will therefore ensure that the travelling public secures the benefits of an increased choice of departure times and of a greater range of direct services – benefits that are of clear value to consumers in both countries.

Tourism

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[8] Combined inventory management is important because when the parties manage a larger inventory, they can more readily accommodate any unexpected increase in the number of full fare passengers. Knowing that they will be able to do so makes it possible for them to pre-sell a larger share of the stock of available seats. This pre-selling typically involves significantly lower prices than are charged to customers buying seats at close to departure time.

The benefits of the Alliance in terms of enhanced tourism will also be very significant.

To understand the Alliance's impacts on tourism it is important to understand the role of the parties in the promotion of tourism. Air New Zealand and Qantas are by far the largest commercial organisations involved in the promotion of tourism to this part of the world. The reason they invest so heavily in tourism and its promotion is simple: securing in-bound tourism is crucial to covering the very high fixed costs the parties' long haul networks entail. Given these fixed costs, the parties have every incentive to seek to expand in-bound tourism whenever they can.

The Alliance will materially increase the parties' ability to achieve this objective. Most obviously, by securing a future for Air New Zealand, it will underpin its continued role in New Zealand's tourism infrastructure. Additionally and importantly, the Alliance will provide gains to both parties' tourism-enhancing initiatives by improving the quality of the services they offer; increasing the effectiveness of their promotional efforts; and bringing together the parties' marketing infrastructure. One impact these changes will have is on the promotion of dual destination tourism; but the overall effects relative to the counterfactual go well beyond this, and are even clearer when a long term perspective is adopted.

(1) Service quality

There is little doubt that the Alliance will improve service quality, making it easier to offer tourists an attractive product. This is not only the case with respect to tourism markets outside our region, but also within it. For example, at the moment, tourism from New Zealand to Australia focuses on destinations in the Eastern seaboard. By giving Air New Zealand better access to Qantas' domestic network, there will be scope for the more active promotion to those parts of the customer base that are committed to Air New Zealand of destinations in regional Australia, and most notably in the Central and Northern parts of Australia. Equally, better services will make destinations in New Zealand more attractive, so Australians who might otherwise have gone to third countries may be more willing to remain within our region. These developments both provide real benefits to Australian and New Zealand consumers and further strengthen the base on which our region's tourism industries can draw.

(2) Promotional effectiveness

As well as improving the products that can be offered, the Alliance will provide new scope for the effective promotion of tourism to this part of the world. At the moment, the parties engage in substantial promotional outlays that essentially cancel each other out. Removing this purely duplicative expenditure will free up resources for better use. At the same time, the larger, combined total will allow economies of scale to be achieved in promotion – economies that are becoming more important as marketing costs, notably for television advertising, continue to rise.

(3) Combined marketing

Adding to these gains will be those that come from bringing together important marketing channels – namely, Qantas Holidays and Air New Zealand Destinations.

Qantas Holidays is a far larger operation than its Air New Zealand counterpart, with a substantial presence in virtually all key markets. That said, there are markets – for example Japan – where Air New Zealand is especially well-established. By working together, the two organisations can sustain their wide reach and use their combined scale to cover the rising fixed costs of being competitive.

(4) Increasing dual destination tourism

One important outcome of the Alliance, and of the two travel organisations working together, will be an enhanced capability and a greater incentive for the promotion of dual destination tourism.

As far as *capabilities* are concerned, combining the parties' networks makes it substantially easier to develop and market dual destination fares on a commercially viable basis. A key factor here, that none of the submitters has queried, is that it will become possible to offer a far wider range of triangulated international fares – fares in which a passenger arrives, say, into New Zealand from Japan, travels on to Australia, and then returns to Japan from Australia. These fares cannot currently be constructed on terms attractive to tourist markets; with the Alliance they will be no more difficult to construct than the multi-site fares each carrier offers domestically.

The *incentives* for promoting dual destination travel will be no less affected. It is important to understand that Qantas Holidays exists to market Qantas, its brand and its services. It is naive to think that it either has, or is likely in future to have, a mandate to sell the services of Qantas' major competitors.[9] As a result, absent the Alliance, Qantas Holidays' promotion of New Zealand will be largely limited to those tourists who both depart from and return to Australia, as it will have very little scope to offer triangular flights at attractive prices. In contrast, under the Alliance, the benefits to the Qantas Group from promoting Air New Zealand's services will be substantially greater, and so too will be Qantas Holidays' interest in and focus on the New Zealand market.

(5) The overall impacts

To our national tourism industries, these developments seem like a mixed blessing. There is a very strong and enduring sense of commercial rivalry, and each tourism industry would inevitably like to have all of the gains for itself. This Alliance, however, is not intended to, and will not, benefit one party only – if it did, it would not be feasible and even if feasible, could not be sustained. Rather, the Alliance will contribute to the long term health of the tourism industry in **both** countries, so that even if there were some cost for each – in the form of a few tourists diverted to the other – they would be greatly exceeded by the gains the Alliance will achieve.

The parties have tried to estimate these gains in as conservative and rigorous a manner as possible. It is quite true that the resulting estimates of incremental tourism are not huge when set against the scale of the tourism industry in our economies. But even the gains that have been conservatively estimated yield large economic benefits to both

[9] Qantas Holidays does offer packages to Thailand that rely on Thai Airlines. These packages were developed only once Qantas itself had substantially scaled back its flights to Thailand, and hence the availability of discount seats on Qantas flights.

Australia and New Zealand. It would be foolish to ignore or downplay these benefits that are consistent with economic analysis and commercial reality, and far from trivial in terms of their likely impacts on our economies.

This is all the more the case when the wider context for the tourism industry is taken into account. As noted above, the parties are by far the largest commercial supporters of tourism in our two countries; they do so because their own fortunes are so closely intertwined with the future of tourism to this part of the world. Their commitment to tourism promotion and their commercial experience means that they are especially well-placed to assess the issues securing our tourism infrastructure involves.

While there are excellent prospects for continued growth in tourism to our region, it is also clear that realising that potential is a difficult, indeed increasingly difficult, task. Other countries' promotional outlays are far greater than ours – and the gap is even larger when account is taken of the subsidies being provided to national airlines (such as MAS) for the purpose of tourism promotion. At the same time, the cost of promoting tourism to our part of the world are rising, and are likely to rise further as the "low hanging fruit" of potential first time visitors is depleted. The gains set out above may not be sufficient in themselves to address these problems fully, but they will certainly make dealing with them substantially easier.

Taking a longer term view makes that assessment even more compelling. The Alliance offers an option for a network airline operation based in this part of the world with the scale and reach to compete in global markets. That operation will have every incentive to aggressively and effectively promote in-bound tourism: indeed, as the parties have noted, securing substantial tourism flows will be essential for covering the high fixed costs of what are the world's longest haul aviation networks. If that option is not taken, the alternative is two carriers that are materially weaker, more focussed on competing locally than on thriving globally, and hence less able to both support and promote the networks on which our tourism industries rely.

Ultimately, tourism in this part of the world will not flourish if the network carriers are not economically viable. VBAs, no matter how attractive their fares, simply do not offer the kind of interlined service that long haul tourism requires – as United Airlines' submission makes patently clear in discussing the interlining service it obtains from Virgin Blue. Nor do VBAs engage in the kind of active international promotion that network carriers routinely undertake.

For New Zealand especially, the prospect of a national carrier that persistently fails to earn even its cost of capital is not one that can make for a viable, much less prosperous, tourism industry. United Airlines' withdrawal from serving New Zealand makes it all the more important that Air New Zealand have access to strong and effective distribution channels in the United States, especially as the "halo effect" from *The Lord of the Rings* and the America's Cup wears down. The likelihood of Air New Zealand having access to these distribution channels, and more generally to the resources it will require to promote New Zealand into the region and globally, is far greater under the Alliance.

The parties are confident that as the Alliance fully comes into effect, the gains it brings to tourism will be substantially larger than those that have been claimed in the

quantitative assessment. In the Qantas-BA Joint Services Agreement ("JSA"), no weight was originally placed on tourism benefits; but the outcome of that Agreement has been to enhance in myriad ways Qantas' ability to promote in-bound tourism from Europe – not only by extending Qantas' sales presence, but also by making it possible to develop a hub in Singapore that can sustain Qantas' direct services to and from destinations in Continental Europe. These opportunities could hardly have been fully predicted when the JSA was entered into, but the compelling incentives the parties have to secure tourism flows ensured that they were actively sought out and exploited. In considering the tourism impacts, it is these incentives that the Commissions need to keep in mind – incentives that will make the Alliance an even more powerful force for the region's tourism industries than the parties' highly conservative estimates suggest.

Other benefits

As the parties stressed in their original submissions, the Alliance will yield a range of other benefits, some capable of being quantified, others not.

It is matter of commercial commonsense that once Qantas has an equity stake in Air New Zealand, it will take account of that stake in deciding on the allocation of the contracted out portion of its engineering and maintenance. That obviously does not mean that Air New Zealand will have a mandate to offer an inefficient service; rather, what it means is that there will be strong incentives for the parties to work together to ensure that the Air New Zealand service at least matches the region's best. Knowing that this is the case will provide Air New Zealand with the confidence to invest in developing this service and in securing not only Qantas' business but also that of other airlines. As it is clearly difficult to predict the full gains this will bring, the parties have assessed the benefits narrowly. However, this should not lead the Commissions to understate or downplay what is at stake.

Even greater significance attaches to the benefits the Alliance will bring to New Zealand taxpayers. Most obviously, the Alliance enhances the viability and ultimate value of an asset they collectively own. At the same time, it will substantially reduce the call made on taxpayers for future funding, thus freeing scarce public resources for other uses. The gains are not merely in the greater funds made available for education, health and other core public sector responsibilities – they are also in the outputs in terms of better education, health and other outcomes that these funds will secure.

Finally, it remains the parties' strongly held view that strengthening the region's major airlines' ability to survive and compete in the global market is a substantial public benefit. Few parts of the world, if any, depend as heavily on a sound, financially stable aviation industry as does our region. It is easy to take pot shots at the notion of national champions; but cheap shots cannot detract from the emphasis the Australian and New Zealand Governments place, and rightly place, on global competitiveness. By making the parties more efficient, allowing them to extend and improve their route structure, and enhancing their ability to innovate, the Alliance will contribute to this objective in a way the Commissions cannot rightly ignore.

The parties' modelling

The parties do not believe that all of the benefits set out above, and hence the net social gain from the Alliance, can be fully quantified. That some of the benefits cannot be quantified obviously does not mean that they are small or insubstantial – it is merely that there is not a ready metric which allows them to be scaled relative to those benefits that can be given a dollar value.

That said, the parties are mindful of the fact that there is, to the extent reasonably feasible, "a responsibility on a regulatory body to quantify detriments and benefits"[10] in assessing matters such as these. To this end, the parties commissioned independent economists to model the Alliance and its impacts, with a view to assessing the quantum of the detriments, the benefits and the balance between these. The results of that assessment are set out in the report by NECG, and in the audit by PWC of the methods and results used by NECG, submitted by the parties with their applications.

The NECG report concentrates its assessment on comparing the future with the Alliance to a counterfactual in which each of the parties is able to sustain, over the period for which authorisation is being sought, the type of competition which has prevailed in recent years. That counterfactual is modelled as involving a continuation of the trend, clearly observed in recent years, for capacity-based competition both on the Tasman and on the domestic routes within New Zealand.

The parties have explained, in their applications, that the results of the NECG analysis are highly conservative. Without restating material that has already been put, two of the several factors that make for conservative outcomes are worth emphasising.

The first is the assumption that both parties can sustain a further intensification of competition. Rather, as is clear from discussion above and from the confidential material subsequently put to the Commissions, even the central scenario used in the modelling involves very substantial risks for Air New Zealand going forward.

Second, the modelling approach NECG has used to assess competitive detriment overstates the increase in fares and the reduction in output relative to the parties' own management expectations. These expectations are based both on long experience with aviation markets and on first-hand knowledge of what is involved in competing with a VBA.

These factors notwithstanding, there is little doubt as to the solidity of the modelling approach NECG has adopted or as to the robustness of the results that modelling approach has generated. This is confirmed by the generally insubstantial character of the criticisms that submitters have made of NECG's work. As NECG has explained in its own response, the critique made by Frontier Economics on behalf of Virgin Blue seems based on numerous technical errors and misunderstandings as to fact and method. With respect to the more substantial critique presented by Professor Hazeldine, his results depend entirely on assumptions which, when rendered transparent, appear manifestly implausible – not least the assumption that the parties, were the Alliance to proceed, would accept *average* load factors that are lower than the lowest single load factors on the sectors they currently operate.

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[10] Telecom Corporation of New Zealand Ltd v Commerce Commission (3 NZLR 1992) at 447 per Richardson J.

Of course, it is in the nature of models that there are always a range of alternative approaches, none of them perfect. However, the approach set out in the NECG report seems far more likely to bias the case *against* the Alliance than for it. Indeed, that was an important reason for adopting it, and why its main finding – that the social benefits of the Alliance greatly exceed its costs – is of considerable significance. The fact that no submitter has presented a superior approach and that many of the criticisms made of the NECG modelling are simply incorrect, should lead the Commissions to give it weight in their assessment.

The commitments offered

The parties are firmly of the view that the Alliance should be authorised on its merits, because on any reasonable assessment, the detriments it causes are outweighed by benefits it brings to both Australia and New Zealand. The parties have nonetheless made it clear that they are willing to offer substantial enforceable commitments that would provide further comfort in respect of the outcomes that would flow from the Alliance.

These commitments address three central issues. First, the parties are willing to commit to maintaining current capacity levels, subject to reasonable protections for their commercial interests in the face of major disruptive events (such as a collapse in demand caused by a terrorist incident). In those situations where the parties are the only sources of supply, this commitment would provide a high level of protection of consumer interests, as it is simply not in the interests of the parties to operate services with low load factors.

Second, the parties are willing to make commitments aimed at facilitating entry. The commitments the parties have flagged in this respect reflect the conditions imposed on similar Alliances in the main jurisdictions overseas.

Third, the parties are willing to lock-in expenditures on tourism promotion that would provide further comfort with respect to the benefits, in terms of expansion of tourism, that the Alliance offers.

Conclusion

When the Australian and New Zealand Governments entered into the Closer Economic Relations agreement, and then into the Single Aviation Market, it was their clear intention for the two countries' economies to be integrated into a single, unified market, which would enjoy the benefits of greater scale and of the free movement of goods, of capital and of labour. In aviation, that goal has been achieved, and the competitive process already now plays itself out at the level of our two countries as a whole. The Alliance reflects that fact, and puts both parties in a position in which they can best be competitive within our region and more widely.

Despite the integration of economic activity across the two sides of the Tasman, the regulatory process remains national in its operation and focus. Each country continues to consider the issues associated with authorisation primarily from the perspective of

its own interests – creating the risk that the long term commonality of interest that binds the two countries will not get the weight it deserves.

The reality is that a central element in the Alliance is creating a viable future for Air New Zealand. This is not to suggest that there are not gains also for Qantas. However, it is apparent that the risks facing Qantas, even though very substantial, are less immediate than those that Air New Zealand must now address. Relative to these risks, the Alliance offers an option for a network airline operation in which *both* parties can secure, by working together, the scale and reach needed to compete in global markets.

It would be a mistake to think that even if that option is not pursued now, it will remain open for the future. Rather, as the parties "fight it out", the gains that they could make from combining their forces will progressively diminish, especially as Air New Zealand is forced into an ever more marginal role. The opportunity both parties have today, to secure a future in global markets, will have been foregone, damaging the region's prospects of remaining an important player in worldwide aviation. It is this very high "opportunity cost" of not proceeding now with the Alliance that makes its stakes so great to both parties, but especially so for Air New Zealand.

The Alliance opportunity is therefore a "Rubicon" for both airlines. In the absence of authorisation, each will inevitably embark on a course of commercial action which it would be difficult, if not impossible, to reverse. The financial consequences are likely to be such that a greater future imbalance in comparative strengths would render a similar alliance commercially unattractive. This is not a situation in which the parties consider there would be any "second chance".

The parties believe that both regulators must weigh those risks carefully, and give value to the benefit the Alliance brings in increasing the sustainability of both airlines going forward. It should not, in other words, be merely a matter of concern to New Zealand whether Air New Zealand has a viable future open to it. Rather, with our economies and society being as interdependent as they now are, the Australian regulator needs to give proper weight to Australia's own interest in the long term health of New Zealand's aviation infrastructure.

That said, the parties believe that on even the most conservative assessment, the gains from the Alliance outweigh its costs. More specifically, there is little competitive detriment, properly evaluated, as competition in the market will become more, rather than less, effective in future – the fact that Virgin Blue has reaffirmed its commitment to expand and directly operate on the routes affected makes that plain. At the same time, there are substantial and wide-ranging benefits, from cost savings to increased tourism.

The authorisation test exists because it is a matter of common sense that competition is a means rather than an end. Authorisation is not intended to be, and cannot properly be made into, a test that is impossible to meet, or that is more onerous than the plain requirements set out in the relevant statutes. There is, in other words, no inference that can be properly drawn that conduct, merely because it requires authorisation, should be or can be presumed to be especially harmful, and that as a result, a special onus must be discharged before it can authorised. Rather, where there are good grounds for concluding that the likely benefits of conduct outweigh the competitive detriments it

is likely to cause, the parties applying for authorisation of that conduct should be entitled to expect it to be authorised. As the parties believe that the Alliance, evaluated on its merits, meets that requirement, they see no valid grounds for authorisation to be withheld.

The parties therefore remain committed to working with the ACCC and the NZCC to address any issues that they may have, as they are fully confident that the Alliance offers an important opportunity not only to each of the two airlines, but to our communities more generally, for securing an aviation industry that is viable, efficient and competitive.

17 March 2003.