19 AUGUST 2003

PRESENTATION BY THE APPLICANTS (cont)

CHAIR: Good morning, and welcome back to the Commission's Conference being held in relation to the application by Air New Zealand and Qantas Airways who are seeking authorisation to enter into the Strategic Alliance Agreement and also the related agreements and the application by Qantas Airways seeking authorisation to subscribe for up to 22.5% of the voting equity in Air New Zealand.

We'll now convene the second day of this Conference, and we did re-order the agenda for the first and second days, and just to bring everyone up to date, we will be starting again today with the Applicants and we will be talking about, I believe, entry, so I will hand over to the Applicants.

I might just say, at 9 o'clock we do need to break this session, if we're not finished with it at that time, in order to do a video conference link with the UK, so we'll just have to manage that as we go. Thank you very much. Please introduce the speakers this morning.

MR P TAYLOR: Madam Chair, thank you for that. We're having some trouble with that video link so we may have to ask for your assistance at some later stage.

Today, starting off with issues relating to VBA constraint, from starting at the far end you all met Mr Paul Edwards from Qantas; Mr David Bental from APG; Mr Mike Swiatek who you haven't met, Vice President Air New Zealand for Joint Ventures, and the guest speaker on my right, Mr Andrew Miller, currently Chief Operating Officer, 6 years with Air New Zealand, was General Manager Domestic Airline Group, was General Manager Ansett Domestic Australia, and Chief Executive Ansett International, and Senior Vice President Sales and Distribution for the Ansett/Air New Zealand group. Four years before that with British Airways, three stints in management consultancy he tells me, and three Chief Executive positions in retail, has a degree in Economics, Statistics and Psychology with MA honours.

We'll do our best to cut back on the presentation in the interests of speed, and take it away.

CHAIR: Please take the time you need to make your key points. I don't want to cut that short in any way. So, when you're ready, please present.

MR MILLER: Thank you, Madam Chair. No two value based airlines are the same, but obviously they have key similarities. All routes generally tend to fall in in the following categories; usually of less than 5 to 6 hours duration with one fleet type primarily selling directly to the consumer usually via the internet.

The high aircraft utilisation that they offer, and also the simplified on-board product are designed to meet the minimum requirements of the consumer. This form of operation always results in lower costs than a full service airline because of these efficiencies that I've described, and also full service carriers, of which Qantas and Air New Zealand are one, have more complexity and, therefore, generate higher operating costs.

In terms of the suitability of the routes, whether they be Tasman and New Zealand domestic, we believe that they're ideal. Virgin themselves have stated that over 50,000 population in a town or city would be on the network

Applicants (cont)

development list, and in fact Virgin Blue have now entered 27 of the 30 largest routes in Australia.

This slide shows that the level of traffic on domestic New Zealand and on our Tasman routes has sustained successful VBA entry elsewhere. Included in this data is the Virgin Blue's data from Australia. It shows the number of passenger movements and the spread of VBA activity. And in the red what we've done is highlight the routes, whether they be on the Tasman, on the top, just to show the similarities that do exist in terms of the demand on the Tasman, and domestic.

Customer acceptance around the world of the VBA model is strong. In fact, it plays to the kiwi psyche, as it were, in terms of, from my old days in retail, you know, places like The Warehouse and Briscoes, they have captured the majority of the retail growth in the New Zealand market at the expense of some of the more established players.

We introduced Domestic Express over a year ago and we saw the following sort of statistics. Our passengers grew by over 23%, our internet sales exceeded 35% and we had a growth in our market share over our capacity share. This is very consistent with some of the elements in terms of VBA entry overseas but however, we have delivered this product at, we know, we assess at a higher cost base than any new entrant starting up against us.

Virgin themselves have made many statements about their intention to enter the Trans-Tasman and also the New Zealand market. They now, as I say, operate in most of all the most popular routes in Australia. They're running out of growth opportunities in Australia; they're about to launch an IPO and they need to demonstrate growth opportunities.

They have a number of aircraft on order and they need to find profitable routes in which to serve them. We know about the slaughter applications and we know they've been in contact with airport companies, and we know that they've been securing heavy maintenance contracts for a larger fleet.

There had been some claimed limitations in terms of their entry to our markets, both Trans-Tasman and domestically. There are two possible infrastructural constraints that VBA raised by Virgin Blue; one is access to slots. A slot is allocated arrival and departure time at an airport.

These are allocated based on the availability of runway, aircraft gates, passenger flows through the terminals etc. The only operations in New Zealand that are required -- that require a slot to be allocated are international operations out of Auckland, Wellington and Christchurch. All other international and domestic operations do not require slots.

For domestic operations there are no slots; any aircraft operator can schedule any flight at any time. If the result exceeds the runway's physical capabilities at the time of the day that they wish to depart, it's the order in which they asked for start-up clearance from the tower that determines when they can take off. [**technical pause**]

CHAIR: Just before you do that. The comment you made on the domestic routes where you say that slots are not required; is that simply because there's not congestion on those...?

MR MILLER: There can be some congestion at peak time, but obviously from a marketing perspective the airline's tried to stick to common times throughout the day and the most popular times, for instance 7.30 to 8 o'clock from Auckland to Wellington. There might be two or three operators that might schedule a time at 8 o'clock, but within a five to 10 minute window the operators can actually, you know, achieve as near as an 8 o'clock time as possible.

CHAIR: In your experience, is that typical on domestic routes such as we're talking about here?

MR MILLER: It is typical in some countries. The slots and runway limitations are one such element for instance. At Wellington Airport there are some environmental constraints in terms of how the aircraft approach the airport and the amount of time they have to have between the aircraft in terms of the landing capabilities, and that can be marginalised sometimes in regards to weather.

CHAIR: And the sustainability of that situation, you think, is without question with the entrance by Virgin Blue?

MR MILLER: There are many many times during the day when there's plenty of opportunity for any operator to have domestic take-off and landing slots.

CHAIR: I'm sure there are many opportunities during the day, but will there be opportunities at the time of day that an entrant is likely to require in order to compete?

MR MILLER: My understanding of that is, yes, and we've given some undertakings to new entrants, specifically Virgin Blue, in that regard.

CHAIR: On the domestic routes as well?

MR MILLER: Yes.

CHAIR: Just while we're doing that, Dr Pickford would like a follow-up question, if we could please.

DR PICKFORD: You said just now that Virgin Blue is running out of growth opportunities in Australia. Does that imply that in fact it has an upper limit on the potential market share it might gain in Australia, and, if so, what would be the forms of the constraints which might prevent it gaining a large amount of share?

MR MILLER: It's our experience from overseas markets that -- or two things. One, value based airlines can create market stimulation and grow the market. The second thing is that their growth in market share is somewhat unstoppable.

If I was answering that question four or five years ago I would say the limitation maybe around 20, 25%, but recent best practice would indicate it can be up to 50%. So as time goes by the rules are rewritten.

DR PICKFORD: But Virgin Blue at the moment has about 27% I think of the Australia market and you're saying it's running out of growth opportunities there?

MR MILLER: What I'm saying is, well I believe they have about 30% of the total domestic network in Australia. They only have a jet fleet. There's other components to that market. Below the food chain there is the (inaudible) market, which takes up obviously revenue and market share, and above the domestic food chain there's in-bound international traffic which they're currently excluded from accessing. So, within that 30% they have an incrementally higher percentage of the total market.

At Wellington and Christchurch we believe there's no barriers to entry in terms of international operations.

In terms of Auckland it's slightly more complex. Of the four slots per day requested at Auckland, Virgin have received all requested slots with the exception of one slot which they have had to accommodate to have a change. This occurs during a late morning arrival of a number of Asian carriers. Gaining such a high proportion of requests of slots is unusual as airlines normally have to be a bit more flexible when they start operations.

It also should be noted that Royal Brunei and Emirates have started recently and have obtained slots for all their new operations at Auckland, and Singapore Airlines and Cathay have obtained slots for their expanded operations. It is our judgment that Virgin Blue would have the majority of their requests satisfied.

To address any residual concerns the Applicants have made a significant number of undertakings and slots. In fact we submitted a letter on 14 August to the Commission explaining the undertakings that we're willing to make to achieve and facilitate their entry.

It may be said that Auckland International Airport is best practice in terms of non-aeronautical income; this is income obviously from retail concessions. The more operators and the more aircraft and the more passengers that they have at an airport means a higher income stream from non-aeronautical income.

In fact, it's well-known that value based airlines who don't supply food and beverages on board have a higher level of food and beverage income on the ground and, therefore, most airports around the world actually try to encourage value based airlines to start up at their airports.

I've listed, and I won't go through, the number of value based airlines and the full service operators that they have actually competed with.

Are there any questions on facilities or airport access before I go on?

MR PJN TAYLOR: I had a couple of questions on barriers. I'm referring to paragraph 356 of your submission in response to the Draft Determination, and the discussion about sunk costs. I'm wondering if you wouldn't mind having a look at it and then I'll pose the question. [**pause**]. The question is, I wonder why you make that statement. Page 16.

MR MILLER: I would make the point that some of the sunk costs that an FSA would have are different from a VBA. Sunk costs, for example, in our lounge facilities. We, through our courier Koru lounges in Australia and New Zealand have invested a substantial amount of money, and obviously we have these facilities like lounges, like loyalty programmes, some of which value based airlines do not have. So obviously from an FSA point of view there are a lot of sunk costs in terms of how we actually deal with our product to the consumer.

MR PJN TAYLOR: So, there's a different scale of sunk costs for an FSA compared to the VBA issue here?

MR MILLER: Yes, definitely.

MR SWIATEK: Excuse me, Mr Commissioner, I believe the issue is not between an FSA and VBA; it is between an existing carrier and a new entrant. A new entrant FSA would have the same issues.

MR PJN TAYLOR: Thank you.

MR MILLER: In terms of the number of value based airlines around the world, I've made a list and compared some of the full service airlines that VBA competing with the value based airlines. The list is quite exhaustive.

What usually happens when a value based airline enters a market, two major headings; the first one is obviously to match lower fares. This is necessary even though the value based airline inherently has a lower cost base and, therefore, is in a better position to survive a war of attrition, as it were.

The second point is that cross-subsidisation by an FSA is somewhat limited because usually the VBA tackles the most profitable or most dense routes first in the network. When I worked at British Airways very early on in my career Freddie Laker(?) when he started up his Skytrain chose the routes between London and New York as his first route.

In fact, two-thirds of Air New Zealand's domestic profitability comes from the two top routes, and obviously the VBA enters against these two top routes and actually steals that level of profitability from the network. So, the ability of a full service airline traditionally is very difficult to cross-subsidise when a VBA enters.

The other issue is, we spoke about yesterday, or heard some evidence given yesterday is the reduction in cost to develop low cost operations, and full service airlines have generally taken two routes; the first is to start up their own low cost subsidiaries while the second, which is the Air New Zealand focus reverse strategy, is to reduce the costs of our network operations, which we've been somewhat successful in, but we'll never achieve the operating costs of a value based airline.

MS BATES QC: You just said that, because of a lower cost base VBA was better placed to win a war of attrition. What do you say about the access to capital. I just put it to you, wouldn't that be a pretty important factor in winning a war of attrition if an FSA had a very good access to capital it could afford to go on for a fairly long time at a lower cost base. Isn't that a factor which may mitigate against a VBA winning a war of attrition?

MR MILLER: It's a very good point and I would suggest that value based airlines are the ones around the world -- the ones that are publicly listed have the highest level of market capitalisation; in fact, Southwest Airlines has a higher market capitalisation than all the other US carriers put together. Their ability to raise capital is substantially greater than full service airlines, especially the ones that VBA value destroyers over the last decade.

So my answer to that question, Commissioner Bates, would be the fact that value based airlines, because of their lower operating cost, the higher level of cashflow, and most of them having sustainable higher levels of profitability, i.e. Higher margins, have a better chance of accessing capital than a full service airline going to market and asking the market for money.

CHAIR: Is there any evidence now that Qantas is in any way constrained in capital markets?

MR MILLER: I would suggest that obviously you would ask Qantas that question.

MR EDWARDS: First of all, we have the constraint on capital because of our foreign ownership limits that are imposed by the Australian Government on the shareholding of Qantas.

Secondly, we are probably the best performing full service airline around at the moment, and so in that sense we don't have perhaps quite the difficulty that other carriers do, but we still run into problems in trying to raise capital from time to time.

CHAIR: But your cash position right now is also very strong isn't it?

MR EDWARDS: Plead annual result defence just at the moment.

CHAIR: I guess it will all be known on Thursday.

MR EDWARDS: That's right.

Applicants (cont)

MR MILLER: The success of Air New Zealand Express class has proven that the market will respond to a value based airline. This reduces risk as far as we're concerned to any entrant, including Virgin Blue. The difference in cost base between a full service airline and a VBA means that Virgin Blue still has the opportunity to successfully enter our markets. In fact Virgin Blue believe that they can successfully operate on the Tasman and domestic New Zealand with lower fares.

We estimate that Virgin's costs per ASK in a like-for-like aircraft within New Zealand operating domestically in New Zealand would be up to 20% lower than New Zealand's Express class when we are fully reformatted in terms of our new operation. I would like to quote from the 7th of August The Sydney Morning Herald. The quote says:

"The looming trans-Tasman fare war could turn into a bloodbath after Virgin Blue's Chief Executive, Brett Godfrey, yesterday threatened to slash fares by more than 40% with Air New Zealand aiming to cut costs by more than 20% through its no frills, yet to be launched Tasman Express, and Emirates' recently cost cutting in terms of their introductory fares to Auckland by 20%. Mr Godfrey said Virgin could slash fares further and still turn a tidy profit. I don't believe that the Tasman route needs to remain profitable, he says. It's one of Australia's largest routes and it's New Zealand's largest. Don't forget Trans-Tasman Air New Zealand service is dual class. You won't get the same cost base for dual class aircraft compared to one class on Virgin Blue."

CHAIR: I think it's interesting that you point the recent developments out to us, because there VBA also reports suggesting that it is -- the current level of competition reflects the fact that we have two carriers and a third trying to enter, and it demonstrates exactly what is potentially to be lost if this alliance goes ahead. I'd just like your response to those claims.

MR MILLER: Madam Chair, I would also say that, you know, on the Tasman it's not just Air New Zealand and Qantas with a new entrant; like Virgin Blue there will be by October this year 13 operators flying the Tasman, and there's been a massive increase in what we call the Fifth Freedom operators, the Emirates etc, and the Thais who have increased capacity in the Tasman this year. However, in fact there's a 40% increase in capacity in the Tasman November this year over the same period November last year.

However, having said that, both FSAs, Qantas and Air New Zealand, do have a higher cost base than Virgin Blue and it's the lower cost base of the VBAs that actually drive their intrinsic growth. And, no matter what Air New Zealand and Qantas can do, because of the different operating models and in some cases some of the legacy overhead costs that both FSAs have, they'll never be able to achieve the lower operating cost of Virgin Blue.

CHAIR: I guess for the Commission, we have to be concerned, not with entry, but the ability to expand and stay in the market. I do understand on the Tasman that we've seen increased capacity, we've seen an increase in the number of the Fifth Freedom, but nevertheless Qantas and Air New Zealand still have a very significant part of this market, and Qantas seems to me to be in a reasonably strong position to respond strategically to any new entry if it chooses to do so.

So, entry conditions may be there, but I think the Commission needs to be satisfied that not only is entry possible on the Tasman and the domestic routes, but it can be sustained through time.

I always find arguments interesting about how awful these competitors are that aren't even in the market yet and how they're going to do terrible harm to two very large companies that arguably together are fairly dominant in the market, and I think the real test is not only can they enter, but can they survive once they have in the face of very strong competition; and without any doubt there are strong incentives for either Qantas, Air New Zealand or the alliance, if it were to proceed, to do everything in its power to limit the ability of that company to expand and sustain entry wherever it occurs.

So, I think those issues have to be addressed in your presentation.

MR MILLER: Well, we've shown that, I think, demonstrated or will demonstrate that the level of market stimulation by the entry of a VBA in creating a larger market, and maybe it's a question you should pose to Ray Webster from easyJet, how the market growth in the first place does not -- in some instances does not remove share from some of the incumbents. It's the market stimulation through lower price on the basis of lower costs that achieves that.

CHAIR: I think that's an interesting point, but we've heard from you today that I think Air New Zealand and in some of the changes it has made has already stimulated the market quite considerably, and I'd be interested to know what the stimulation in the market was in Australia with Virgin Blue's entry, and compare that to what's already happened in response to changes that Air New Zealand has made itself already in New Zealand, and Air New Zealand and other airlines have made on the Tasman; how much of that potential market stimulation has already occurred? And just as a rough sense of it, I wonder how much was the growth in market in Australia in response to entry by a VBA?

MR EDWARDS: If I may. In Australia what we have found is that, in a market where Virgin Blue enters, it is not difficult for them to stimulate the market by 20%, and just a little reminder in the history in Australia, that during the 90s we went through a number of new carriers, not low cost carriers, but you know, Compass Mark I and Compass Mark II, and that had brought about big year -- they had already brought about big yield reductions and big step changes in growth, yet still when Virgin came along they were able to stimulate the market quite strongly. It was not unusual to see them move into a market and grow a market by 20%, and drop fares by 20% and grow the market by 20%.

CHAIR: What has been our most recent experience on the Tasman and the domestic routes in New Zealand, in terms of market growth and drops or variation in prices?

MR MILLER: Madam Chair, we've only just introduced new pricing on the Tasman in the last week so, it's early days yet. Domestically we have seen --

CHAIR: Sure, but we've seen -- we've talked about extensive increase in capacity on the Tasman; that's been going on for some time.

MR MILLER: And obviously we do market share calculations, but some of the data sources that we have have some sort of lag, for instance, so I'm not in a position at this moment in time to tell you.

CHAIR: You've probably made some projections however?

MR MILLER: We do project a 10% stimulation in market with the introduction of Air New Zealand's new fares; but given the differential and our operating costs, if another operator came in and reduced the fares by 20 or 30% over and above what we've done, obviously the market will stimulate further.

CHAIR: And what's happened on domestic routes? I think you mentioned it earlier in the presentation?

MR MILLER: We've had a 23% uplift in traffic as a result of reduction in fares, on an annual basis.

CHAIR: So in Australia we saw with the entry of a value based airline, the stimulation of 20%, we've already seen that in New Zealand in response to Air New Zealand's moves, and many people claim that Air New Zealand has basically taken up the space that Virgin Blue might have had in terms of stimulating market growth, and it almost seems to match actually perfectly what happened in Australia. I'd just like your comment on that.

MR MILLER: Obviously, there are some similarities, but, you know, Air New Zealand's a network carrier, we've seen stimulation throughout the whole network by the reduction of fares, and the degree of stimulation in Australia is very much related to the jet routes and not the turbo prop routes where obviously we operate in terms of our total network offering.

CHAIR: I guess the other thing that happened in Australia, of course, that assisted Virgin the ability to expand and sustain its entry, was the collapse of Ansett, and created huge room for both Virgin Blue and Qantas to take up that space.

With this alliance, that opportunity certainly isn't going to exist in New Zealand; and so again I come back to the issue, how do you sustain entry, particularly on the domestic routes, if the market stimulation has already occurred, maybe not completely, but to a large degree, and the other factor that seemed to assist Virgin Blue in Australia was unlikely to exist here if this alliance proceeds, not going to see one of the major carriers go out of the market?

MR MILLER: I would suggest that Virgin's position in Australia was one of acceleration, but the end point would have been the same. There was just a speedier position acquired by Virgin Blue in Australia by the default of the collapse of Ansett. In fact, probably the market capacity, now domestically in Australia, would be equal to the pre-Ansett collapse position, but the market is characterised by lower overall revenue from the domestic network because of the collapse in the average fare levels.

MS BATES QC: The question I was going to ask you, probably you've just answered, but in the Applicant's application, chapter -- well, the section on structural change, says:

"History shows that while VBA entry stimulates demand and more passengers travel, fares also decrease across the board resulting in total market revenue generally remaining relatively static."

MR MILLER: We would concur with that -- well, I would concur with that statement obviously, and in some instances in some markets the value, the market value actually declines even with a 20 to 30% passenger stimulation because of the lower fares.

MS BATES QC: So what's happened in Australia? Are you able to say?

MR MILLER: I would probably like to refer that comment to my colleague from Qantas, if possible.

MR EDWARDS: I think a couple of things; can I just go back perhaps to the slightly earlier question, and then come back to yours. That, on the Tasman and domestic New Zealand, Virgin Blue will not come in with the price structures that Qantas and Air New Zealand have; they will come in with prices that are 20%, you know, 15 to 20% below, that lower price will create the fresh stimulation of the market.

What we have found throughout Australia is that, in broad terms whatever the fare differential is, that generally equates to the market growth that will come about. So, as they lower their fares, as they lower the market fares they will stimulate the market; because they have a lower cost base than either of the existing airlines, they will be able to sustain that. So hopefully that may help a little bit on that growth side of things.

As to what has happened in Australia is clouded very much because of the, you know, collapse of Ansett as far as what is the dollar value that is left in the marketplace as a result of it because, as Andrew was saying, the capacity levels that are operated in Australia now are just slightly more than what were operated at the time of the Ansett collapse, so there has really been a -- you know, a bit of a hiatus in the natural growth. So therefore the impact on the total dollar in the marketplace hasn't been as significant as you would normally experience.

But, prior -- if I go back to the period prior to the Ansett collapse, we were seeing that same sort of phenomena in Australia; that there was no more money being spent, there was just less -- you know, there was more travel but less -- the same amount of money being spent.

MS BATES QC: Just to follow-up on that; it seems that what Air New Zealand has done, said it's done is to pre-empt the VBA entry with its Express fares?

MR MILLER: I would restate that as saying that we've done our research and we know what the customers want, and with our hardened experience, because of our ownership of Ansett in Australia, we've actually delivered what the customers actually want. Obviously, we understand how the market works a lot better than we did 2 or 3 years ago and we know that lower fares do stimulate demand. But we'll show you later on that the lowering of fares at the market entry levels, the lowest fares actually brings down the average fares but actually lowers the brand.

MS BATES QC: I understand that, but you are saying the lower fare structure had nothing to do with what you say is a certainty of the VBAs to entry?

MR MILLER: Obviously it had something but it wasn't totally governing every move 100%, because, you know, giving long-term sustainable value to your customers where you've got a strong market position is clearly something you wish to achieve, because no matter whether it be Virgin Blue tomorrow or somebody coming along in a couple of years' time, you know, a lot of customers, if they feel they've been gouged in any way, shape or form will move to a new carrier on day one if they feel they're not getting sustainable long-term value, as we've seen in our market.

MS BATES QC: I'm just trying to work out to what extent VBA influence; because if you are trying to prevent your customers from going to VBA on day one --

MR MILLER: What we're doing is giving long-term sustainable value to our customer base where we do have a fairly strong position in domestic New Zealand.

MS BATES QC: So, what will you do by way of response when, as you say, Virgin comes in with 15 to 20% lower fares than you are able -- than you'd have decided to deliver?

MR MILLER: They will capture a proportion of the market which, in a sustainable position, usually equals the capacity share in the market in which they operate. So, if they come in with 20% capacity share, they will, over about a year to 2 years, achieve a 20% market share or slightly below the capacity share. It's a truism in the innovation market that capacity share equals market share.

MS BATES QC: Do you have any strategic plan to deal with that, or do you accept that's the way life is?

MR MILLER: Most airlines have to accept that's the way it is. We have a market position as a full service network carrier; we inherit a higher cost base and, therefore, we're not as competitive at the lower end of the fares because of that higher cost base, and in most markets overseas the full service airlines retreat in terms of capacity mix of the FSA and give up some proportion of that market to the value based airline.

MR SWIATEK: Madam Chair, if I may. Those are excellent questions; I believe that is the heart of why we are here today, is to offset some of the cost advantage that our competitors, the VBAs have, relative to Air New Zealand and Qantas. The way that FSAs handle this situation is to try to have a revenue premium that's equal to the -- offset the cost advantage that the VBAs have.

The work that David Bental to my right from APG showed yesterday on the city presence is the effect of this. The ability of network carriers to have the connectivity, I think what you'll look -- and encourage you to ask David -- is that FSAs in the US and Europe have higher load factors than their VBA competitors. That's the essence of this, is that by letting two FSAs to work together, it allows you the ability to have that VBA in and not have all the FSAs slowly trickle out of existence.

CHAIR: Can you tell us, how combining two high cost, arguably inefficient airlines, leads to a low cost-efficient airline?

MR SWIATEK: Madam Chair, I don't view Qantas or Air New Zealand as inefficient airlines. Again, I view us as very efficient FSA airlines. As Dr Tretheway said yesterday, it is his belief and my belief, and the applicant's belief, that the FSAs are efficient for that business model, but that still leaves a gap of cost improvement that the VBAs have below us. But again, that is not to say that VBAs will not be constrained by the FSAs through the revenue advantages that we can produce.

The way these are augmented by the transaction is the fact that Qantas and Air New Zealand are working together; that's at the heart of our tourism arguments, that's the heart of the Qantas holidays arguments you will hear later today, and I believe Professor Willig as well will show the benefits that the on-line connections, that as the FSA network becomes larger, it brings extra value not only to those carriers but to the consumers and the general population by expanding the revenue.

CHAIR: I understand your point about being an efficient FSA, but at the end of the day, you know, efficient prices have to be related somehow to what consumers demand, and --

MR P TAYLOR: Madam Chair, just before we start, we will be able to make the connection at 9 o'clock.

CHAIR: Thank you. I lost my train of thought. I'll come back to that, but Commissioner Taylor would like to follow-up.

MR PJN TAYLOR: Just on the context of the discussion about lower prices stimulating growth. How does that reconcile the statement made a couple of times in the submission, and I'm referring to para 377, that in the event prices increased scope to grow the market would present itself.

I'm just having a little trouble thinking through the logic there.

MR MILLER: Well, the logic is clear that, if two carriers with a reasonable market share get together and, you know, decide that they're going to squeeze the market for higher yields by putting the fares up, all you do is create more value in the market and more opportunity for a carrier with lower fares and lower cost to come in and grab more share.

MR PJN TAYLOR: So it's the entry rather than -- yeah, okay.

MR MILLER: Most airlines know, if there's a degree of unreasonable value, let's say, being created by an incumbent operator or an incumbent FSA and that encourages them into the market at a quicker degree.

MS BATES QC: Could I just ask a question of Mr Edwards. I just want to ask you about how Qantas actually responded to Virgin's entry in Australia? Did it respond in the way that Air New Zealand is planning to respond to Virgin's entry in New Zealand?

MR EDWARDS: We responded with a fair bit of gusto. We matched prices, we then had to go through a process that, because our prices have dropped by 20%, we then have to go through processes where we put costs out to the business and that gives us the forum in which we can go to unions and suppliers and that sort of thing and negotiate the sort of conditions and, you know, operating cost structure that the value based airlines have.

But, you know, you can't underestimate the complexity in an established business trying to reduce costs where so many of the costs are controlled, if you like, by external forces. And so, we lower prices, we have to lower prices otherwise we go out of business. We then have to pull costs out of the business and that's what -- why you see so much media noise coming out of Australia about the various cost reduction programmes that Qantas has got running. Geoff was talking yesterday of pulling $1 billion out over the next 2 years and, you know, that's the reality.

MS BATES QC: So, just suppose that the proposed alliance doesn't go ahead, and you are Qantas and you're responding to Virgin's entry on to the Tasman in New Zealand; what will you do?

MR EDWARDS: Well, first of all, we won't just be responding to Virgin; we'll be responding to all operators on the Tasman, because --

MS BATES QC: Fair point.

MR EDWARDS: -- everybody's going to be doing different things. We'll be doing similar things to what we've done in Australia; matching the price then pulling the costs out of the business.

MS BATES QC: So, you will try and match price?

MR EDWARDS: We have no choice.

MS BATES QC: So if the alliance does go ahead, proposed alliance, will you try and match price? If say the VBA comes in at 20 to -- 15 to 20% lower than the Express class, will you try and match the price?

MR EDWARDS: You have to.

MR MILLER: Definitely. In fact, I would --

CHAIR: I think that's what I meant when I said inefficient. I mean normally we think about efficiency as an efficient price and, you know, if your customers don't value the extra services you want to charge them for, and you have to match the lower price because they'll leave, that suggests to me what the efficient price is, and you'll have to match it.

But, I mean, the interesting thing about this conversation is, we hear about this and I hear it and I think that's great, that's the benefit of competition, but you present it as, it's awful because it means we're gonna have a hard time competing and, therefore, we should be allowed to combine with another airline, it gives us tremendous market power to, if not prevent, at least delay the benefits of the competition that is emerging; and I have some difficulties sort of getting to the point where I hear all of this and I think, oh my goodness, this is a good argument to allow an anti-competitive application to proceed.

MR MILLER: Madam Chair, if I could; the conditioning effects that Mr Edwards spoke about in regards to Qantas' which is in Australia, or conditioning effects that were learned from the competition of Virgin Blue, in fact the previous 60 odd years of competition between Ansett and Qantas did not produce nearly the fare reductions nor the market stimulation. So it was a conditioning effect as far as I'm concerned of VBA that taught Qantas the lessons that Mr Edwards was talking about.

CHAIR: I understand that point and I guess my concern and what

I'm asking you to respond to is that, it is the entry of the VBA that brings these potential benefits.

MR MILLER: Absolutely.

CHAIR: And the concern we have is that, the alliance is not without cost in terms of erecting higher barriers to entry and expansion for that VBA entrant that brings the competitive advantages to consumers, and it's that bit that I'm trying to get you to respond to and tell me why we shouldn't be concerned about that.

MR MILLER: And our premise is, there's two fundamental issues. The first fundamental issue is the market stimulation of a VBA because of lower prices, and that market stimulation can be achieved because they're fundamentally lower cost than the full service airlines. Even although Air New Zealand and Qantas would actually get together, they're still fundamentally going to be network airlines with fundamentally higher costs than the VBA, and I have some further slides to try and demonstrate that and also the conditioning effect of a value based airline has on an FSA network even at very low levels of market share.

CHAIR: We have seen a number of attempts at entry and expansion that have tried to get off the ground but weren't able to be sustained in this part of the world. Even in Australia there are cases where companies have not been as successful. And there still remains the argument that a lot of people would have, that even Virgin Blue's ability to sustain their entry in Australia was at least questionable until Ansett collapsed.

So, I hear the evidence about the overseas markets; I hope that you're right, that there is an inevitability of a VBA coming in to these markets stimulating the markets,

Applicants (cont)

offering lower prices and something that consumers want. But, I wonder if the evidence is there to support the argument that this market has the same ability to sustain that in the face of something as powerful as the alliance as compared with what's happened in other markets, other much bigger markets.

So, you know, I still think the issue that has to be raised, is this alliance going to be so powerful and so strong that it will create a significant barrier to expansion for any VBA trying to enter these markets.

MR MILLER: Well, I would evidence a lot of full service airlines around the world with far greater resources than either Air New Zealand or Qantas and their ability to actually effectively compete with value based airlines has been somewhat limited, and this is why a lot of full service airlines around the world are in retreat, or they're fundamentally trying to review their operating cost base, like a lot of the US carriers using Chapter 11 to fundamentally reduce their costs to get to an operating model which has some long-term sustainability.

CHAIR: With respect, we just were told that Qantas is probably the most -- the best performing FSA in the world; a very strong cash position. Even Air New Zealand, despite what happened with Ansett, is -- in terms of its relative performance in the last 12 months, has probably done exceedingly well.

So, I just wonder, is it right now to suggest that these two FSAs are sort of having a hard time making it?

MR EDWARDS: Excuse me, could I just clarify that -- and I'm mindful of tomorrow -- but we are nowhere near cost of capital returns. Even though we could be the best in the world, but we're nowhere near getting cost of capital returns. So, it depends upon the -- you know, where the hurdle is, and so, you know, we're the best of a very sick bunch.

CHAIR: I bet you'll never ever acknowledge that again outside this forum.

MR EDWARDS: We are in a confidential session, aren't we?

CHAIR: No, we're not actually, and I can almost guarantee that will be the headline for tomorrow.

MR CURTIN: Just following up on that point. I think when the application came in and we all started to look at the aviation industry long-term, one of the thoughts that occurs to practically everyone as you look at extended periods of time where the airline industry doesn't seem to be making its economic cost of capital. I appreciate the last few years VBA pretty rocky for everybody, but as a longer term proposition how has Qantas been going?

I think we had evidence that Air New Zealand -- I wouldn't call them glory days -- but certainly the days when the international routes were doing quite well and things were reasonably hunky dory. Over a longer term perspective, extracting from 9/11 and stuff, has Qantas been able to meet its cost of capital on the longer run basis?

MR EDWARDS: Umm, no. I think you will find that if we go back over the last 50 years of aviation, airlines have lost more money in 50 years than they have made in 50 years. You know, it is a sick business in that sense. Qantas has made cost of capital returns in a couple of years but not -- it's not tradition.

MR CURTIN: I hope I'm not sort of revisiting some of the stuff from yesterday, but in other capital intensive industries like pulp and paper or something, sooner or later people finally wake up and they don't over-expand in the up-swing the way they used to and gradually some kind of discipline in the capital markets exerts an influence on investment behaviour in the industry. And again I'm just trying to get my mind around why over long periods of time you appear to see companies not making a cost of capital and in spite of that able to continue to attract new equity in debt funding.

MR P TAYLOR: Madam Chair, I wonder if we can come back. Mr Webster is on-line.

CHAIR: Can we hold that thought, and we will come back to it.

MR P TAYLOR: If I could give you a quick summary of Mr Webster's position. As you know, he's the Chief Executive of easyJet, he's going to briefly cover sustainability and suitability of the New Zealand Tasman services entry and growth strategies, impact of entry on fares and a couple of points on distribution.

CHAIR: I don't know, Mr Webster, if you can hear me now?

MR WEBSTER: I can.

CHAIR: Okay. We don't quite have the picture fully, but I will take the opportunity to welcome you while we're trying to get the connection through.

I'll just say to you briefly that we are in an open session, so just so you're aware of the circumstances in which you will be coming into this discussion. Can you still hear me?

MR WEBSTER: I can hear you fine, thank you. Can you hear me?

CHAIR: Yes. Our normal practice is to ask questions as you present, but I think because of some of the challenges of these sort of links we will let you speak for some time and if we need to I might stop you for a few minutes for questions and then let you return to your presentation, but I'd ask that you start your presentation now, if you would please.

MR WEBSTER: Okay. What I'd like to do is just introduce myself and make some initial comments and perhaps it might be best to try and have questions at the end if that's practical from the point of view of managing the link. But as you say, if you want to interrupt, please do.

My background, I spent 27 years with Air New Zealand in various operations and commercial roles. My final role was General Manager of Strategy, and one of the primary responsibilities I had was to help Air New Zealand develop its strategy to deal with the transition to a deregulated Australasian market.

I joined easyJet in 1996 as Managing Director to implement the VBA model in England and the UK, and I was appointed to Chief Executive of easyJet in 2000. I should point out here that I still have a continuing role consulting to Air New Zealand, particularly in the low fares airline arena, a role that I've maintained since I left easyJet.

Qualifications: A hold a First Class Honours degree from Canterbury in Electrical Engineering, a Masters in Air Transport Management from Cranfield, and a Masters in Business from the Stanford Business School.

Market knowledge: Obviously with my ongoing consulting role I'm reasonably up-to-date with events in Australia and New Zealand. However, in my previous role as General Manager of Strategy I was intimately involved with both markets. As General Manager of Strategic Planning I was involved in assessing new market opportunities. I led the development of the VBA model which was intended for deployment within the Australian domestic market as well as the Tasman and domestic New Zealand.

I also led the development of Freedom which was based on an adaptation of the VBA model. Whilst Air New Zealand was uncomfortable with the deployment of the VBA concept within domestic New Zealand and the Trans-Tasman for reasons of cannibalisation, I've always believed that the model would be a viable model for use in those markets. Further, my experience with easyJet has given me no reason to doubt that those markets are indeed very attractive for a VBA business.

Just moving on to easyJet: EasyJet began flying in November 1995, flying from Luton that's about 30 miles north of London to both Edinburgh and Glasgow with two 737s. I arrived four months later to lead the development of the airline from those early days. We currently operate 72 737s to 107 -- 107 routes are flown between 38 European airports. We're the largest low cost airline in Europe at this stage. In this year alone we've added 10 new routes to our system. So, that's a little bit about my background.

I'd just like to make three introductory points; strategies for market entry for a VBA, and the impact of entry, marketplace impacts, and a couple of points on distribution.

First of all on strategies for entry. The thing about VBAs, if they're implemented purely in the way that easyJet has, using a direct sale model, one must focus not on rules but on markets. To get efficient use of the investment in the brand which is necessary for direct selling we focus on linking a market to as many destinations as possible. So in that context market share on a route is not a particularly important aspect of the way that we manage the business.

So, it's likely that a VBA starting on the Tasman or starting in domestic New Zealand will take origin market and then find ways of linking that market with many -- as many destinations as it sees viable. That's likely to lead to a low frequency model but serving multiple destinations.

Beyond that entry point one would expect to see frequency and the development of -- frequency to increase and the development of new origin markets to occur progressively.

It's important to note that low fares makes many more routes possible and viable which are not attractive to a full service airline. Therefore, the type of network you would see a VBA evolve over a period of time may look very different to the route structures that exist today and operated by a full service airline operator.

In my opinion the initiatives launched by Air New Zealand, both in the form of New Zealand Express, and more recently Tasman Express, is unlikely to deter a VBA entry for a number of reasons. First of all, a true VBA will have a cost base significantly better than those products. The VBA can also develop these new routes I mentioned, and in those cases it's very unlikely that a full service airline would follow, because it's not going to be profitable for them and it's not core business.

Thirdly, a point that applies directly to Virgin; coming back to the point I made before of developing services from an origin market in which the brand can be adequately developed, Virgin already have a very well-established presence in several attractive origin markets within Australia from which it can start flying operations across the Tasman at very low risk.

Finally, I don't believe that Freedom will deter VBA entry either. Freedom is a form of a VBA but it's been very strongly constrained by Air New Zealand; it's a small airline and would require time to scale its management infrastructure and its systems to become an effective deterrent against a true VBA.

Perhaps I could pause there and ask if there are any questions on the strategy for entry.

MS BATES QC: My question to you, Mr Webster, is this; you say that -- the strategy would be including developing many more routes that are simply not feasible for full service airlines. Correct? Did you not hear me, Mr Webster?

MR WEBSTER: I heard part of the question, I'm not sure that I understood exactly what you are asking me for.

MS BATES QC: Well, what I understand from what you say is that part of the strategy is to develop an origin market, right?

MR WEBSTER: Yes.

MS BATES QC: And then look for as many routes off that as possible.

MR WEBSTER: Yes. Many of those routes would be routes that are currently not flown by full service airlines.

MS BATES QC: Yes, that's the point. And I'm asking -- the question I have for you; do you think that that is as feasible in a market like New Zealand where the population is very small, as it is in Britain?

MR WEBSTER: Well, I do. I think that the issue is that, if you have a market -- an origin market the size of say Sydney or Melbourne and you link those markets with a broad range of destinations in New Zealand for example, Trans-Tasman, Queenstown, Dunedin, Christchurch, Nelson.

Some of the markets that VBA developed in the UK here, for example, just had no air services at all before the low cost industry began, and even today we're still seeing those new routes developed. The point that hitherto has never had services. Some of these cities that VBA flown to have populations of around 15 to 20,000 people as a permanent population base, so it really is quite difficult to understand, without actually going back and having a look at the desired travel habits of people; there may be family connections, it may be that people want to develop holiday homes, and what we've seen with the low cost industry is not just a question of people wanting to fly more, but fairly significant structural shifts in the pattern of use of air transport.

It can relate to location, it could relate to setting up businesses in new communities which are financially attractive and which low cost air travel makes viable. It can be people deciding to relocate and live somewhere else and commute by air, accommodation of telecommuting and travelling by low fares. There are a number of things that go on that don't necessarily go from day one, but over a period of time we have seen change within the European market.

MS BATES QC: Thank you.

MR WEBSTER: And I believe those same characteristics are likely to be seen in Australia and New Zealand when you consider the amount of migration that has occurred, particularly from New Zealand into Australia. I think starting from Australia and then linking back to New Zealand could be a very attractive way for a VBA to start.

CHAIR: Can I just ask you what similarities and differences do you see between the way Virgin Blue has introduced its low cost airline with that of easyJet?

MR WEBSTER: EasyJet really took the Southwest model and applied more modern management thinking and technology to what we believe improved the model. Essentially, we sold directly to the consumers, we had no involvement with travel agents, we charged for food on board, we decided the best way was to buy new airplanes rather than use secondhand airplanes -- there are a number of incremental innovations, but the basic principle of the easyJet model is the well proven Southwest model.

I think the main difference between the way easyJet developed and the way that Virgin Blue developed was that, we started in a marketplace that was unused to the concept of a low priced airline; we were the first airline to start to spread the concept, Ryanair then quickly adapted to it.

In the case of Virgin Blue a number of the people working for Virgin Blue in fact worked for easyJet at some stage, and so certainly they did have a role model, a new start up airline role model to refer to, but I think their biggest difference is the fact that -- was caused by the fact of Ansett vacating the market, that they had an opportunity to grow at a very very fast rate.

Now I suspect, I don't know this for certain, but I suspect that there are a number of things that they did during that period of time to perhaps lose some of the focus over the true VBA concepts.

CHAIR: Can you elaborate on that, please.

MR WEBSTER: I think at this point in time my understanding is that the purity of the model is not 100%, however I suspect that those things that are not 100% of what I would consider to be a pure VBA are aspects of the business that they could go back and revisit.

CHAIR: Isn't it possible, Mr Webster, that the reason it isn't a pure VBA model, say for instance like easyJet, is because the market circumstances are different and, therefore, it needed to be different?

MR WEBSTER: I don't believe that to be the case. My experiences across quite a number of European countries now is that the consumer, once they're comfortable with the notion that low fare airlines are safe and reliable, that no one wants to pay any more for their air travel than they need to. It's a question of how long do consumers take to get comfortable with that notion.

Now, in the case of Australia, Virgin Blue developed very very quickly and I would expect at this point in time that consumers would be quite comfortable with a low cost concept. However because they developed it in the way that they have, there are a number of things that I would not have considered to be part of VBA. For example, their alliance arrangements and lounge arrangements, they're probably marginal issues rather than fundamental issues.

CHAIR: It may suggest, however, that Air New Zealand's recent changes make it closer to Virgin Blue than what you might normally think it would be in terms of a value based airline, the offering may be closer to what a Virgin Blue might offer than it would, say an easyJet offering.

MR WEBSTER: I think if we just examine the basic premises of a VBA for a minute. The first premise is that the point to point business is its core business, and nothing else. It doesn't get itself tied up with alliances, it doesn't see itself as a network carrier, it tends to focus on a single airplane size, perhaps type. It tends to direct as much as possible directly with the consumer; Southwest doesn't do it 100%, but it tends to focus on direct selling channels and offers a very simple product on board, generally an undifferentiated product. It tends to strip away a lot of the pricing mechanisms that traditional airlines have had in place. It looks to operate airplanes very -- on a high intensity flying programme to get good amortisations of fleet. It tends to employ young, highly motivated and incentivised people; it uses its own reservation system, and doesn't use the traditional airlines' GDSs.

I mean, there are a number of dimensions that I could keep going through here, and if you grade Virgin Blue on that checklist, I think most of the boxes will be checked.

CHAIR: What if you grade Freedom on that checklist?

MR WEBSTER: Freedom checks out most of the boxes. The problem with Freedom is that it's a very small airline. Its reservation system, for example, is the right size for its current business; its management team is the right size for its current business, and to grow an airline to the size of an airline that Virgin is today, requires a lot of capital and a lot of commitment to see that growth managed in such a way that the robustness of the airline is properly managed.

Now, easyJet grew very quickly, in some of our early years we grew as much as 100% in a year. We find growth now at the rate of 15 to 25% as being the range which we can grow per year. Now, that's of course on a much bigger base of operations, but it would be several years before Freedom could develop itself into say a 20 fleet airplane operation safely. And that's the point that I made earlier, that the scaling -- the lead time to scale an airline that's been developed in the way that Freedom has been developed and really held back, is not a trivial step change.

CHAIR: I didn't hear what you said the lead time was; can you just repeat that?

MR WEBSTER: Its current size to say 20 airplanes, which would be a reasonable fleet size to operate domestic and Trans-Tasman services I believe, would take something of the order of 2 to 3 years; 2 years minimum.

CHAIR: Can I just go back to your --

MR WEBSTER: It took easyJet 5 years to grow from two airplanes up to 20 or 21 I think at the time we floated the airline.

CHAIR: What sort of -- when you were entering the market what were the more significant barriers to entry that you faced?

MR WEBSTER: I'm sorry, I just missed the point of the question?

CHAIR: I'm just asking what the most significant barriers were that you faced as you tried to enter and sustain your entry with easyJet?

MR WEBSTER: Can I perhaps just move on to the next section and answer that point at the same time?

CHAIR: Yes.

MR WEBSTER: Because what I was going to address next is marketplace impacts.

CHAIR: Okay.

MR WEBSTER: Yes?

CHAIR: Please proceed.

MR WEBSTER: Thank you. The first thing that we noted as we developed was initially, the dramatic fall in traditional airlines' fare offerings. That occurred for two reasons. One is that, once consumers are offered a cheaper choice, they're willingness to pay a higher price, even though they may have paid it for many years hitherto, becomes difficult for them to accept.

Secondly, there is a high degree of substitution between routes and whilst a low cost airline may operate some of its capacity on a contested route, it's also likely to be able to attract customers who would otherwise have travelled that contested route on to new routes that in the past have not been operated.

So, there are two mechanisms that we observed. So even small market share going on to a contested route is not necessarily going to protect a traditional airline from pressure on its fares.

The second observation, and I believe this has already occurred in Australia and New Zealand, is that the market distorting mechanisms that airlines traditionally have introduced around fares, including fences around Saturday night stays and so on, are dismantled as the traditional airlines realise that they're actually penalising themselves by keeping those mechanisms in place.

Initially we've observed that it's the very price sensitive travellers that adopt to the low fare offerings initially, but over quite a short period of time, somewhere we've observed over 6 to 18 months the more discerning business and leisure travellers, both leisure and business, will migrate to low cost, particularly as the reputation of the airline is developed.

So, very price sensitive travellers will buy off the headline price as advertised, but more discerning travellers will migrate once they get comfort either through friends, relatives or just hearsay, that the airline is safe, it's reliable and can be trusted.

The other point to note is that a full service airline such as Air New Zealand and Qantas will be carrying short haul point-to-point traffic as well as short haul connecting traffic. Someone travelling from perhaps New Plymouth down to Wellington and then across to Brisbane. The full service airline is likely to lose that connecting traffic as well as the VBA offers point-to-point connections on these new routes that we talked of before.

So, I think that the bottom line here that I believe is valid to look at is that, a full service airline is likely to see erosion of its fares across all classes of travel and across large numbers of its routes, even if the low cost airline is not in technical terms providing a lot of frequency compared to the full service airline. The leverage is in the advantage of the low cost airline.

In the case of easyJet, we have not yet pulled off any route in our development since 1996 for any reason let alone competitive reasons. We have had -- in fact, one of the things that we don't do is worry when we are developing new routes to look at the competition levels of full service airlines. We're mindful of what other low cost airlines are doing, because it clearly would be value destroying to end up with a fight, a head on fight with two low cost carriers who have both got the same low cost base.

But what we look to do is, one make sure that the routes that we go on to are large and, therefore, in the long-term capable of supporting a significant amount of our capacity; we look for a cost base advantage to easyJet because my belief is, over the longer term, medium to longer term it's really the cost base that delivers the protection to the business model.

The response to the market by these low fares cannot be fully predicted; each route tends to be somewhat different, and so, when we go in and offer low fares to start with we can never be exactly certain of the response in terms of what the mix of leisure and business is going to be. Initially the leisure market responds quickest and the business market follows. So, it's true to say that the competition of the traditional carriers has really not been a significant factor.

Clearly, if there's an opportunity of developing the business without competition, it would be very attractive but we have to live in the real world, we're part of a movement to increase competition and reduce the fares for all consumers.

The one case that we've had one difficulty was in the early days when easyJet started to fly into Amsterdam and KLM was dumping seats offered on a 747 to London at very very low prices, and that was the only instance that I think we've asked for an intervention by the -- by Brussels, by the competition authorities and which they investigated very thoroughly and they disciplined KLM, but my belief is, providing the competition is fair, the low cost base will drive the success of the VBA.

Any other questions on marketplace?

CHAIR: I just wanted to come back to the question I put to you before, which was, what were the significant barriers to entry that you faced in the early days of the easyJet?

MR WEBSTER: I think I tried to answer that by saying that there really weren't any from the market point of view. The barriers for us was making sure that we developed a reputation for safe and reliable operations. The market really did not constrain us; competition did not constrain us.

CHAIR: Were there any issues around access to airports and this sort of thing?

MR WEBSTER: In the early days, and I think it was around 1990 -- late 1996, we had established the airline successfully as a small operator within the UK and we wanted to start branching out into Continental Europe, and we chose at that stage Amsterdam as the first point, thinking that the culture -- remember that in these days the concept of low fare airlines was not established in Europe at all, we were pioneering.

So our first service was selected to go into Amsterdam because we felt that the culture of the Dutch and the English were sufficiently close that it would be a lower risk than, say, going into Spain or Italy. And just after we made that decision there was a problem in Holland where restrictions were imposed on the airport to reduce its flying capacity because of noise constraints. So, that was our first exposure, if you like, to a barrier; not a market barrier, but an airport capacity barrier.

Typically now most of our airports are not slot constrained, although a number are. For example Gattwick which we entered last year is slot constrained, Orley is slot constrained. Both of those airports we operated into in response to the cut-back of traditional airlines following September the 11th. One other airport, Madrid in Spain, and one other in Switzerland, in Zurich, are also slot limited airports, but we've been able to incrementally, from season to season, get slots sufficient to meet our market needs.

So, whilst it may be on paper look to be a limiting factor from the point of view of wanting to progressively develop a route commensurate with the size of the market, they have not been inhibiting factors to the growth of the airline.

CHAIR: I just want to come back to the comment you made that the key issue for you is the cost base advantage and that -- I know I'm paraphrasing, but that that is what protects your business model.

I want to ask you, and if I'm correct you're continuing to advise Air New Zealand on its strategy, would it be fair to say that, if that is the major factor in determining your success, that Freedom and Express class are an attempt to get at that very thing, to put at risk the Virgin Blue business model through attacking the cost base advantage. I want to ask you if that is your advice to Air New Zealand to pursue that strategy in order to deter VBA entry?

MR WEBSTER: I think just in the big picture for a minute, I don't believe that a single VBA airline is going to be evolving in Australia, New Zealand. I think without question we will see more than one low cost airline; it's not natural for a single airline to exist anywhere and I think the market, certainly in Australia and the Trans-Tasman domestic New Zealand combined, is large enough to support more than one brand, and I'm sure that will evolve in time.

CHAIR: Can I follow that one up before you go on. The Applicants have submitted to us that the New Zealand market isn't big enough to support more than one VBA and one full service airline, and if I hear you correctly, you don't agree with that view?

MR WEBSTER: Yes, I'm referring to the market as a whole; the

Australasian market, Australia, Tasman and New Zealand combined.

CHAIR: I would like you to speak to the New Zealand market, please. Can you tell me whether you think the New Zealand domestic market can support more than one VBA and a full service airline?

MR WEBSTER: I believe the New Zealand market by itself would not sustain an airline in its own right, and I think going forward if you want to get the economies of scale out of a VBA you need a substantial marketplace in total; one, to get the brand well-established and second, with a lot of economies of scale coming out of the deployment of the brand, and secondly, to be able to buy airplanes, fuel, insurance at competitive rates.

So, you have a VBA in Australia and a VBA -- let's say the markets were not linked. It's likely that a VBA in New Zealand by itself would have difficulty in operating and complying just to the New Zealand market --

CHAIR: I didn't mean to imply --

MR WEBSTER: -- if competition opened up.

CHAIR: I didn't mean to imply that they couldn't be operating in Australia, but what I want to ask you is; is it clear that, if there are more than -- say there are three airlines operating in Australia, is it clear to you that New Zealand would be an attractive market for all three of those airlines to simultaneously be operating across the Tasman and into the New Zealand domestic markets?

MR WEBSTER: Yes, let me tackle it a different way. The New Zealand domestic, the former two domestic airlines up until a little while ago, one could argue as to how profitable they are, and I'm certainly not qualified to speak on that. The low cost model, I believe, will completely -- the VBA will completely make obsolete those traditional models.

The lower fares should expand the market quite dramatically. Australia and New Zealand contain a lot of very price sensitive leisure travellers and price sensitive business travellers, so the cost base, for example, could be reduced by a half. Rule of thumb would suggest that the market should double in volume plus or minus.

So therefore, if a traditional airline is available in the New Zealand market, or two is viable in the New Zealand market then there's no reason to expect that two VBAs could not coexist in that market in the long-term as well. That would be the way I would think about it.

CHAIR: And two VBAs and a full service airline?

MR WEBSTER: Well, I'm not sure there's any future for the VBA airline and I think that's the issue that airlines like Qantas and Air New Zealand have to contemplate. I think that the Swiss Army knife model of airlines which they represent; that is, you know, we'll do everything from regional flying to long haul 747 flying, I think is an antiquated model. I don't believe that as the world deregulates in its next stage of deregulation between the US and Europe, I don't believe we'll see much future in network flyers at all, they will be long haul point-to-point flyers and I think Air New Zealand and Qantas have got to think about where their long haul future is going to come from, because I certainly don't believe it's going to come back from long haul flying.

CHAIR: I'd like to come back to the earlier question about what advice you've given, or you would give to Air New Zealand,

and is the current strategy with respect to Express and Freedom an attempt to undermine the key support for the VBA business model, and that is the cost base advantage? Did you advise Air New Zealand to pursue that strategy in order to undermine the key advantage that VBAs have?

MR WEBSTER: No. Not at all. My view is that Air New Zealand, whether you call it Express or any other brand, will never be successful competing with a true VBA, it has too much baggage; and transformation of an existing airline into a completely different model requiring far fewer people, different relationships with customers has been attempted by many airlines around the world and has never been successful. So, I don't believe for a minute that it will be successful for New Zealand and I certainly haven't advised that.

The reason I believe in that is why I left Air New Zealand; that I believe that there's a tremendous future in the VBA concept, I didn't see any opportunity of deploying that in Australasia apart from in Australia itself for Air New Zealand because of the conflicts of interest and cannibalisation, and I was fortunate enough to find an opportunity in the UK here, and I still very much passionately believe in that.

So, I think Air New Zealand's challenge is not to worry about domestic, I think a slow retreat is going to be in order there over the next 10 years. Its real challenge is to figure out how it's going to be successful in a much more contestable long haul market; that's where the bulk of its investment is, that's where it can be successful provided it doesn't spend too much time thinking about what it's going to do about it. So, that's basically the type of advice that I've been helping with.

CHAIR: Is it your view, that an airline like Air New Zealand can't transform itself into a VBA?

MR WEBSTER: Well, the only airline that I'm aware of that's successfully set up a low cost airline is British Airways. When they set it up they didn't know what to do with it so we bought it from it. But I'm not aware of any other low cost airline that has ever been developed, or in fact migrated away from the traditional model, and many many airlines have tried over the last 10 years or more.

I remember the first I think was Callight(?) that started up in the US when we were looking at the VBA concept, and that would have been about 1992. So, there was Callight(?), there was Shuttle by United. Delta is trying another one called Song(?) now. Of course, BA set up -- had a go. There's been a whole series of attempts, but no airline has managed to set up a true VBA.

CHAIR: I just have one more question and then Commissioner Bates has a question as well. I'm a little surprised about the advice that Air New Zealand should have a slow managed retreat from its domestic business and put the emphasis on the long haul, given most of its profitability has traditionally come from the domestic side, and they've struggled on the international routes from what we've been told.

It seems like a fairly major transformation in itself to make that work, particularly given the competition it faces in the long haul business, and I'd just like your comment on that.

MR WEBSTER: Well, I think that what I am really able to share with Air New Zealand is my experience in running a low cost airline and observing the responses that we've seen from traditional airlines in Europe; I think that's all I'm able to do. I'm not providing any detailed analysis in support for Air New Zealand, I'm purely conveying, if you like, my personal experiences and experience in running Europe's largest low cost airline.

My message to you is the same message I sent to Air New Zealand, is that you can slow down perhaps the rate of wealth -- the rate at which depleting shareholders' wealth, but you won't stop it. You will not stop the success of a true low cost airline. In time the low cost airline will win because of its superior cost base and tiny specialised business processes.

CHAIR: What could they do to slow it down?

MR WEBSTER: Well, the traditional response of a well funded large airline is, throw money at it and heavily discount seats. Now, that works okay on contested routes, but it doesn't work on new routes. It doesn't help when more capacity goes on by the low cost airline, and the full service airline has then got to say, "Well, I filled all my seats at these very very low fares, I'm not making any money; am I really going to put more capacity on to this route and further take the airline into loss?"

Now, clearly Air New Zealand doesn't have that situation -- opportunity available to itself because of its current financial predicament. But if this was a very strongly funded airline, and probably one I can think of in the UK here is Lufthansa, that is the sort of response, and I would call it a marginally anti-competitive response, that one might see. That may slow down the development of a low cost airline for a period of time, but it's not going to stop it from gaining a foothold by stealth over a longer period of time. It may slow down the full frontal attack but a low cost airline will win ultimately.

CHAIR: We were just advised by Qantas that it's pretty much what they did in Australia, a fairly robust response; met the prices, put on capacity, and that they'd have to do the same thing here with or without the alliance in response to VBA entry.

So, whether Air New Zealand on its own could do it or not, it's readily apparent that Qantas is prepared to do it, and certainly in the form of the alliance they seem -- seems like they'd have the capacity to do it, and they have stated a view that they probably would.

So, in terms of delay, what sort of delay can be affected by that sort of anti-competitive response?

MR WEBSTER: I think it depends on -- yes, it depends on what they think the end game is. If a low cost airline is poorly funded, then a strong traditional airline may feel that it can hold the young upstart under water long enough for it to run out of cash. We've certainly seen that scenario.

However, a rational board would have to take the view and that is, in the long-term there was no chance against the well-funded VBA, that it was actually going to ever make profits; ultimately surely the Board would intervene and say, "let's focus our attention somewhere where we can actually be successful in the long-term."

I think there's a very strong body of evidence around the world with Southwest, with JetBlue, with easyJet and with Ryanair to suggest that traditional airlines are not an effective form of competition against a value based airline, and I think the challenge for traditional airlines is to

Applicants (cont)

develop an exit strategy.

It's very very difficult for a traditional airline to back out of capacity commitments, to back out of markets and to reduce staffing, or in fact to displace staffing out of the loss-making short haul airline into its longer haul business, but I think that, you know, for an airline such as Air New Zealand or Qantas, which is able to observe in other territories such as the US and Europe, what is happening. It's actually got quite a good lead time to actually work to to try to reposition its business before its domestic business is dramatically affected and before the rules of the game of the long haul business also changes, because clearly deregulation is something that eventually will be global.

So the rules that we learned to apply in short haul are going to be exactly the same rules we're going to see in the medium and long haul markets through time; we just don't know when. At the end of the day we're talking about consumers and consumers don't want to pay more than they need to and they're paying a lot more than they need to at the moment both in the VBA arena and also in the full service arena.

CHAIR: Thanks for that Mr Webster. Commissioner Bates and then Commissioner Curtin would both like to ask questions.

MR WEBSTER: Yes, I just had a couple more points to make, particularly on distribution, shall I hold them for later?

CHAIR: Can you just hold them until we get these questions through; thanks.

MS BATES QC: Mr Webster, I was interested in what you had to say for the long-term future for FSA, I think you may have characterised them as dinosaurs or something like that. But

Applicants (cont)

certainly you don't see the model as surviving, do you?
MR WEBSTER: Not without changing.
MS BATES QC: So, do you see them concentrating predominantly on the long haul? That's the first question.
MR WEBSTER: Yes.
MS BATES QC: And, point-to-point rather than networking?
MR WEBSTER: I think that particularly with the advent of the internet, that a lot of the complication that traditional airlines built into their so-called network operations is largely redundant. More and more people travel these days, more and more people are comfortable to use the internet effectively as the marketplace to provide hotels, connections, rental cars, directly from their computer terminal.

So a lot of the investments that airlines have made in the past in the form of alliance relationships, in terms of coming on to the GDS, travel agent relationships and partnerships and so on I think we will see fall away over the next few years as long haul airlines find a way of becoming more competitive. Because I don't think that consumers will pay airlines the prices needed to sustain those arrangements.
MS BATES QC: Yes, I can understand exactly where you're coming from. It's in contrast to some of the other evidence we've had before us which tends to -- the evidence really is that there's enormous value in connectivity and network that a VBA can never hope to supply, so that gives the full service airline the ability to carry on, and so it's actually quite -- to me it's in quite stark contrast to what you're saying.
MR WEBSTER: Well, I think that the issue -- when you stimulate

short haul flying with a point-to-point network and lower fares, the amount of connecting traffic is naturally diluted, and it's diluted for two reasons. One is that the amount of flying increases, and secondly, the full service airline -- sorry, the VBA airline is likely to be flying into new cities that weren't hitherto connected and, therefore, the requirements of the short haul connecting traffic is dramatically reduced.

The VBA is not going to affect the demand for long haul travel into or out of New Zealand; it's unlikely to in itself. So the amount of connecting traffic that Air New Zealand would have over Auckland, for example, into Australia or to other parts of New Zealand, is probably going to stay where it is today, but the rest of the traffic around the region is going to dramatically increase as a result of those lower fares applied by the VBA.

So, I think the big problem for the traditional airlines is to get their hearts around whether they can actually stop doing some of these things that they've done for so long in the past.

I mean, I can comfortably sit here and make these comments because I don't have to take responsibility for making some tough decisions here. But if I was running Air New Zealand I'd probably -- you know, I might have to think about it a little bit, but I guess I see that the traditional airlines really have to change and I think, if you've got the low cost airlines coming in and taking out that lower ground of the short haul market, then the traditional airlines, the long haul airlines particularly, have got to think about how they take capacity out of the that market because they're not going to be successful in it and how they deploy that efficiently somewhere else.

And my view is that the way they should be doing that is to focus on learning from the low cost on the short haul and applying the same model on the longer haul market; maybe a middle, medium haul and long haul.

MS BATES QC: I understand that.

MR WEBSTER: I'm not a paid advisor to Air New Zealand in terms of speaking their strategy; I mean, I'm basically independently sharing with you my view of the way things are possibly going to be heading in the next few years.

I mean, it's very interesting, not everyone believes in this; at the moment you've got Airbus building the word's biggest airline, on the other hand you've got Boeing saying point-to-point is the way of the future, we're building smaller airplanes, so there are different opinions out there at the moment.

MS BATES QC: Just pretend for a moment that you are advising Air New Zealand on what to do to increase its long haul business. Would you be advising it to do that on its own or would you be advising it to cast in its lot with Qantas and do it with Qantas?

MR WEBSTER: My view is that the region needs a strong network, and I think both carriers are very small when you compare the size of the competition against the European carriers or the US carriers, and they're the carriers that the South Pacific will have to compete against in the future, with a much more aggressive and fit set of competitors, I would view.

So, I think the industry does need to consolidate. Certainly, my view of Europe is that Europe is well overdue for a round of consolidation, and even in territory the size of Europe, over 250 million people, I believe there's only room for three, four major airlines, and the remaining airlines should be consolidated.

MS BATES QC: Thank you.

CHAIR: If you would please complete the rest of your presentation, Mr Webster.

MR WEBSTER: Yes, thank you. It was just a question of distribution, and I'd like to say that easyJet was the first airline which completely bypassed the travel agent. We've never ever paid commission to a travel agent. 95% of all of our seats sold are sold on the internet, on-line; 95%, and the remaining 5% over the telephone. They appear staggering statistics, but I think it's an example of what happens when you encourage consumers to find a better way of doing business.

Most of Europe is now moving over to our model in some shape or form. Travel agents still have a role to play, but what has changed is that, instead of airlines paying the travel agent, the travel agents are now paid by their clients who are in the best position to determine whether they are getting value for the advice that the travel agent is providing.

So it's a different incentive model; travel agents are still there. Without doubt, some of the poorer travel agents are no longer in business, but the good ones are offering better services to customers than they've ever done in the past.

I think a point to make here also is this concept of direct selling works well for a simple product which point-to-point flying really is, and it also of course provides lower fares to consumers because it takes a lot of cost out of the distribution channel, not only in commission but also in the need to support GDS systems and the need to retain a sales force and providing advertising collateral for travel agents. So there's a whole series of costs.

When easyJet got started we believed that about 30% of our cost advantage came out of distribution alone.

As I mentioned, most of the full service airlines around Europe now are embracing this model or variants of it. British Airways is certainly one of those, as is British Midland. I think the underlying point I would say here is that, although easyJet led the charge, the consumer is now very much in charge. The consumer is really forcing the industry to become a lot more efficient, initially because it was the only way they could get these low fares, but traditional airlines have had to respond to that pressure in order to try and maintain as much competition in the market, or success in the market as possible, and I understand that that's something also that is occurring in Australia and New Zealand.

So that's good, I think it's very good for the consumer; it causes some pain to the travel industry, however, again I think it's been a protective industry in the past and this is something that must continue to develop. That's the last of my comments.

CHAIR: Thank you for that Mr Webster. I might just check with my colleagues if there are further questions. We have a question, Mr Webster, from one of our external advisors, Professor Gillen, and I don't think you will be able to see him, but hopefully you will be able to hear him.

PROF GILLEN: Mr Webster, when you're look at entering markets, how important is things like the current margin on fares and the number of competitors in the market influencing your choices?

MR WEBSTER: The approach we take is looking -- or estimating what we believe is the average fare in the market today, and in the case of full service airlines of course, the cost base I mentioned before is taken for granted; we know what the cost base of all the other airlines is roughly, so that's not a factor.

Now, in most of the routes that we look at in Europe the fares are very high, so it generally is not a consideration, although we do look at it. It's likely to vary because of the amount of leisure travel on the market and contestability of course could be a factor, but by and large it's not really a strong driver of our decision-making.

If we take, for example, an exception, which would be the Greek Islands out of Athens, that market has been distorted because Olympic has been competing, propped up by Government subsidies, competing with surface transport, the fast ferries and, therefore, you will see the price per seat mile, available seat kilometre in that marketplace very very different in an outlier well below that of the rest of Europe.

So, I'm just putting that one to one side, but that's certainly the reason we've not entered that market. But, where an airline is not being subsidised, then one would expect that the fare structure and average fares pretty much follow the cost base, plus or minus; obviously the degree of competition may change that a little bit, but by and large it's not a factor.

The biggest factor that we actually focus on is, what makes sense in terms of linking our current origin markets where we've already invested in the brand, how can we extend that market into new routes, into new destinations and capitalise on that investment? So, that's the first determinate.

The second point of focus is really on -- well, should I say the first point of focus we have is just increase in frequency, increase in frequency on existing routes.

The second one is to see whether we can actually, as I say, tap into that brand and encourage people to go to new destinations, and the third one is then to look at a new destination or a new origin market; that requires a large commitment of capital investment, and we do look at that very carefully.

The determinate of that choice is -- let me just take you through something here in Germany at the moment, but traditionally in most of Europe we would really only consider the size of that market and where we felt that market could be linked to, which other points in our network would it fit with and, therefore, how many airlines could we deploy.

We tend to now look at deploying something between 6 and 8 airplanes every time we enter a city into that city it itself. The reason is that we have a lot of airplanes coming, we have 240 airplanes on order, 120 of them will be delivered over the next five years, and we have to focus on profitability but also being able to deploy a large amount of capacity on a cumulative basis going forward, which is pretty large.

Now, the only market that we've actually stood back from, and this is something that's happened recently in Germany, we had an option to buy a British Airways owned subsidiary called Deutsche BA, which is based in Munich, a 16 airplane operation, and it's run like a charter business, not too dissimilar from Freedom in a way. It's very low cost, but it's never had any of its own customers, it's basically just pilots and an airplane, and they have flown under a BA sponsored brand, but very little in the way of marketing.

When we took that option, Lufthansa got a little bit upset and started to throw its weight around and very heavily discounted all of its domestic market, sponsored the start-up of another carrier, then we had three or four other carriers, Air Berlin, Hapag-Lloyd Express, we had Virgin in Brussels, Virgin Express, all start to focus on the German market, and we felt this was just too much noise, there's too much going on here and we just walked away from it.

That's not to say we're walking away from the German market; in fact it's quite possible within the next few months we might make some announcements on Germany, but we felt it was the wrong time to go out and buy a large operation; 16 airplanes is quite a large operation to acquire; so soon after acquiring go in a market which is being disturbed by so many different players.

So, you know, we can be cautious when we need to, but I don't believe that there's anything structurally wrong with the German market that will deter us from going in there in an organic way over the next five years or so. Does that answer your question?

PROF GILLEN: Yes, it does, thank you.

CHAIR: Okay, Mr Webster, I think that completes the questions that the Commission has for you. I'd just like to thank you for taking the time; it's been very valuable for the

Commission to be able to listen to what your experience has been and we're very appreciative of that, so I'll let you go back to, must be a late evening there, but thank you very much.

MR WEBSTER: You're welcome. Thank you.

CHAIR: I think what we'll do now is, we'll break for 15 minutes and, if people could -- we'll break for 15 minutes and if people could be back by about 22 past from my watch; I don't know what everyone else's say.

MR P TAYLOR: Madam Chair, a lot of what's still to cover has been largely held in questions. So a large part of what we're still to cover has come out during that discussion, so we'll be able to move quite quickly through the rest. There's just two or three slides we need to concentrate on.

CHAIR: Okay, thank you. We'll take that when we get back.

Adjournment taken from 10.08 am to 10.30 am

CHAIR: Okay, I'd like to resume this session, if everyone would please be seated.

MR P TAYLOR: Madam Chair, Mr Edwards would just like to clarify one statement.

CHAIR: Thank you. Mr Edwards.

MR EDWARDS: Thank you. Earlier in response to a question about what would Qantas do with Virgin Blue entering the market I made the distinction that we would match fares and reduce costs. Unfortunately in your translation to Ray Webster you used the comment that we would "put on capacity", that Qantas had said we would put on capacity, and that was not --

CHAIR: Not what you said.

MR EDWARDS: -- not what I said, and it is something that we would need to see corrected.

CHAIR: All right, thank you for that.

MR MILLER: Madam Chair, I'm going to try and speedily go through the remaining of my slides on the basis that some good questions came out during Mr Ray Webster's -- after Mr Ray Webster's presentation and during his presentation. So, if you wish me to slow down, please say so, but I intend to finish off my slides in the next 10 minutes.

CHAIR: As long as you speak slowly enough for the transcription.

MR MILLER: In terms of Freedom, Virgin Blue has withdrawn its demand relating to Freedom and we have given very simple undertakings with regards Freedom's deployment in the marketplace.

In terms of incumbent response, two examples here, and I'll give you a third one in Australia. The march onward, a value-based airline capacity even against well regarded incumbents, whether it be British Airways or United, US Air or indeed Air Canada, the march keeps going on, and as Ray said, it is almost impossible to stop. You can slow it down, but you can't stop it.

Virgin Blue itself in regards to Australia; there's been orderly growth over a protracted period of time, although I would accept that the demise of Ansett speeded up that growth, but I would say that their position in the marketplace would be very similar in a couple of years' time as to what they've managed to reach now, with 30% of the total domestic capacity.

I'm now going to show you some time lapses in terms of FSA share and VBA capacity share. This is from Australia, Canada and Europe. The first pie chart top left shows 21% VBA share at point of entry, and then the next pie chart to the right is after year 1, year 2 and year 3.

What this clearly displays in these markets is that it's the FSA capacity share which diminishes over a period of time. This also applies to the US domestic market as well, where the reduction in FSA capacity share is a result of VBA entry. Clearly, characterised because of the lower costs of the VBA and the customer's incessant requirement to have lower fares.

Just in terms of Virgin Blue's or the early entry into the Australian market over the three year period, June 2001 to June 2003, the red lines clearly show the number of new routes that they've actually started to fly, and indeed Westjet's experience in the Canada in regards to their growth over a three year period as well.

In terms of timeliness of entry, Virgin Blue's entry plans are well advanced, and Virgin Blue's entry, we believe, is imminent in terms of the Tasman and latterly the domestic market.

In fact, Virgin Blue's CEO, Brett Godfrey, stated at the year end results that they believed that Virgin Blue would definitely have its first international service and flight by Christmas, and obviously they've applied to the authorities in Australia for international flights to places like Fiji and Vanuatu, and we know through slot applications that obviously they've actually applied here in New Zealand.

So let's look at the impacts of VBA into the market, and you've heard today that most incumbents definitely reduce fares; the VBAs because of the lower fares do stimulate demand and grow the market in terms of passenger heads, although in some markets obviously the revenue base does decline, it remains flat, and it causes an ultimate reduction in full service airline capacity, and it does have significant impacts on the full service airlines even when the VBA has a very low level of market share, which I will demonstrate in the following slide.

MS BATES QC: When I'm looking at your -- the extent of entry that Virgin Blue's network having expanded rapidly; all I wanted to ask is whether, you know -- or maybe I should ask Mr Edwards -- whether Qantas has started flying routes that it didn't otherwise -- that it didn't used to fly?

MR EDWARDS: Sorry, have we started...?

MS BATES QC: Yes, what Mr Webster said is that VBA are able to take on routes that the full service airlines can't, and I just wondered whether one of Qantas' responses to VBA entry had been to actually, you know, put on flights to different routes?

MR EDWARDS: No, no, we haven't. I think the very good illustration of what Ray Webster was saying, was that Virgin have started operating services from Sydney to Coffs Harbour with, you know, 160 seat jets and that's just something we can't do.

MS BATES QC: Okay.

MR MILLER: The next slide tries to demonstrate various levels of VBA share and the impact that they have on FSA in terms of pricing. I would evidence my own experience when I was in Melbourne running Ansett Domestic; when even at a very lower level of market share of Virgin Blue, that did destabilise the total market in terms of fares and also the impact on profitability firstly on Ansett Australia and ultimately causing its demise.

The reason why they have very high leverage and very low market shares is obviously, the FSAs respond in terms of pricing across the total network rather than pricing just against the specific routes that the VBA tends to operate. This happens because the customers are not only the customers of the route and the full service airline, these customers are flying in other routes and it would be unsustainable for the full service airlines to have doubled the fares on one route where it's not contested by VBA versus the route where they are contested where they might have fares of half.

So clearly there's a network effect and this did happen in Australia both with Ansett Australia and Qantas where they reduced the fares across the total domestic network, even at low levels of penetration. So it's a lever, it has a conditioning effect on the FSA network.

MR CURTIN: I know you want to illustrate one point from that graph, but I was also interested in the shapes of curves, and it looked to me as if by the time you get out to a fairly long haul section there doesn't seem to be much difference between VBA and FSA costs. I was just wondering what's going on here; are there some fixed costs -- what's explaining the shape of this curve? Is it fixed costs getting spread over more kilometres or does petrol dominate -- or aviation fuel dominate everywhere you go or what?

MR MILLER: I'd like to pass that question to David, if that's possible. David would be able to answer that better. He'll have a go at it, and if he doesn't have a good go, I'll have a go.

MR BENTAL: The shape of the curve is incurred by the cost incurred by the airline, and what you tend to see is in short haul segments, higher percentage of the costs are the fixed costs and when you allocate that over a smaller amount of miles, you get a higher yield, so that explains the shape of the curve.

In terms of the fact that, as you get to a much longer length of haul, the two curves are closer to each other, is because the -- at very high length of hauls the cost advantage of the full service tend to be lower than it is in a very short segment. The main advantage of VBAs on low cost carriers on the cost side tends to be as de-utilisation(?) and labour. Those are the two components that you get a lot of value when it's a short haul segment. As the length of the haul increases you see the differential getting smaller, so that explains the reason that the curves are closer at the end at the 1,500 miles as opposed to at the short hauls.

MR CURTIN: Thank you.

MR MILLER: I'll also add an operator's perspective to David's good response, and that's the fact that when we introduced Express domestically, it was across the total network from 19 seaters to 737 aircraft. On the 737 aircraft we were able to take out business class and increase seating capacity by 12%. We also reduced one crew member from 4 to 3.

The ability to replicate a lot of these efficiencies and cost reductions in a 19 seater aircraft where we couldn't increase the number of seats we couldn't remove cabin crew because there was no cabin crew, we couldn't remove food because there's no food. They have a higher level of fixed costs which are unchangeable in terms of the commercial and product model, so that also reflects the difference between stage length and obviously aircraft type.

MR BENTAL: Also, we're looking at the data a year before and a year after, so we do need a good sample. If you look at the US and European experience, very few low cost carriers were flying long haul flights; only in the last year, year and a half with JetBlue and a few Southwest flights the low cost carriers entering the long haul markets. I would suggest that if we do this curve 2 years from now you are going to see a much more significant difference.

MR CURTIN: Thank you very much.

MR MILLER: One of the other issues that we wished to demonstrate is that the entry of value based airlines has a total conditioning effect on all fares, and you will see before VBA entry the histograms are in red and after VBA entry are in blue, and what you can see is a migration down to the lower end of the fares and a growth in volume at the lower end of the fares.

Now, this happens for a lot of good reasons. Firstly, VBAs tend to have one-way pricing, so if you're working in the business market, a lot of business people know when their meeting is starting; let's say you're in Auckland and go to Wellington for the day, you have a meeting starting at 10 o'clock in the morning, so therefore you can pick the cheapest fare on the day on the internet, but maybe your return is conditioned maybe by the length of your meeting, so you want total flexibility in the return, therefore you'll pay a slightly higher price.

So, generally speaking, even in the business market there is a conditioning of that business market to reduce the average level of fare in the business traveller's market.

DR PICKFORD: Just in terms of that last graph, isn't there another factor potentially at work as well, in a sense that when a VBA comes in and starts to grow the market particularly at the lower end, so there are more fares coming in at the lower end, so when you proportion out, as you have done, that would tend to generate that effect; it's not necessarily that there's a bigger impact at the upper end fares it's just that there's more fares and a wider range?

MR BENTAL: The data that you're looking at in the chart is only the FSA, so in a sense -- so we're not including the low fares that the VBA is putting in.

DR PICKFORD: Okay, thank you.

MR MILLER: But if you want to do that you'll be absolutely right, there will be massive growth in the lower end of the fares because of the massive market stimulation, but as David said, this is only the FSA distribution.

The impact does affect other markets, and Ray's talked about this, the various airlines around the world changing their fare structures and their terms and conditions, so you don't have to wait until high tide and full moon and 21 days advance purchase to get these cheapest fare; these barriers have been removed as a function of consumer demand, but also the requirement for easier selling through web-based mechanisms.

VBA entry, as demonstrated, has impacted business as well as leisure fares. Business travellers in the past have been regarded as fairly inelastic, but VBA entry has shown a higher degree of inelasticity in regards that traveller than has briefly been expected. Do I believe that easyJet's business in the most mature routes up to five years, up to 50% of the traffic can be travelling for business reasons rather than leisure reasons.

Another good example would be that Air New Zealand, in terms of the new Express fares, for instance down to Queenstown, we've had a 65% growth in traffic down to Queenstown as a result of the lower fares, but also as a result of increasing capacity to Queenstown to stimulate the demand. In fact Air New Zealand, through its new Express class fares, has stimulated the market with 1 million incremental travellers in the domestic arena.

So, in summary, I'd like to say that VBA entry we believe is certain in the Tasman and in domestic New Zealand. VBA entry will stimulate demand, it's undoubtedly the case. VBA entry will provide an effective constraint on fares even at the lowest levels of entry in terms of market share.

This is also exacerbated because VBAs usually enter into the highest profitable routes, or the highest density routes as the first and second move. As I said, it's very difficult for the full service airlines to cross-subsidise under this arena because two-thirds of Air New Zealand's domestic profitability comes from the two biggest routes.

Indeed, VBA entry will constrain business as well as leisure fares and will affect markets wider than just those markets in which they've actually entered.

That's the end of my slides.

CHAIR: Thank you very much. We'll see if there are further questions. No questions. Thank you very much for the presentations.

The next item on the agenda at this point is, I believe the travel distribution market, and Mr Taylor, would you like to tell us how you propose to handle that?

MR P TAYLOR: In respect of the travel distribution market I think we'll postpone and just pass up to the Commission in due course some slides. Then, if the Commission has any questions at any stage during the rest of the process, we're happy to bring somebody forward to answer them. Rather, we would propose otherwise to move on to Clifford Winston. [**Pause**]. Sorry, Madam Chair, my mistake, Dr Clifford Winston.

Dr Winston is a Senior Fellow of Brookings Institution, has a PhD in Economics from Berkeley. Previously taught at the MIT and his research has been concentrated in the economics of transportation. He has co-authored and co-edited nine books, including The Economic Treaties of Airline Deregulation and The Evolution of the Airline Industry.

CHAIR: I'd just like to welcome you, Dr Winston and apologise for the delay in coming to your presentation, but we'd ask you now to begin your presentation and the Commission may wish to ask questions as you go through it. Thank you.

DR WINSTON: Thank you, good morning, thank you for having me.

Let me just give a little background. I -- myself and Dr Morrison, we're American economists who, among other things, study the US airline industry and we've been doing this probably since we knew each other in graduate school, for a long time, and have done a lot of empirical work, published literature on this.

The implication of this is that, as time has gone on when we are confronted with public policy questions, our instinct is to think about them in terms of things that we've already published and said about it. That may appear egocentric and in fact it is, but there's a certain comfort level we get from it in that, we speak from an empirical basis on policy issues.

So, in terms of how we got involved in this enterprise, we were asked our reaction to the proposed alliance, and so our first instinct was to think about what we had written about it, which was nothing; since, as I said, we're US orientated, but our instinct was then to think through these at least conceptually how our research might shape our perspective about this problem. And that was the first task that we set out to do and basically forms the bulk of our presentation.

But I think the useful thing that it has done is it's then raised the empirical questions which we felt needed to be addressed to hone in on this specific problem, and to do so required data for us to analyse. We don't have access to data down here, although we certainly had a framework on how to think about it, and we said we'd be quite happy if that data were provided to us to analyse it and report our findings. And so the data were supplied and we reported findings that I think then give us now an empirical basis for our views. Or we're comfortable in now saying from empirical perspective how to think about this problem.

So in summary we're empirically based policy analysts. In terms of our respective roles, Steve is the talented computer programmer, likes working with the data sets and executed the empirical estimation, and I enjoy writing and thinking about the policy implications of the work and report to that.

I'm trying to speak slowly, I actually speak quickly, extremely quickly, so the trade-off may be some inexplicable changes in speed, but I know what you're trying to do. Just realise this is a considerable constraint for me.

All right, so with that I'll begin and I'm going to take you through, as I said, about the first three quarters is just basically summary of what our research has been about that we think bears relevance to this issue.

A fair amount of this has been covered, so I think I can go through it quickly, although speaking slowly. All right, so I think the first thing that we thought about was the big picture question of just in general what it takes for success in this industry, and I think as has already been stressed certainly three key factors, low costs, efficient operations, however defined, excellent execution of service is certainly very important; and then the dynamic, or what we call technical efficiency, ongoing innovations and operations and marketing; you can't just be satisfied where you are, you've got to be responsive to consumers and engage with them, think about what to do.

Now, this has been said before where I think we want to push the argument a bit further is, there's really no magic bullet, you know, secret form of success here that you can get around this; that is, there's no consistent source of what we call economic rents, express profits, you know, places you can really count on to make a lot of money for a long period of time that might mask the fact that you're not terribly efficient or what have you.

And, to give you just some perspective on this, you know, consider other industries like the railroad industry. It's extremely competitive whether you're shipping manufacturers competing with trucks, but in railroading at least in the US they have what is known as what they call captive shippers who mainly ship coal, and you can pretty much count on that type of market to charge a high price and earn a fair amount of money.

Now, there are some regulatory constraints on this and I may actually get to that later in a different context, but railroads can look to captive coal shippers as a pretty nice source of revenues.

Airlines it's difficult. There are pockets of opportunities, these things do happen, but for the most part you pretty much have to make it on the kinds of efficiencies that I've noted previously. So I think that's one important thing to keep in mind about this.

Second, again, there's no magic formula. Efforts to obtain market power are not your long-run strategy of success, and what I mean by this are the things that can get you into legal issues; that is, an anti-competitive act, computer reservation system bias, collusion, predatory behaviour. You know, I can't think certainly of a single example where one looks to somebody who's been successful in this industry and says, they didn't earn it; you know, they competed unfairly, you know, they merged with someone else, got big and destroyed everybody in their market so on and so forth.

So again, that's a prior that we have going into this. All this said, there are major differences among carriers. There's not a right formula. I think you can be a successful full service carrier, you can be obviously a successful low cost carrier, but the engagement of carriers can be very idiosyncratic.

American Airlines try to cultivate a certain reputation as being very aggressive with Bob Crandell as the CEO. You know, you cut a price in a market we're in, we're going to match you very aggressively. Delta tried to be a little more laid back about things, you know, they didn't want to ruffle feathers and tried to cultivate, sort of a mortgage co-operative understanding of things. Southwest is not an aggressive carrier in the sense of trying to spur fare wars. They obviously engage with low fares, but they too want to get along, and I think there's been cultivations of just certain representations and styles. And when you say carriers engage it's not always a general thing you can say.

The bottom line is, the identity of who is in a market is critical. I think you just don't want to look at a market and say, you know, what is N? Are there three, are there four, are there two? It often matters who they are in terms of what the consumer benefit is going to be in competition in those markets.

All right, so that's pretty much how we see what this industry is about in terms of the level of competition, how competition has started to evolve, and now let's move forward to now some policy questions.

Where do mergers fit in all of this? What's their role in what's going on, and what's gone on? Stepping back in the most general terms, mergers are an investment; you know, you're a firm and you can spend money in many different ways, one of them is to acquire somebody else. This is a risky investment. If one looks at this in terms of all US merger activity, the surveys have been done. The average return, whether financial methods of doing this, or looking at other measures, is normal, if you will, with a pretty big distribution.

Applicants (cont)

A fair number of these do not succeed. I've seen financial economists, if you will, study this and anywhere from 30 to 70% of these things are not judged to be successful on a variety of different measurements. So one doesn't go into this saying, you know, all mergers are going to be successful in raising economic returns significantly. On average they're okay, but they're not great.

Now, going from here into the airline industry, we thought it's important first to go with the positive economic question before looking at the normative implications when we should do it or what actually happens. In one area we thought it might be interesting to step back and say, why are they doing this? And we embarked on a study collecting data for US airline routes -- sorry, for US airline markets over time where we considered all possible potential, if you will, mergers that could take place between carriers identifying as 1, if you will, as 1 what had happened, and zero is for all other cases, which is usually what happened.

So, if you look at a given year, all prospective merger partners who hooked up, so to speak, you will get many zeros and then you maybe have a 1, and that can go on for several years. And our empirical task was, what's explaining this distribution of outcomes?

And there are many numbers of competing theories. If anything, there was a surplus of theories, but of course of particular interest among other things were, are there anti-competitive motivations; the ability to raise fares, suppress somebody that you're competing with a lot in fare wars, so on and so forth.

To preview what we found, as we can see in the slide,

Applicants (cont)

the big ticket items if you will that seem to be driving these things, at least in the US, were to acquire international routes, and the intuition behind that is, in the US those are regulated for US carriers as well as others, and so to get in you can merge with someone and get access if you wanted to serve these markets. And also then, to relieve financial distress in that one of the partners was in trouble in some financial way, cashflow, assets, and seeking a partner was their way of addressing this. Obviously somebody had to take them on, and those seemed to be the important influences.

The specific breakdown of our variables when we went through this, so what we're estimating is -- I think the most intuitive way is to think of a pie chart, right, and we're just trying to divvy up this pie, if you will, in terms of potential influences on merger activity where these variables stood, and this was our breakdown. It's a little concise in descriptions, but I think the key ones obviously I note are foreign routes, which is basically acquiring international routes and what I call assets, tended to be, what I was getting at here in the measurement of the variable, was the minimum of the assets of the merger partners, as that thing grew, so to speak, became more minimum, it was more likely they would seek a merger partner and a merger would come to fruition.

The variables obviously of interest for our discussion were potential anti-competitive influences. Would there be a revenue increase, price increase from the merger? So we had to do some auxiliary empirical work here; simulate what the impact of the combination would be, make a prediction of that price, and that would be an explanatory variable; if these guys merged there was going to be a revenue increase, how much would that increase the probability of the merger?

That came in, you know, as relatively on the small side in terms of its contribution. Common route with fares where people had overlapped was their way of ending this trying to merge. Again the effects were significant, but I think in terms of the bigger picture I think it's reasonable to say that we didn't have any strong evidence that at least tended to be motivated by anti-competitive objectives.

All right, but that's motivation; still, they can occur and have anti-competitive effects.

MR CURTIN: Just very briefly by way of clarification. The interest rate variable there, does that say more mergers when interest rates are low?

DR WINSTON: No, these are absolute values, so obviously the variable itself is a negative effect, lower bond rate more likely to acquire. So these are absolute values I'm proportioning at, but the absolute coefficient was negative on the interest rates.

MR CURTIN: Okay, so lower interest rates, more mergers?

DR WINSTON: Absolutely. Okay. Right, now let's look at what prospective, and I want to emphasise that, and then retrospective evidence do we have on what these things are doing on fares.

So this was a prospective simulation that we did. Let me put a little context on this. This was in our book, the evolution of the airline industry done in 1995. In the early 90s US airline industry was in very serious trouble, not quite obviously post 9/11 but it was a very serious period in the industry with serious financial concerns.

And there the issue was, who's gonna survive? I mean, there was sort of genuine belief it would be, you know, maybe American, United, Delta and Southwest and then everybody else was gonna go under. So then there was concerns about people leaving the industry and also consolidations.

So what we did is, we developed a model that had three components to it, the termination of fares that carriers provide as a function of among other things distance and that kind of thing, population income, and then presence of who's on the market. Then we treated entry and exit though as variables that we also wanted to treat as endogenous, so entry of each carrier was something that was modelled as a function of partly what Mr Webster said, average price in the market, but a prediction of the price that they thought they would charge based on their specification of fares. So, a sort of relative fares is what we thought would be important there; and then exit.

And then we proceeded, based on this empirical information, to run simulations of at that time what we thought to be potential mergers. We were right on one, wrong on another, but this was several years ago though; not bad. We thought AA and TWA might represent prospective merger partners, and so we looked at what would happen. And, rather than focus on the specific numbers, I think what is the more important message is what this is picking up as the role of entry and exit.

That is, what we have here is an initial effect, these people merge, we're not turning on the entry and exit model if you will. There is the reduction in competition, the entry exit model gets turned on and you start getting into what we think is important, start thinking about the long-run effect of what's gonna go on, and we obviously see the change in sign.

We did another one, United and Northwest, they have not merged but replicated a similar type of pattern. So I think the main message I take away from this point is just, in our prospective characterisation about mergers, it's very important to start thinking about the role of entry because that's going to obviously shape the long-run effect of these markets. Again, just on prices here is what we're looking at.

Then we move to the retrospective assessments which were really not, I have to confess, our primary intention when this part of the analysis was done; we were actually looking at other issues, but in our specification of fares, this is one thing we did want to control for.

So, this was statistical analysis of fare determination across routes, and in there we identified routes where variation mergers had taken place, and the ones that we identified were Northwest Republic, TWA, Ozark, US Air and Piedmont, tended to have negative effects; I wouldn't push it in terms of the effects, but again, it was more on the "negative side" subject to the statistical reliability on it.

So, coming into this, you can start to see how our ideas are starting to evolve. You know, we have a view of a competitive -- fundamentally competitive industry. We are obviously impressed by the role of entry and exit in determining long-run effects of changes in market structure. We don't see a priori evidence that people tend to merge, trying to acquire market power. We see very legitimate reasons for trying to do it.

Applicants (cont)

We don't see in the retrospective evidence that there are anti-competitive effects on prices, and I want to stress that I think there are pieces of non-price evidence available that are probably very important and may be the dominant part of what's gone on in US mergers. And what I would try and stress here is the role of frequent flyer mileage. That, when some of these carriers merge, what we have calculated is that travellers have a surprisingly high value of frequent flyer mileage.

I believe we're the only ones actually that do this, so I want to offer a standard error in the sense of, one study; that the value of frequent flyer mileage that we found tends to be quite high.

I mean, if you are close to getting a free ticket, you know, you'll almost do anything to get in terms of what you're willing to trade-off on fares, and so what happens when you have mergers and you can consolidate those miles on a carrier and use them on more cities, the benefit is huge.

So, if one wanted to say, you know, what is the retrospective assessment of the impact of mergers in the US, I would say they're positive and probably pretty high, but it's clearly coming from being able to wrack up those miles and use them and go to more places. So that's an important consideration. I've never put it together, so to speak, but the evidence is certainly there if one wanted to do it.

All right, so that's where we were going in, and as I summarise here, I now am bringing into your part of the world to my thinking and saying, okay, you know stipulating what I've been told is true, we have two carriers aligned and there is this competition from this low cost carrier Virgin Blue who is going into the market where the merger is going to take place, then it seemed to me this is a very powerful form of competition, a desirable form of competition; I don't really see the cost detriments here that I would if it was not going in. I stress that, believe me, my view would be very different if I did not have this information, and the fact that we're starting to see other people who could come in too.

So, this then led me to the empirical questions, well, I need some verification that this carrier is for real. I've heard of it, but I don't know really what its impact has been on competition in this market. So, that led us to two things that we wanted to do; one, we wanted to see what truly does Virgin Blue in terms of its empirical impact on fares. Qantas is apparently where the evidence would be. What we've heard consistently throughout this Conference is qualitative evidence that indeed they discipline fares, but no-one, I guess, has offered yet a number, and institutional evidence as to how this thing works, so we wanted to test that proposition.

Then there was another concern raised about, well will they enter into New Zealand markets? And we said, well, let's see what we know about their entry behaviour. So, that pretty much is where we were in all of this and then the rest is reporting what we have done.

Do you want me to take questions on what our research is about before going to the new research?

CHAIR: Any questions at this stage?

PROF GILLEN: One of the questions we always face, and because the US is such a reservoir of data that none of the other countries have access to for our own policy decisions; the importation of the US experience, the notion that even if you have a merger in the United States you still have three or four fairly effective competitors. How does that colour your view of the assessments of the mergers and the transference of that into other jurisdictions?

DR WINSTON: Oh, it colours it considerably in the sense that, if I couldn't get data to look at here, I wouldn't be here. I wouldn't come down here and say, well, we've had mergers in the US and they haven't done anything, so don't worry about it. No, I think you have to bring the tests on the data of the country that you're analysing.

PROF GILLEN: Thank you.

DR WINSTON: I don't think there's any substitute for that.

CHAIR: Okay. Go ahead and continue, please.

DR WINSTON: Okay, so I'll now talk about what we then did. Let me just put this in perspective too. We're running what is called in the literature a fair regression, a fair model. These VBA around 20 plus years, people have been doing this -- probably half the people in this room have done one of these -- and there's a lot of evidence that's been accumulated about what the impact of competition is on average fares, or how you want to look at the fare distribution.

So, we did not go into this without any a priori views, I assure you, of what this relationship ought to look like. I think literally there are dozens, if not maybe even a hundred empirical regressions. I have yet to see one that consistently finds that competition has no effect on fares. Let me stress, though, it is certainly possible and I have seen it define particular competitors in terms of their marginal effect having no impact on fares given who else is in the market.

Applicants (cont)

But generally my expectation was that you're going to have some impact on fares, the question is the magnitude. And I think, if one thought of like this as a meta-analysis, for lack of a better word, where you combine all studies and try to look at the distribution of documents and come up with some sort of consensus recommendation, our thought was, well, it could be anywhere from something like 4 or 5% to something like 25%, which is the kind of numbers that we've seen for Southwest and even generated ourselves.

So, that's how we've thought about this coming in. At a minimum we said we need what we would call a bare bones fare specification; you're not going to have all the data we want in terms of every possible variable, but there are obviously some critical things that we need to get. In particular for this purpose we need to see some relationship between the presence of Virgin Blue and Qantas' fares.

So, that's what we thought about going into this, data were selected and sent to us, we ran these regressions, but there wasn't really much to run in terms of specification search, I want to emphasise that too. Pretty much what you see is what you got. There's not much behind the room drama of, you know, let me make it non-linear, let me take out this route; that kind of fun wasn't really part of this, we just didn't really have that much to work with. You know, you can read the details of what's in here in terms of our sample size and we're not hiding anything in here. This is pretty much what we ran, first take; Frank Sinatra is that way. Sorry about that. Okay.

So what you see in front of you is the summary results of this regression, and, you know, to cut to the chase, you know, Virgin Blue does have a statistically significant impact on Qantas' fares and the magnitude with a slight dummy variable adjustment is about 11%. Ansett did have an impact, it is no longer with us I understand, but it's interesting that Ansett had a bigger market share at the time, I'm told, and Virgin Blue, though, still had this bigger effect. And then this distance variable which is extremely reassuring because it is consistent with the evidence preceding fares increase with distance, but less proportionately because of economies of length of haul.

So, this was our first cut at it. The only other thing that would be natural to do is to account for everything else that could have been in here, and the standard way of doing this statistically is putting in what they called fixed effects across the routes. And, I don't have that on the slide, but can I just simply report that if we put in fixed effects the results do not change that much. The impact is largely to raise Virgin Blue's effect; it's co-efficient is now in the order of 15% and reduces Ansett's effect to closer to 4%.

So, that was pretty much what we had, and I personally was somewhat surprised. I've not done business down here before and did not know about the data; it was collected from different sources, and apparently has not been done before, but it is remarkable that it is dead on with the hundreds of other studies. If I brought down here 20 of my closest friends and enemies to weigh in on what airline fares could be expected to be in this kind of situation, I really can't think of a better set of results that would fit in with that tight distribution. So, I think it's quite plausible what we have found, even though I'll be the first to admit, we're dealing with one study.

Let me make a few then other comments about these. I already noted that it is interesting that Virgin has a bigger effect, which goes to show you that identity matters, is really what we're saying here.

A comment I've heard throughout this Conference is some sort of -- I guess I would characterise it as, sort of, you tended to draw a distinction between price and capacity. I would urge people not to do that because they're extricably linked to it. I mean, you don't go in charging low fares not planning to have the planes to put the people in them.

On the other hand you don't go into a market with 10 planes and not thinking you can put the people in them. So, in a sense you basically, you're over identified. Once you've got price settled, your capacity is adjusted accordingly with it. So, I just want to make that point clear.

Now, I do not know, to be honest with you, how important this third comment is here; I mean, I think you have to judge this better than I. But in America this is very important. Competition supplied by low cost carriers goes beyond competition on the route but includes both potential competition; that is, you do not serve the route but you serve the airports on the route.

So you could go in, okay, or you don't even serve the route but you serve a parallel route, and the example I can give you in the US is, you can fly out of what they call Baltimore, Washington Airport to Oakland on Southwest, or you can fly out of Washington, Dallas to San Francisco; so if you want to go to basically the Washington area to the Bay Area of California two ways to do it; Southwest's presence in this adjacent route has a very powerful effect on fares in that parallel market and that is empirically demonstrated by us in other work.

So I would think, if you just look at the impact of a powerful low cost carrier on the route itself, you're underestimating actually its total impact because potential and adjacent competition can be good.

Now, I want to stress, we've found it for Southwest, I've not found it for other carriers, but this is something else to look for in terms of where competition can develop when it's not transparent that it has.

And then entry, where I think the most important evidence here rather than the statistical work was just the fact that in our sample all the routes that Virgin serve were served by Qantas. So, I didn't really get any sense -- we have a very small sample here -- that there was any evidence that I could look for that Virgin wasn't ready to take on Qantas; that's certainly consistent with somebody having a cost advantage, they tend not to run away here.

The regression here on few observations has the positive impact; that is, Virgin enters routes where Qantas is. The negative sign on Ansett is obviously puzzling. I've been told that Ansett was on the way out, if not out, after -- let me get this right; before our sample ended, but apparently that's not true, there were three routes that it was in when our sample was around.

I don't know how much you take from this -- I mean, if they're peeling out, so to speak, and picking up zeros, then what you may just be capturing is, they're out, Virgin Blue is in, it sort of looks like there's some causal relationship when there isn't one. My recommendation, and I think it's reasonable that we reported it, but I think the more important evidence is really the descriptive data at this point that all the places where Virgin was, Qantas also served.

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

MS BATES QC: Dr Winston, I'm just looking at your page 10 in the bullet point saying "price competition is inextricably linked for the provision of capacity"; that bit, and I'm trying to understand this so it's a question by way of clarification for my own understanding; but do you mean that there has to be a certain level of capacity or frequency before there is a competitive effect on the fares or not?

DR WINSTON: Let's take it one step at a time.

MS BATES QC: Okay, that would be helpful.

DR WINSTON: Let's look at it from the perspective and the way I do it, from a sort of a rational carrier. When I'm making this statement I am saying, when they set a fare, they also have in mind an appropriate -- I think that's the word, I don't want to say optimal -- I wish I could, but I'll say appropriate level of frequency in which they're able to achieve a level of demand, i.e. Load factor, that will enable them to at least break even.

MS BATES QC: So, that's any airline?

DR WINSTON: Anyone; they all do this. In other words, you know, you don't go in with low fares and say well, yeah, but I'm not gonna get the load factor to do it; you're going to bleed yourself to death, at the same time you're not gonna go in with super high fares and have "a load factor" that isn't going to match up.

Now, in terms of your second question, is there some threshold of frequency before I "come competitive"; the beauty of the price variable and its link with frequency is, that's what you're capturing. In other words, when you run these statistical relationships of presence on fares and you see that it has an impact, it is really capturing both whatever this person is doing in pricing and what it is doing in its supply.

MS BATES QC: The reason I'm asking you this, and why I'm having a little trouble with it is that we've had it put to us, and you will have heard it, that where a VBA enters a market, that 5% market share by the VBA, and presumably that means it's got limited capacity at that point; correct, has a very very significant effect on the fares immediately.

So that, I'm just -- and I might be just misunderstanding, but I'm struggling with this inextricable link when it's being said to us at a very low capacity, suddenly we get a huge decrease in the fares across the board.

DR WINSTON: The inextricable link is, you don't want to think about pricing independent of capacity; that's sort of what I'm trying to -- the point I'm trying to get there. That, you don't think of them independently, right. I mean, it's just irrational from a carrier -- so let me get to your thing.

Then in terms of when something has a significant effect, let me work toward the negative, okay. If indeed Virgin Blue's presence in Australia was, let's say, one flight every other day, okay, and I ran the regression that I ran; my prior would be that its present impact on fares would be statistically insignificant, picking up the fact that it is not there.

So whatever I have found in terms of its effect indicates what that level of service was -- I can't speak exactly what percentage of the market they have, you know, 10, 20%, I don't know -- was sufficient to generate the beta if you will, the elasticity, the 11% that I found.

Now, to ask the question -- to empirically answer the question, what is the threshold that it would have to have --

MS BATES QC: To achieve what it did, which was a 11% reduction.

DR WINSTON: I can only answer it in what it has done; in other words, the experiment -- let me tell you the experiment we'd have to do. We'd have to say Virgin Blue enter at 1%, let's see what happens in the market and stay there for X number of years. Go in at 3%, and somehow generate data that could then enable us to systematically estimate this relationship. Now, the 5% threshold, I can't really explain how that was achieved; I don't know the answer to that, but it's certainly something I couldn't do.

MS BATES QC: Well, may the answer be that there isn't actually empirical data to support the proposition that the 5% had the so-called huge impact? I mean, you have had a look at the position, have you seen any data that you would say supported that proposition?

DR WINSTON: I heard the statement; I did not hear -- unfortunately I did not hear you ask him, and I was kind of interested myself, what the empirical basis was for it, and I don't know.

MR P TAYLOR: Would you like David Bental to come forward and respond to that question?

DR WINSTON: That would be fair.

MS BATES QC: I'm genuinely interested, I'm not trying to pull tricks; I just want to know.

DR WINSTON: I don't know.

MR BENTAL: I think as Professor Gillen stated yesterday, the best source of information for this kind of analysis is the US domestic market. The reason for that is because, in the US domestic market we know exactly what every airline is carrying in terms of passengers --

MS BATES QC: Can I just stop you there. Are you going to tell me about figures in the US or figures in the Australia? I'm looking for the actual data.

MR BENTAL: The actual data in Australia I do not have.

MS BATES QC: Well, I don't think that's going to help me really. I wanted to know what actual data there was to support that statement. Are you telling me there isn't any?

MR BENTAL: No, the statement was that empirical data in the United States supports the --

MS BATES QC: I see, so it was actually getting some United States data and kind of putting it into the Australian context?

MR BENTAL: The slide was just discussing the empirical evidence in the US that illustrates that in the US when a VBA or any carrier goes in with even a very small share of the market, the rest of the market has to react and the market matches the fares. That's the evidence, and that's empirical evidence.

MS BATES QC: I understand that. So, is that consistent with what you have found, Dr Winston when you've been doing your extensive studies?

DR WINSTON: You mean for the US.

MS BATES QC: For the US.

DR WINSTON: I've never asked that question. I think it's a plausible finding, if you ask my judgment.

Applicants (cont)

MS BATES QC: So you don't know from data?

DR WINSTON: I'm trying to get my mind around how I would actually know from data; I mean, it's not -- this is something that -- remember, we want to get a causal relationship here, so let's take it slow, it's not a descriptive datum.

MS BATES QC: It's not my field so I'll be taking it very slow.

DR WINSTON: I can say the way I would do it, I just haven't -- you know, I haven't done it. But I think it's a plausible finding and, you know, believe me, I can assure you that if I thought it was implausible, I'd say it. I think it's plausible.

MS BATES QC: That's why I take you back to your statement that price competition is inextricably linked with the provision of capacity, because to me there's a disconnect somewhere; if you're just putting on a very small capacity, 5% can't be much, and it seems to have this disproportional effect on the fares, and I'm having difficulty with reconciling the two points of view.

DR WINSTON: Oh, I'd be careful about saying it's a disproportionate effect. I mean, 5% could be quite a bit. I mean, keep in mind -- suppose -- let's --

MS BATES QC: 5% capacity's quite a lot then?

DR WINSTON: Oh, if that 5% is at the expense of an incumbent carrier, it's huge; huge. I mean, at the margins that these people work at, you know, they fight over, you know, points of percent, I mean that can make all the difference in the world.

MS BATES QC: What you said was --

DR WINSTON: So you will fight to protect your share.

MS BATES QC: We're trying to find a threshold, you know when we were talking before and you said you'd put on I think it was one plane twice a week, whatever it was, then it has an infinitesimal effect and so I'm trying to work out at what point you do that.

DR WINSTON: In the statistical sense what you are trying to do is figure out when a parameter, carrier presence that's what we're talking about here, becomes statistically significant.

MS BATES QC: Yes.

DR WINSTON: Okay. That's a hard thing to do. I mean it sounds like it's something that should be easy to do, and the reason is because nature is not necessarily giving you that experiment. In other words, nature is giving you a world that is fixed in terms of the level of entry we have.

What we would like to do is vary that level of entry over time and see what happens as that changes, okay. Apparently the data that generates the 5% must have done something in that spirit; that's the only way I can conceptualise the experiment. I haven't done it, but I can believe that's how it was done. I take where they are and say, once you're there, what impact are you having on fares, but in terms of the 5% number, that's a big impact.

MS BATES QC: Thank you.

CHAIR: I'd like you to complete the presentation now and then we'll take some further questions.

DR WINSTON: All right, so that's pretty much really what I've sort of brought in a nutshell to the table, that I looked at really what the nature of competition was, the US saw the questions that were motivated, I think, for this case, and then tried to test them or bring them to data.

So my final points were that, from a marginal effect my concerns about Air New Zealand's losses would suggest to me in their market -- remember I'm now taking a long run view, we have our alliance and we have now Virgin Blue in there, that its marginal impact would not really be doing much in terms of disciplining Qantas certainly as compared with Virgin Blue.

So, to me the policy trade-off is this: Why have Air New Zealand continued to lose money -- I'm taking that as auxiliary evidence that's been said -- where you get then a benefit to the New Zealand people of freeing up Government resources that could be invested to get a higher return and allowing the financial investment to be coming from Qantas to get your benefits, not to mention what you'll hear from everybody else as potential benefits in terms of operations; where I see on the cost side little downside risk because of the power of what a low cost carrier would bring.

So, thinking in what I would say traditional cost/benefit terms this is really where I see in a nutshell away from a policy perspective to think about it, and that's where I am.

CHAIR: Thank you for that, Dr Winston. I just would like to ask Dr Pickford and Professor Gillen if they have any questions at this point?

PROF GILLEN: I have a few. I have some technical questions, Cliff.

In the estimation of the fare regression, how did I distinguish between direct and indirect routes?

DR WINSTON: The sample that we have is what we used, I don't think there was any distinction there, of routes that we had. This is all straight OD paired.

PROF GILLEN: Okay.

DR WINSTON: So obviously, fixed effects are going to be doing that.

PROF GILLEN: And I think you reported in your paper that you did estimate that model, so those fixed effects would actually be route specific effects, right?

DR WINSTON: [**Nods**].

PROF GILLEN: The second question is, how did you pick up -- I think your data went from 1996/1997 to 2002, on a quarterly basis?

DR WINSTON: Was it monthly -- monthly.

PROF GILLEN: How did you pick up any macro effects because you had this kind of booming period in the late 90s, then you had this bust after 2000?

DR WINSTON: Right, the only macro effect would be the effort to put in the GDP variable.

PROF GILLEN: So, in your view, is that a strong enough variable to reflect, say, changes in the demand for air travel, particularly by business customers, and that might explain some of the reductions in fares that you are seeing?

DR WINSTON: I don't think that you're gonna get problems in terms of the impact of Virgin Blue with what's going on in the measurement of the macro variable. I mean, it's not significant and I think the problem is, its level of aggregation is not consistent with the level of aggregation of the data. But it's trended and I think that -- I don't see, you know, an omission there that's working against the precision or the reliability of the Virgin Blue parameter, and again, you know, fixed effects have their weakness and you don't know exactly what's going on, but they soak up a lot, which is their strength. So, I don't think there's contamination that's going on there.

PROF GILLEN: In your view, do you think that Air New Zealand has a greater likelihood of exiting the market than Qantas given the strength of Air New Zealand in its domestic and Tasman markets?

DR WINSTON: I have no basis for answering that question. I mean, I think that's pretty clear. Again, my instinct is obviously to try to empirically think about how to do it, and I can't even come up with that one.

PROF GILLEN: That question is related to your first bullet in your final comments, given New Zealand's economic losses suggest that you should combine the two.

DR WINSTON: I did not realise that you do not have bankruptcy laws here; I thought you did, and so -- and I also didn't realise how much of Air New Zealand was owned by the Government. So, I don't -- it's hard for me to really get a fix on the future of this carrier, but -- and I don't think that's what's the issue. I've changed in terms of, the more I know what's going on here.

It's costing the country money to have this happen, where you could be making investments elsewhere, and I don't see any benefit in, you know, allowing money to be taken out of your public treasury away from your people from some abstract notion of what you think is, you know, preserving competition if it really is going to be a weak competitor.

I mean, in the US we have this problem that there's so much money that's sunk into Public Works, whether it be Amtrak, transit systems -- I mean, this is real money that adds up. So, I think that's really more where my thinking has evolved; the cost is just -- the opportunity cost to the country I think is potentially quite large.

PROF GILLEN: My final question; in the opening statements you said that there's no source of rent for the carriers on a consistent basis and there's some work that refers to hub premiums. Do you want to comment on that?

DR WINSTON: Let me comment on that. Just some background. In the United States there is a concern that carriers have built hubs and are able to extract a premium from doing so. Now, the empirical question on this is, how much of this premium is a pure premium as opposed to other things?

So the trick is, what else do you hold constant to really isolate what the effects are, and in our manuscript here we revisit this and the tricky problem is, is what you'd want to do is, you get a route where you have a hub and then a destination and look at fares on those types of routes, and then you have a comparison set of routes.

Here's the problem: If you put Southwest in those comparison of routes you really drive the prices down and it looks like there's a big hub premium. You take Southwest out, premium disappears. So, in my view, is there a hub premium problem, or is there a Southwest problem, and it's just a question of when Southwest's gonna get there. And increasingly we see those "hub premia" disappear as Southwest expands.

So, I don't want to be, you know, naive about it, I think there's some, but I think there's a very very serious potential to overstate the extent of how much that really is.

PROF GILLEN: I guess a final comment is -- or question is, when you look at this 11% impact that Virgin Blue is to have, do you view that as a short-run or long-run impact?

DR WINSTON: I think, just the nature of our data, I think we have to interpret it as long-run.

DR PICKFORD: Just one question, Dr Winston. We've had earlier comments that over the long haul the historical experience is that airlines don't make their cost of capital. I wonder if you had any views about that yourself and what the reasons might be if you agree?

DR WINSTON: I think the US, I mean as best as these things can be measured when we've done it, it's -- I would say it's close to a normal rate of return. I mean, we've written this, so obviously I'm not gonna back away from it. In our 86 book we did a calculation and basically it was close to our normal rate of return, and even with the cycle up to 9/11 I think that was true. Post 9/11 obviously, you know, maybe the average is now way down, but let's hope things turn around. So in the US I think it's certainly workably competitive in the sense you can earn a normal rate of return.

Can I make one comment actually?

CHAIR: Yes.

DR WINSTON: This is just from me listening, you know, because there's a lot of learning on my part. Just in the nature of a lot of the questions, there's been a concern that's raised about the impact of the alliance on Virgin Blue; you know, sort of Virgin Blue is portrayed as, you know, a vulnerable carrier. And my own thought on this -- and again I don't possess intimate knowledge of this carrier -- was that in the US, if there were a route where there's Northwest, United and Southwest, I would hope that Northwest and United can do everything it could to compete intensely with Southwest. Southwest has a huge cost advantage and that's great, that does good things but does things that really irritate me, and it's able to continue to do them on non-price matters because United and Northwest don't push it hard enough sometimes.

So, I would look positively and urge you to do so, that the alliance can compete heavily with Virgin Blue because it will put continual pressure on prices that will only benefit your travelling public, and again it's got to be fair, I'm not recommending, you know, somebody breaking the law, but intensity of competition is really what you want, and so I would -- I think that's a very important point, and I can understand the carriers saying, you know, we're not going to be so aggressive or whatever.

But I think it's something you do want, it's going to be a good thing, I think in the long-run what you hope for is just an extremely intensely competitive New Zealand Tasman market and let the chips fall where they may. I think just from the US experience that builds you stronger, better, to take on the world.

MS BATES QC: I just have a follow-up question on that, and it's this: Do you think that it would be easier for Virgin to compete if the alliance proceeds or if the alliance doesn't proceed?

DR WINSTON: I thought actually about that through the things, and was running my own regression in my mind, and I honestly think the effect is going to be pretty small. I mean, I think that Virgin -- I don't think it's going to make much of a difference. Now, I'm stipulating that if the information I have about that, that they have a cost advantage that's pretty substantial, is true, if that is true I don't think it's going to matter, I think they're going to lead the market and I hope the alliance can push them.

MS BATES QC: But you don't think the alliance will be in any better position to push them than --

DR WINSTON: It's possible, but here's the problem. Suppose you have a 25% cost gap, suppose the alliance can knock off 5%, which is a lot, and it's still a 20% cost gap; it's great, but they've still got to keep going and I don't think the marginal effect is going to be that huge. So I think that's good that they're going to go in the right direction, they're probably going to be able to be more likely to be able to eventually get there in the alliance, but let's see, and I hope they do.

MR CASEY: Dr Winston, you said before that a lot of the benefits of the airline mergers in the States were generated through the use of airpoints. One of the issues in the present application is whether Air New Zealand remains a member of the Star Alliance, or becomes a member of one world. I wonder if you've considered that?

DR WINSTON: I think it would be good if they were in the Star Alliance, because I fly United extensively, and I'm racking up many many miles. I'm sure that if I was in One World I'd hope they'd be part of that too so that I'd get American miles. I don't have an analytical perspective on this, I frankly only have a personal interest in this.

MR CASEY: I also wonder if you've considered the way -- and perhaps my colleagues want to ask about this too -- price and capacity are linked in the NECG model?

DR WINSTON: You mean, what the other people have done? I haven't read it. Is that what you mean?

MR CASEY: Okay. And finally, just on tourism, which is a major area of benefits projected from the alliance as well; one of the issues is, will the alliance be able to pursue increases in tourism better than the unallied airlines. The suggestion is that there will be a lower profit incentive to pursue increased tourism without the alliance, but more importantly there will be a strategic incentive not to pursue increased tourism without the alliance.

I wonder, do you think, considering that airlines do operate on fairly tight margins, do you think that if this increased business were there, these opportunities were there, that airlines would pursue them with or without the alliance?

DR WINSTON: I haven't studied the tourism part. My only thinking there, just as you were raising the question was just more the operational ability to do so. So, I can't comment on the incentives, I don't know that in the sense of the thinking, but I would think that when you're lined up and can get better on-line operations, I think that's going to be a big advantage; I think that will help considerably with the tourism and the marketing and so on, and so forth, and I think that's good.

CHAIR: It just leaves for me to thank you Dr Winston for your presentation, and Mr Taylor I'd just like to check on what you propose to cover next, please?

MR P TAYLOR: Madam Chair, could I just seek your indulgence as a matter of clarification. The data on that yield curve was available only in the US, not available in Australia, so that's why it only covers -- it wasn't a deliberate attempt to avoid covering it; it wasn't available in the Australian market.

CHAIR: I think we understood that, thank you.

Am I correct that the next item on the agenda is the Fifth Freedom competition issue?

MR P TAYLOR: That's what I'd like to take next.

CHAIR: Okay. If we can just switch presenters, please.

Mr Taylor, if you could just introduce the next presenters.

MR P TAYLOR: On my immediate right is Mr John Harrison who is the Vice-president, Network and Revenue for Air New Zealand, and Mr Peter McCumstie from Qantas who I think you've met in an earlier session.

CHAIR: Welcome, and please proceed.

MR HARRISON: Thank you. I will look at the effects of Fifth Freedom carriers on the Tasman, and just briefly what I'm going to go over is a look at the capacity for the coming schedules season that Fifth Freedom carriers represent and then we'll look at ways that they effect the competition, really two ways through revenue management and I'll give a brief overview of revenue management during that, and then the direct pricing impacts.

To start with, looking at the northern winter schedule, which is November 2003 to March 2004, this table shows the nine Fifth Freedom carriers that we'll be flying on the Tasman and that includes two new entrants of Emirates and Royal Brunei.

Now while the capacity of these carriers is primarily intended to feed their long haul services, they represent a significant chunk of the traffic on the Tasman itself. So, for instance, in the Melbourne-Auckland market, Emirates alone represents almost 23% of scheduled seats and in the Auckland-Brisbane market, five carriers represent almost 50% of the scheduled seats in the market and in Sydney to Auckland the six carrier Fifth Freedom carriers there represent about 25% of the seats in the market.

MR CURTIN: Mr Harrison, I think this is probably going to crop up during the course of your presentation, so I just wanted to get one thing clear, and they're the percentages of what? I take it this is just pure seat share irrespective of whether it's just the OD leg or the through leg; this is the total?

MR HARRISON: That's right, it's total scheduled seats in the market.

MR CURTIN: And will you be telling us what the estimates are of the OD?

MR HARRISON: Not estimates, but we have the historical, the last point on the page showing that for the year ended January 2003, Fifth Freedom carriers before the Royal Brunei and Emirates entry represented 16.7% of the Auckland-Sydney local passenger market, and 22.1% of Auckland-Brisbane.

MR CURTIN: I need to understand those percentages too. Are they the percentages of -- explain to me what those percentages are.

MR HARRISON: Okay. Those percentages are passengers flying from New Zealand to Australia and no further. So, they would not be going for instance to Thai's hub in Bangkok.

MR CURTIN: So they're OD passengers. Now the passenger shares are percentages of what?

MR HARRISON: Of total local passengers in those markets. So, the total local Australia/New Zealand market on Auckland-Sydney, Fifth Freedom carriers carried almost 17% of the local O&D passengers.

MR CURTIN: Okay. Sorry to belabour this. Of all the passengers that went Auckland-Sydney, and only Auckland-Sydney, Fifth Freedom carriers carried, you reckon 16.7%?

MR HARRISON: Yes.

MR CURTIN: Okay. Do we know what -- what does that tell us about what percentage of the seats on any given fifth carrier plane were OD passengers as opposed to through leg passengers?

MR HARRISON: Well, it would depend on demand. The carriers would be managing probably as a first priority to take the network traffic. So, flying beyond Australia to their home hub, and any excess seats would be sold in the local market.

Now, because they're not just carrying New Zealand to their hub traffic, they're also carrying Australia to their hub; the planes would not be filled from New Zealand. I don't know what percent of the seats on average have been sold on that network traffic on the New Zealand to Australia leg. Peter has data on that.

MR McCUMSTIE: If I can elaborate a little. I think in one of our submissions, and I must say with some difficulty in arriving at the calculation because we obviously don't have knowledge of their traffic data, I think we've estimated that something to the order of 50 to 65% of their traffic that they actually carry represents through traffic, and that the local market for Australians and Kiwis travelling between the two countries is about a third towards a half of their business.

MR CURTIN: That's very helpful, that's what I was trying to get a handle on, thank you.

MR HARRISON: The additional point, though, is that that traffic would not represent 100% load factor and the plane, so we don't know how much remaining seats there are after it.

MR CURTIN: Yes, I'm with you. Thank you.

MR HARRISON: So, while the capacity is scheduled primarily for network traffic, the carriers do carry a significant portion of the local O&D traffic.

Now looking at the effects of the Fifth Freedom carriers on the competition on the Tasman, there's really two ways; one, the loss of market share for Air New Zealand and Qantas would affect the way that the flights would be revenue managed, and then there's some direct pricing impacts in that Air New Zealand or Qantas' price can't be significantly different from a Fifth Freedom carrier's price, because that price becomes the benchmark for what is a good deal in the market. So, pricing beyond that becomes quite difficult.

Now, to explain the revenue management impacts, I just want to give a little overview of revenue management. Revenue management attempts to optimise revenue by filling the most seats at the best prices that can be achieved in the market. To do that, if demand is strong, so the flights are expected to be full, the revenue management system would discount -- allocate less seats to discount fares and, therefore, the objective is to improve yield on the flight.

Alternatively, if demand is low, the flight's not going to be full. More seats are allocated to the discount fares and the revenue management objective is to fill empty seats and maximise revenue.

So the key inputs to the revenue management are the demand forecast, which is based on booking pace and historical trends, and fare values which are grouped together into booking classes.

It's the demand per booking class that's forecast and that together with the value of each forecast is what is optimised in the revenue management system.

Just to illustrate in a simple two fare example where there's a $1,000 fare and a $500 fare. The expected value of those two alternatives is the same, so the probability times the value of the fare, so Air New Zealand would be

Applicants (cont)

indifferent between carrying a passenger on either one of those fares in terms of availability of forward seats. But as the forecast weakens the probability of selling the higher value fare decreases and it's expected value therefore decreases. So the revenue management system would allocate more seats to the discount fare because that becomes a higher relative value.

The revenue management adjustments can be automatic or manual, so the RM system, the revenue management system automatically updates the forecast as the latest booking trends come in, and will automatically allocate more seats to discount classes as the forecast weakens and vice versa.

However, there can also be manual adjustments to the availability of fares. So, if something unusual were to occur, the revenue management analyst wouldn't wait for the system to adapt to the change, you would make an influence on the demand forecast yourself, and an example of that would be high demand; we know schedules for special events, like a Bledisloe Cup match in Christchurch, and would allocate less discount seats to maximise revenue. And conversely, if there was a significant increase in competitive capacity, we would allocate more discount seats, or influence the demand by saying we expect lower than the forecast is immediately showing.

Now, revenue management, the horizon, generally for managing flights is zero to in short haul markets really about six months, but the system range is about 11 months. So, during that timeframe capacity and costs are pretty much fixed; you're managing the next schedule period. So, with costs essentially fixed, maximising revenue maximises the profit of the network over that period.

Applicants (cont)

However, over time, if a flight's not profitable, the second type of manual adjustment, which is really outside the bounds of revenue management, is to reduce the capacity, or scheduled capacity in the market on a city pair. So, if flights aren't filling, decrease capacity. If flights are only filling at prices that are unprofitable on the route, decrease capacity. Or, on the other hand, if flights are continually full and spilling traffic we would increase capacity.

And, if passenger volume and yield are consistently below what's profitable, Air New Zealand would reduce capacity on a route, and a significant increase in competitive capacity, whether it's Fifth Freedom or not, is something that could cause that type of adjustment.

Now, the second way the Fifth Freedom carriers impact competition in the local Tasman market is on the direct pricing impacts. So the Fifth Freedom fare levels are the ones that get promoted in the market, they're the ones that are in advertisements and become the benchmark for what's a good deal for air travel on the Tasman, and they're the fares that the passengers tend to recognise.

For example, after the recent announcement of Air New Zealand's Express class there was an immediate comparison to Fifth Freedom carrier fares to gauge whether Express fares were really a good deal, and I've just shown a quote from the New Zealand Herald from 13 August in which the general manager of Flight Centre is comparing the new Express levels to the Aerolineas Argentinas airline's fare of $299 in the Auckland-Sydney market.

MS BATES QC: Is that return or one way?

MR HARRISON: That's return. So, Air New Zealand fares need to be similar to those levels in order to capture market share at the price sensitive end of the market. And even advantages in network, on schedule and frequency, frequent flyer programme and product, if any, can't justify too big a price differential or else Air New Zealand and Qantas would lose market share.

Now, lastly, those wide discrepancies, and while at the beginning of this I showed you the Fifth Freedom carriers in three Trans-Tasman markets, any large price discrepancies can't be sustained across markets for a number of reasons. One being passenger resistance and ill will; Air New Zealand prices the total New Zealand market in sustaining prices across the three major gateways would create ill will.

There's also the opportunity for passengers to undercut the local O&D fare out of each city in New Zealand by building an itinerary using, for instance, the Aerolineas fare of $299 plus a domestic Express fare, so Wellington-Auckland return for the domestic express is about $120; that combined with the $299 fare is a $419 fare. So, if the prices are much more different than $419 there is the opportunity to build an itinerary with a lower fare from another city.

Lastly, Fifth Freedom carriers can move capacity from Auckland to other city pairs if the opportunity presents itself. Up until a few years ago Korean Airlines flew into Christchurch via Auckland, but a number of carriers that fly into Australia could also fly into Christchurch or Wellington if there was a local fare opportunity.

CHAIR: Why did Korean exit that link?

MR HARRISON: I believe it was around the 9/11 time when total international traffic was down, but I may not have the timing exactly right. But carriers do come and go.

CHAIR: Quite a few have gone over the years?

MR HARRISON: Quite a few have gone, yes.

CHAIR: What I wonder is, is what's changed recently? Why suddenly do we see what appears to be a bit more constraint from the Freedom -- the Fifth Freedom area on the Tasman, at least to Auckland? Why suddenly is it different? Because they have been around for a long time, a lot have come and gone for a short period, now we've seen a significant change in behaviour. What do you -- how do you account for that?

MR HARRISON: Well, I see it as part of the return in the industry over the last year and a half in that carriers are putting back more international capacity; they're flying the planes where they can earn money and the planes that are sitting on the ground in Australia represent an opportunity to earn an additional return if they can fly to Auckland, or Melbourne -- or Christchurch and back.

CHAIR: What determines the capacity that the Fifth Freedom flights -- what determines how much capacity they put on these links across the Tasman? Is it how much demand there is here, or is it something about how their own demand on the links to Australia actually -- how it's faring?

MR HARRISON: I think it's a combination of things. Some carriers fly across the Tasman to -- as a cost-effective way to start a new market for long haul service, so they develop it first by tagging it on to an Australian city with the intention of eventually flying it non-stop. Some just see an opportunity to get more network traffic relatively -- well, actually at the margin by using available aircraft time to fly a return leg, bring more network traffic in and then sell the remaining seats, essentially to cover the marginal cost, the variable costs of making that operation.

CHAIR: The Commission's been told that the ability to -- or the willingness to switch this capacity into other city pairs is pretty limited; first because the runway in Wellington and in the case of Christchurch because the local population is so small it's not worth their while to do that.

I'd just like your comments on that.

MR HARRISON: I would disagree. Christchurch, relatively speaking, is a bigger sort of destination city than Auckland, so it has more in-bound traffic than out bound traffic, and the South Island tends to be a -- you know, the tourist destination, so I would see, as far as network traffic is concerned, Christchurch being at least as attractive as Auckland.

Wellington, while there are the A340s and 737s cannot fly into Wellington, an A330-200 which is a wide body aircraft, can fly into Wellington and the number of carriers that fly to Australia do fly that aircraft, like EVA from Taipei, Asiana, Emirates, and several others. So, there is an opportunity there that includes Wellington.

CHAIR: I'm having trouble closing the link here. There's excess capacity available in Australia to fly to additional city pairs; there's markets that can sustain that. From what I understand the fares have not had the same downward pressure to those cities from Australia than they have in Auckland, and yet they're not taking up that opportunity. I just don't understand why they're not if that -- I think there must be something that I'm missing in this scenario.

MR HARRISON: I think airlines in general tend to fly to the biggest cities first and grow from there and that's probably what we're seeing. With Fifth Freedom carriers Auckland as the largest population base would have a larger out bound market than any other city.

CHAIR: How long has Fifth Freedom been coming to Auckland?

MR HARRISON: In my experience it goes back to 1999.

MR McCUMSTIE: I think it's prior to that; I think they've been coming for many many years and my recollection is that for many many years they have had, you know, something to the order of 8 to 10% of the total local Tasman market principally focused on Auckland, about 10% of the market.

CHAIR: Your proposition is, they start in Auckland and they get established there, and they might move on to these other city pairs, but they've been doing this since 1999 -- was it 1999 you said?

MR McCUMSTIE: I believe that several of the Fifth Freedom operators have been there for a considerably longer period than that, yes.

CHAIR: But they haven't taken up this, other than Korean who did it and exited, but you still maintain that this is a serious constraint that they might move the capacity to other city pairs?

MR HARRISON: I see it as a constraint. There's a significant amount of international traffic that does fly on Air New Zealand to Christchurch. Koreans represent -- Seoul-Christchurch, I believe, is the second largest O&D on that route, and that would be traffic that's getting off of Korean planes at Sydney and flying on Air New Zealand to Christchurch. Frankly, I'm surprised that so many are now flying out of Auckland and none have moved to Christchurch as yet.

MR CURTIN: A different question, if I may. We haven't had a conversation yet about whether there are different business and leisure markets and no doubt you'll go into that, but one suggestion has been that there may be some constraint from Fifth Freedom airlines, furthermore price sensitive end of the market, but that the Fifth Freedom scheduling is not hugely lined up with the kind of frequency or times that the business traveller might want. Now, that's been put to us and I'd just like to get some feel from you as to how substitutable the Fifth Freedom offering is to the business traveller?

MR HARRISON: As far as the fares are concerned, they're very substitutable. The Fifth Freedom carriers tend to not to have restrictions on their fares so they're available to business travellers.

The discussion on city presence I think works in the favour of Qantas and Air New Zealand in that we do have a better schedule to satisfy business passengers, and that schedule alternatives and frequency and the rest of the network feeds that Air New Zealand and Qantas bring to the market in New Zealand would give us an advantage.

However, at what price is the question, and as the price gets greater the Fifth Freedom carriers do become a better alternative, and you have to argue that product-wise many of them are better than either Qantas or Air New Zealand; maybe not many, but some.

MR CURTIN: Okay. The other thing I wanted -- in terms of when they leave, I presume some of them will be arriving in Auckland at the end of a long flight from somewhere else, and again, I think you mentioned that in general your frequencies are probably better than the Fifth Freedom's, but would it be true to think of the Fifth Freedom carriers as not having full flexibility in being able to leave at

6.30 in the morning if that's when people wanted to go to Sydney?

MR HARRISON: Yes. Generally speaking their primary sort of constraint would be the hub connecting network to their home market.

MR CURTIN: Yes, the long leg.

MR HARRISON: Yes.

MR CURTIN: I have an impression, and I might be wrong, that there might be sort of funny leaving times from Auckland, or Wellington, or Christchurch partly because of the long leg.

MR HARRISON: Some of them intend to be good leaving times. In fact the new Emirates schedule actually stays overnight in Melbourne I believe and comes to Auckland in the morning, so carrying through traffic on that flight -- well you're obviously not going to sit on the flight overnight, so to some extent it looks like it's scheduled more for the local market than for direct connections through to New Zealand.

MR CURTIN: Thanks very much.

MR McCUMSTIE: If I can just add something there. Emirates, who are recent arrivals on the route and who will be expanding some further in October, in fact offer quite an attractive schedule. They have a daily, or they will have a daily flight from Sydney, Melbourne and Brisbane to Auckland at fairly attractive times, just built the down times of their aircraft in Australia, and I guess particularly for the New Zealand origin market, that even provides the opportunity for people here to use Emirates from Auckland to Brisbane, travel separate to Sydney and come back on the Emirates to Auckland again.

The Emirates is probably potentially the most significant of these Fifth Freedom carriers because they're a very good quality carrier, they've made some very blunt statements about their intentions of becoming a significant player in this part of the world, and they do offer an attractive schedule on very attractive equipment.

MR HARRISON: I believe Emirates has also expressed, or stated their desire to fly into Christchurch around Auckland as they've been announcing the new service. As I mentioned before, any sort of capacity change like that into a city would trigger an automatic sort of change in the way the flights are managed, in that siphoning off some amount of demand in the 16 to 22% that we've seen in other cities is significant enough to change the revenue management of the flights where an automatic sort of reallocation of discount of seats would occur. So, to some extent the impacts are not controllable by us.

MR PJN TAYLOR: I'd like to explore a bit the passenger resistance and ill will aspects of pricing into Wellington and Christchurch. I'm just wondering if there's something in the yield management systems that at an overt or a covert level, if you like, you may have headline prices that indicate the price of the discount seats is the same, but if the yield management system provides much less discount seats in Christchurch and Wellington, you overcome the issue of -- or it hides the issue. Do you see where I'm coming from?

MR HARRISON: Not exactly.

MR PJN TAYLOR: Okay. I can understand if people living in Christchurch and Wellington would feel ill will towards you if you priced higher, because there was no competition coming in there. If you are allocating less discount seats to Christchurch and Wellington through your yield management systems because the demand features coming through indicate that's what you should do, you can work round this ill will.

MR HARRISON: By allocating more discount seats?

MR PJN TAYLOR: Less discount seats to Christchurch and Wellington.

MR HARRISON: Assuming that lower fares were in the market but I guess not making them for sale to the market?

MR PJN TAYLOR: Lower fares for Auckland were in the market but not lower fares for Christchurch and Wellington. Lower fares for Freedom into Auckland.

MR HARRISON: Sorry to be dense, but I still didn't understand where you're going.

MR PJN TAYLOR: Well, it may be my explanation, or my questioning. Given you've got discount fares into Auckland from Freedom then you've got to match them or relatively so. Your argument, I think, is that you've got to flow those headline pricing anyway into Christchurch and Wellington or you'll get customer reaction.

MR HARRISON: Yes.

MR PJN TAYLOR: I'm wondering through your explanation of how the yield management systems works is whether albeit that the cheaper prices do flow on, but there's much less -- there are much less seats available in Christchurch Wellington at the prices that compare to the ones you're forced to give in Auckland.

MR HARRISON: I see. The availability of the discount fares is driven by the forecast. So, if the fares are the same across three major cities in New Zealand, and that drives high loads for constrained capacity into Christchurch and Wellington then there would be less because it would be a natural reaction, the same way the revenue management system allocates more seats when demand is weak, it would restrict availability if demand is strong.

MR PJN TAYLOR: So there's absolutely no fiddling with the forecast because -- or the yield management systems because of the issue I'm raising?

MR HARRISON: Not that I know of. There is constant fiddling with the forecast trying to get the best forecast.

MR PJN TAYLOR: Adjusting.

MR HARRISON: But no strategic fiddling, as I think you're talking about.

MR PJN TAYLOR: Well, I was actually, yes.

MR McCUMSTIE: I think it also gets back to something that John mentioned earlier about the perception of what is a good deal and there are the pressures that drive the airlines to have the same fare level available from Christchurch to Sydney as may be available from Auckland to Sydney, and once that fare is there, then that tends to become the consumer's perception of what is a good deal, and it becomes fairly impractical to say, well, we only have a handful of seats available at that fare.

CHAIR: I think it might be interesting for us to see what the average fares are that are paid for these different -- that are actually paid for these different city pairs. Because you're putting to us that you can't really play these games; people have a price expectation and you have to meet it. So you put to us that you can't have wide price discrepancies both in terms of a particular offering, but also on average.

So, I think it would be quite helpful for us if you actually provide us the data that showed there are not price discriminate season average in terms of what is actually paid by all of your customers flying across the Tasman and into the different city pairs.

MR HARRISON: Okay.

CHAIR: I think we had one question on whether these Fifth Freedom carriers increase their capacity at Christmas when there is probably considerable increase in demand. Do you see a capacity response from them at that period?

MR McCUMSTIE: Not that I know of.

MR HARRISON: I don't think so. I guess, it is the peak season for the Southern Hemisphere, and generally flights south do have more capacity, there's more capacity than in the northern winter schedule than the northern summer, but likewise there's more demand going into their network so those extra seats might be taken by extra network traffic as opposed to local traffic.

But as Peter said, I don't recall noticing any significant increase during that period.

CHAIR: I just wonder if you could expect the capacity to change in response to market conditions, why we wouldn't see it, because I suspect that the average price paid across the Tasman is considerably higher during the Christmas period than it is otherwise.

MR HARRISON: It's not so clear. While there's higher demand in the Christmas season, there's also very little business traffic and much more leisure traffic, so the mix of fares yields -- the yield on the flight is determined by the mix of fares on the flight. During a non-holiday season you probably have a higher yield than in the holiday season, just because of the change in mix.

CHAIR: Maybe you could provide us with that data as well, it would be interesting to see. We have some bias sampling from Commissioners who try to travel at that time.

MR HARRISON: It is true, there's seasonality in leisure fares.

CHAIR: Thank you very much. Let me see if there are further questions.

MS WHITESIDE: Janet Whiteside from the Commission. This is a question that actually comes out of information that's been provided by the Applicants regarding Fifth Freedom airlines rather than anything you've said today, so see how we go.

The Applicants have claimed that, if fares increased on the Auckland-LA sector, United Airlines could re-enter that route and carry the Melbourne passengers it currently carries on a one-stop service to Los Angeles via Sydney, to LA with a one-stop service over Auckland, not Sydney.

Why would United take these passengers via Auckland instead of Sydney, and how likely is that in reality?

MR HARRISON: Well, United hasn't done it in the past. I would say one reason why that might be likely is the opportunity to sell local traffic in the Auckland to Sydney market whereas -- and Peter might correct me if I'm wrong -- I don't believe United can carry traffic from Melbourne to Sydney in the local market.

MR McCUMSTIE: No, that's correct, they don't have local Australian domestic rights, but they do have the rights to carry full types of traffic across the Tasman.

MR HARRISON: So those local passengers can offset the operating costs of Auckland-Melbourne, but you can't carry those passengers to offset the cost from Melbourne to Sydney.

MS WHITESIDE: There's been a general comment that's come from some of the Fifth Freedom airlines and industry participants generally about the entry of Emirates in particular, about their coming in with considerable capacity which according to people we've spoken to will exceed demand, and that there is therefore some doubt as to how full anyone's aircraft is going to be and how long Emirates may last and the effect it will have on the market generally.

Do you have any comments on that, about how demand and capacity are going to compare once Emirates have come full strength, and Royal Brunei?

MR HARRISON: There's gonna be a lot of seats in the market, and I would agree with you, it's interesting to see how it sorts, because while the Tasman may represent for Emirates 2 or 3% of their total network, and they're approaching it on a marginally costed basis, it represents about 20% of Air New Zealand's network and is a market that we need to make a profit in locally as opposed to using it simply for feed. So I guess to, some extent while everyone will be hurting relatively speaking, it should hurt Emirates less.

MS WHITESIDE: We've got some questions about entry generally rather than just Fifth Freedom. When would be the best time to address that? Now or...?

MR P TAYLOR: Entry of...?

MS WHITESIDE: Just going back to one or two things about Virgin Blue, some of it is to do with entry on the NZ-US route; just not strictly speaking Fifth Freedom.

MR P TAYLOR: I can check, but it's probably more a question for Mr Miller than Mr Harrison.

MR HARRISON: We could try.

MR P TAYLOR: Well, do you want to bring Mr Miller up as well?

CHAIR: Will he be appearing later in the proceedings?

MR P TAYLOR: He will be appearing again during the confidential session, but not during the public session.

CHAIR: Okay. Well, we better take the questions now then.

[**Mr Miller and Mr Edwards approach table**]

Applicants (cont)

MR MILLER: I'm also Mr Harrison's direct boss; so most of what I know, he's taught me.

PROF GILLEN: I have a question. I'm puzzling over. There's lot of effort been put into the claims that Fifth Freedom carriers have disciplining in fares and with all the capacity, and the evidence is anecdotal at best, and Professor or Dr Winston just presented us with some evidence from Australia where basically over time on average over all these routes you get an 11% decrease with the entry of Virgin Blue, and given the importance you put on Fifth Freedom carriers why wouldn't you have carried out exactly the same experiment using exactly the same data to try and demonstrate the impact of this increased presence to both numbers of carriers as well as the additional capacity?

MR HARRISON: Well, we haven't carried out that analysis.

PROF GILLEN: I know you haven't. Why didn't you? I mean, if you thought it important enough to try be demonstrate the importance of the entry of Virgin Blue in Australia, and given the kind of emphasis that you have put on the Fifth Freedom carriers, I'm just wondering why; was it an oversight or you never got time or...?

MR HARRISON: I would have to say, those choices are more oversight. It's not something we planned to do, and we didn't.

PROF GILLEN: I would just like to emphasise; I think it's important providing the data due to exactly the same experiment that Dr Winston did.

MR P TAYLOR: Madam Chair, I'm not sure whether that data is available. I'll have to check.

MR CURTIN: There is, to be charitable to you folks, there is a table of the actual Auckland-Sydney fares that are being charged in one of the submissions. But putting it the other way, I suppose if those fares are available we might be able to do a bit more manipulation of what they might or might not be showing, so...

MS WHITESIDE: Just a point about loyalty schemes. Dr Winston had emphasised their importance. Another party said that -- not today, but this is some of the information that we've had in which we need to test; is that a proportion of leisure travellers will pay a higher fare to stay with their nominated airline to earn points, and that the extra paid is sometimes higher than the value of the points earned, probably because they haven't quite done their sums.

Could you comment on that, please?

MR MILLER: I would say that there has been -- there is a change taking place in the marketplace globally with loyalty programmes. Domestically when we introduced our new Smart Saver fares, which were the lowest possible fares in the marketplace; these fares do not accrue frequent flyer points and 20% of the people who are purchasing these fares are frequent flyer members of the Air New Zealand programme. So these are customers who are electing to choose the cheapest fares knowing they do not accrue points.

Now, that is something that a couple of years ago I would say was not going to happen, and that has indeed surprised us. So even with our most frequent passengers a lot of them are making a conscious decision to take the cheaper fare rather than accrue points.

Now we're one of the first full service airlines in the world to do that, and we've even surprised ourselves.

MS WHITESIDE: So, there has been a shift you feel?

MR MILLER: There has been a conscientious shift even with most frequent flyers if you -- one would have regarded to be price elastic to actually choose cheaper fares and forego earning points.

MR HARRISON: That was actually the point on this slide of the -- while there are advantages in network and frequent flyer programme and product, if any, how much of a premium you can get for that -- well, we don't know, but at some point there is not a premium you can get to cover that.

MS WHITESIDE: Just a point about the Applicants have said about Virgin Blue's entry in the submission on the Draft Determination, you said that Virgin Blue would cherry pick 54% of the domestic and 89.6% of the Tasman routes simply by establishing a presence in Auckland, Wellington and Christchurch. What sort of timeframe were you talking about with that?

MR McCUMSTIE: I think in terms of the assumptions we made through the process, particularly for the modelling, we were assuming that the VBA would enter the Tasman route in the first year of the alliance, and I believe we also assumed they would enter in year 1 in domestic New Zealand as well. But I'm struggling to remember the scale of the entry we assumed; I think it was something like three aircraft flying the Tasman, three and a half aircraft flying the Tasman and I think three aircraft flying domestic New Zealand to produce that type of presence.

MR HARRISON: We can check that and give you the schedule build that was assumed in the analysis.

MS WHITESIDE: That was in the factual, if the alliance goes ahead is what we were interested in. Because that's what that was to do with.

MR McCUMSTIE: If the alliance proceeds, yes.

MS WHITESIDE: Also on Virgin Blue, another claim was there was no reason why Virgin Blue might not acquire smaller aircraft and operate its own aircraft to smaller centres. This was just talking about the provincial routes. Given Virgin Blue's stated intention to only use one type of aircraft and the type of aircraft they've been purchasing; what is information is this claim based on?

MR MILLER: What we have noticed in the United States, for instance JetBlue, which we've actually spoken about just now, JetBlue has been flying A320 aircraft and they've placed orders for 70 smaller jet aircraft to fly shorter routes as part and parcel of their deployment of their model. We are suggesting that this again is another change in some of the value based type models that we have seen, and there is a possibility for carriers such as Virgin Blue to deciding to go down the food chain, as it were, to grab smaller population catchment areas by using smaller aircraft which are more appropriately a tailored for that market.

MS WHITESIDE: How realistic do you think that is in the near future though?

MR MILLER: It is possible that they may do that. My personal view would be that they have greater opportunities with their single aircraft fleet to deploy additional numbers into the existing marketplace, and that would be a priority that I would choose first before I chose smaller city's pairs.

MS WHITESIDE: Another statement was to do with the possibility of United Airlines or Air Canada entering the New Zealand-US route. Just a query; have you had any information from them or from anywhere else indicating that they would be likely to enter the route, particularly if Air New Zealand left the Star Alliance, or is that just simply stating a possibility?

MR MILLER: What we are seeing in the US and indeed in the Canadian market through their Chapter 11 process is that a restructuring of a lot of their cost bases; employment contracts for greater productivity and lower cost. The reasons they pressurised United out of the Auckland-LA route were fundamental ones to do with lack of profitability. Post their restructuring, and if and when they do come out of Chapter 11, they will have a lower cost base.

An example I would give; that 21% of all Air New Zealand's costs are tied up in labour costs. United was 50%. Now, post Chapter 11 they will restructure that 50% down to a more economic level which clearly would allow them opportunity to come back into the route. Obviously I can't say when because there's been no discussion with United on that, but clearly it allows them that sort of opportunity.

And clearly in regards to your question on alliances, we are a partner of United and if there were any change in alliance alignment, as it were, that might trigger their reason to re-enter the market.

MS WHITESIDE: And there was also a statement regarding the NZ Pacific routes, that there's likely to be constraint on that; what airlines do you think are likely to enter the New Zealand and to the Pacific Islands, particularly to Fiji routes to an extent that would constrain the proposed alliance?

MR MILLER: Well, there's many many different airlines in the Pacific airlines. You know, some do have more critical mass than others; some operate very small fleets. Some operate models which I would suggest are of non-commercial models, or they pursue models with other objectives, like Air Tahiti Niue who have brand aircraft and capacity into and out of the Islands and also through fares out of Auckland to LA.

You know, all I can say is, when the market is right and there's high load factors or higher levels of profitability, that does encourage other carriers into the networking system, because these load factors, or high degrees of profitability are transferred to other carriers, and just as we watch other carriers reaping the benefits of value from the market, they look at our markets and do the same calculations.

MS WHITESIDE: Thank you.

CHAIR: I just have one last follow-up question from David Ainsworth, please.

MR AINSWORTH: Just following on from Janet's questions; the huge thrust of your evidence that we've heard on entering constraints concern the Tasman and domestic markets with the VBA entry and Fifth Freedom etc, but we've heard virtually nothing on other routes such as Japan, most of the Pacific Islands and to the West Coast of America. Now I'm just wondering whether perhaps you've conceded that an SLC in respect of those latter markets that I mentioned? Substantial lessening of competition.

MR MILLER: I was just asking what "SLC" meant. I thought it was a new type of carrier.

CHAIR: It may be if the alliance goes ahead.

MR MILLER: John, do you want to answer that question?

MR HARRISON: I guess the focus has been on domestic New Zealand and the Tasman because that's where the substantial lessening of competition is. Japan other than our alliance with Japan Airlines, in which we sell them a block of seats and compete on a single aircraft, there is no lessening of competition. So, I guess it was a matter of priorities and focus in that this market in the South Pacific is the one where the competitive issues really are.

MR P TAYLOR: Madam chair, there is no aggregation in those markets.

MR MILLER: I would also add that, you know, we're an in-bound leisure market, and in a place like the UK and Europe where we have less than 1% of market share, we have absolutely no market power under that sort of situation. Indeed in Japan to Auckland, where 90% of the revenue is actually sold in Japan, obviously we have to work very closely with the Japanese based carriers to achieve the market clout that we cannot achieve under our own brand or our own presence in these markets.

MR AINSWORTH: There must be some aggregation to Los Angeles though?

MS WHITESIDE: Or to the Pacific.

MR AINSWORTH: And to the Pacific.

MR MILLER: That would be correct. Most of them, the markets that I just described, that is correct, but that level of aggregation has been a result of most full service carriers not being able to achieve an economic return. In fact there were substantial losses that United were experiencing between Los Angeles and Auckland were to do with their fundamentally higher cost base.

Now, under a deregulated market, carriers such as Emirates, for instance, can come into this market with a lower cost base and exploit that lower cost position.

MR P TAYLOR: Madam Chair, I think the question was already answered previously anyway in respect of the -- when we were talking about -- when Mr Miller talked about the United Airlines re-entry.

MR CLEMENTS: I'd just like to go into an issue further considering Fifth Freedom carriers. It was stated that capacity decisions are influenced by the wish to utilise available aircraft, and a wish to develop long haul services. To what extent are those decisions influenced by pricing and capacity of say Air New Zealand and Qantas?

MR MILLER: Well, I would answer the question, you know, in the first instance by saying that, you know, basically I would have characterised the Fifth Freedom characters, and there's two basic camps; the ones who have redundant aircraft capacity, i.e. aircrafts sitting on the ground maybe for 11 hours in Australia and New Zealand trying to make that through connection to a hub as one category.

And the other category, which would be something like a Thai, for instance, Thai Airlines; and the other category I would say is very much like Emirates. Emirates have a different strategic objective than Thai. Emirates' strategic objective is not one of utilising return capacity during the spare lie time that would have on the ground. Emirates has very much established a beachhead for the technological developments of aircraft to establish a position in the marketplace prior to the technology allowing them to fly from Dubai to Auckland or indeed Sydney.

In fact, very soon they will be able to fly direct from Dubai to Sydney, so they're using these incremental thresholds of technology with longer ranges to access markets, and getting in prior to the technological advances to establish a beachhead is very important for them. So, I'd say the Fifth Freedom characters fall into two camps;

the Emirates camp and very much the Thai camp.

How does our pricing constrain them? Clearly they allocate more capacity to the cheaper fares generally and that they establish carriers on the Tasman and from an extreme of Malaysia, which is around about 65% of the total capacity, they actually give up to the cheapest fares down to what we presume Emirates are currently doing around to about 50%, but clearly they do constrain -- they do accept the fares that prevail in the marketplace and they know they can't charge fares 30, 40, 50% above the prevailing levels because with the lower frequency they can't get into a lot of the business markets that Air New Zealand and Qantas do.

CHAIR: Okay, thank you for that. I just want to look at the programme. I believe we have two confidential sessions coming up after lunch. I propose that we break now for lunch. We will return at 1.45. We will do the two confidential sessions which I will allow two hours for, we'll break for tea at 3.45 and reconvene the open session at 4 o'clock. Does anyone have any questions about that proposed agenda? [**No comments**].

All right, so after the lunch break the session will be closed to all of those who are not either with the Applicants, employed by the Applicants or signed confidentiality undertakings. Thank you very much.

Adjournment taken from 12.50 pm to 1.45pm

***

Hearing held in confidential session from 1.45 pm to 5.20 pm

CHAIR: I'd like everyone to be seated, please. Before we start the next session that is scheduled, I'd just like to say that the Commission has a number of questions on procedural matters, and we will do those questions first, please, and I will ask Commissioner Bates to direct those questions to the Applicants.

MS BATES: Mr Peterson, I understand you're going to answer these questions which are largely directed at in tandem applications as we have here, because you'll be aware that at least one of the submitters has some different views from the Applicants as to the correct procedure etc.

So, I'll start with this: Does the scheme of the Act in your view contemplate the possibility of parallel trade practice and merger authorisation applications?

MR PETERSON: If I could answer the question in two ways. First, the first answer is yes, and the reasons are principally set out in our written opening. But, if I could summarise those.

MS BATES QC: Yes.

MR PETERSON: The way we have looked at it is, it essentially boils down into two areas, and they're interrelated. The first is Conference procedure and the second is the statutory test, and the submitter has for the most part focused on the second, which is the statutory test, but we think it's useful to look at the two in tandem.

The first point though, if I could just address because it is raised by one of the submitters -- in fact Infratil, if I could allude to it in the memorandum filed by Infratil on the 18th of February this year, in paragraph 3.1, the submitter refers to the Applicants being required to discharge an onus. If I could just address that point because it is of some moment.

The issue we would submit is not -- does not fall properly to be determined along traditional lines of onuses of proof, and in our opening submission we referred the Commission to the *Foodstuffs* decision of the High Court. Now, that decision was a decision in 1992 and it concerned a clearance application, but for this particular point it's quite apposite in our submission.

The Court in that instance stated that, when considering whether the Commission was satisfied or not satisfied as the case may be, the Court stated -- and if you'll bear with me, I'll just quote the judgment from Greig J, I think it was, on page 721 said:

"We do not think it is appropriate to deal with this question on the ordinary application of an onus of proof. No doubt, there is, to some extent, a preliminary or threshold onus on the applicant who makes his application, but the matter cannot end there.”

And this is the critical point:

"The Commission is an investigatory body which has the function of inquiring into and deciding the matter before it. It is not a strictly adversarial procedure -- *wishful thinking for the next point* -- there may be no opposing parties, but it is necessary at all times to consider the general public and community interests.”

The point -- I don't want to make a big deal of that, but it's important we just correct the record on that, that we do not accept that there is an onus to discharge; there may be a thrash issue for the applicants to raise, but the process is an investigatory process and in my view that links to the way the Commission has flexibility over the way it runs its Conference and, in turn, the way it reaches its decisions.

MS BATES QC: Sorry, I do have somewhere in this bundle of papers your process submissions, but do you have -- did you have that point covered in that way?

MR PETERSON: No, that point was not covered in the submission, although the *Foodstuffs* decision is referred to in that under the standard, "statutory standard of proof".

MS BATES QC: It just might be helpful to give us an addendum --

MR PETERSON: Certainly.

MS BATES QC: -- on that point.

MR PETERSON: Be happy to.

The next point is that we agree that the Commission is able to combine the conferences for the two applications. The Commission does have a discretion to hold a Conference in respect of business acquisitions. But, where it does exercise that discretion, then it's very clear from the Act that the basic procedure applies to both Restrictive Trade Practice Act conferences and business acquisition conferences.

Now importantly in that s.64(3) provides scope to the Commission to consider the application with as little formality and technicality as possible, consistent with a proper determination of the application.

MS BATES QC: That's the application

MR PETERSON: Yes, it is, but bearing in mind that that provision is read into the provision relating to business acquisitions, by virtue of s.69(b)(2) which relates to business acquisition; in other words, that particular language in s.64(3) in that context was written as it related to the Restricted Trade Practices application.

MS BATES QC: We just might need to reinforce that link that gets you from our discretion as regards handling conferences and procedural matters on a particular application to supporting a view that we can do it on two applications at once.

MR PETERSON: Again, in our submission it is -- the Commission is holding a Conference in relation to both applications here.

MS BATES QC: Yes.

MR PETERSON: And what we're saying is that s.64(3) provides for the Commission the scope and the flexibility to consider the applications in that context. So, in other words, you are perfectly -- the Commission is perfectly entitled to hold a Conference with as little flexibility and technicality in relation to both of the applications.

MS BATES QC: You mean, as little "flexibility".

MR PETERSON: Sorry, with as little formality, pardon me. Pardon me.

MS BATES QC: I hope we would be reasonably flexible.

MR PETERSON: With as little formality.

MS BATES QC: Yes, okay.

MR PETERSON: There is, as we acknowledge in the opening submission, a difference in the way in which the public benefit test is formulated but not the substantive test of course under s.47 and s.27.

For the reasons which we have outlined in paragraph 6 through 9 of our opening submission, we submit that there is no material difference in the test, and certainly which would allow the Commission to do anything other than weigh up the -- or balance the competitive detriments against the public benefits.

In fact, as we have said in paragraph 8 of our submission, it -- this approach not only makes both commercial and regulatory sense, but having regard to the policy and intent of the Act as a whole it is an inevitable approach, and we make the point because it illustrates the force of our submission and our view that any other conclusion would mean that the Commission would retain a residual discretion to authorise a merger or acquisition where the public benefits were outweighed by the competitive detriments rather than the other way around.

MS BATES QC: Yes, I have read that. Just moving on, if the Commission considers the applications in tandem, do limits need to be imposed on the circumstances in which the Commission should permit this approach to be followed? For example, does this approach set a precedent contrary to the intention of Parliament in your view, that anti-competitive mergers cannot be remedied by behavioural conditions under interconnected Trade Practices applications.

MR PETERSON: We don't believe this sets a precedent because we believe that the Act already envisages that this process is permitted, and the reason is simply embedded in the commercial reality of this particular transaction, and that is that the benefits and detriments would not flow from either application without the other. In other words, the strategic alliance and the equity stake by Qantas are not alternative strategies.

MS BATES QC: So, just going back to the question; should there be limits on the sorts of circumstances we will do this, what's your opinion?

MR PETERSON: If there were to be a limit, I suppose the limit might have to be set in circumstances where, like this, there is an equity element to the transaction and a behavioural element, but they are nevertheless inextricably linked or inter-related.

MS BATES QC: So, it's an inter-related relationship; that's key point from your perspective?

MR PETERSON: Yes, it is.

MS BATES QC: In paragraph 24 of your opening submission you submit that the appropriate standard of proof is the civil standard of the balance of probabilities.

MR PETERSON: Yes.

MS BATES QC: Is there anything in the Commission's Draft Determination or otherwise in relation to the matter currently before the Commission that would suggest that the standard is not the one that we're applying?

MR PETERSON: [**Pause**]. Having not read the draft over the last few days, I'm hesitant to answer that, but in the affirmative, other than to say, not to the best of our knowledge.

MS BATES QC: And that goes for the other legal advisors around the table at the moment?

MR P TAYLOR: I think the position is going forward rather than looking back.

MS BATES QC: If I take that answer from Mr Taylor, there's nothing that comes to mind where you could say you think that we haven't applied the correct standard?

MR PETERSON: Well, at the moment I think the point, with respect, is that the standard has probably yet to be applied in the sense that it will only be applied once you make your Determination.

MS BATES QC: Right. So, that's what you mean by going forward, Mr Taylor, that we're not dealing with some review point that's going to look --

MR P TAYLOR: Not in the Draft Determination, no.

MR PETERSON: No, certainly not.

MS BATES QC: I'm glad of that.

MR P TAYLOR: Not, Madam Chair, in the final, if it's right.

MS BATES QC: So, you're not raising the matter, obviously, in respect of something that's been done, but just reminding us?

MR PETERSON: Politely.

MS BATES QC: Politely, with great respect and all that, what we ought to be doing.

MR PETERSON: Yes. A similar question: In paragraph 24 of your opening submissions you say that the appropriate test on an acquisition authorisation application is a quantification of detriments and benefits.

Is it your submission that the Commission is at risk of not correctly applying that test?

MR PETERSON: There has been some discussion and debate over the issues of the modelling approach, as the Commission is aware. The issue for us is to ensure, in so far as possible, that the focus of analysing the benefits and detriments focuses as best as possible on those benefits and detriments that can be quantified.

There have been, or there has been some discussion about the reference to qualitative factors and the prospect that the modelling issues in effect become difficult, or there becomes -- it becomes in a sense a debate amongst a range of economists, and it is the applicant's submission that it's incumbent on the Commission to come to a view as best it can based on a modelling approach.

MS BATES QC: So again, we're looking forwards and not backwards?

MR PETERSON: Yes.

MS BATES QC: The Government, as you know, hasn't issued a Policy Statement under s.26 of the Act. What weight, if any, should therefore be given to informal statements of policy such as some recent reported comments of Dr Michael Cullen?

MR P TAYLOR: Commissioner Bates, I think probably the answer to that is that the Government made a statement at the very outset of this alliance and when it was working through the national interest benefits that it had to work through as a shareholder, that it would not take part in the Commission's inquiry in any way, shape or form, and my understanding is that the decision was made that it would not put forward or advance anything for or anything against the alliance.

In terms of weight going forward --

MS BATES QC: In fact, look, I can't quote you chapter and verse, but I certainly have seen comments coming from Dr Cullen which support the alliance, so it hasn't actually -- if that was the intention, that hasn't exactly been stuck to.

MR P TAYLOR: I think the Government very early on also decided that it was going to have different representation within its own body from qua shareholder qua regulator and as a shareholder I think Dr Cullen has felt himself free to make some statements publicly, but he was not stating the position of the Government from a regulatory point of view.

MS BATES QC: So we shouldn't give any weight to it?

MR P TAYLOR: You can give the weight to it as a shareholder setting out what its view of life is going forward, but it's not a s.26 notice, no. And I think the decision in Kiwi makes it pretty clear that going forward the Commission doesn't have to give weight to a s.26 notification in any event. It's bound to take it into account, but not bound to --

MS BATES QC: Yes, it doesn't have to follow it, it's got to have a pretty good look at it but, yes.

MR P TAYLOR: Sorry, on that point too; it's only a faxed copy, but here's a copy of that letter that you asked to be provided to you. [**Letter handed to Commission**]

MS BATES QC: So obviously, I think you've accepted that the Government's left the competition issues to be dealt with by the New Zealand Commerce Commission and the ACCC?

MR P TAYLOR: Absolutely.

MR CURTIN: Just following up; Mr Peterson, you cited the Amsay(?) case where we were required to quantify benefits and detriments where we can, and I think that's unexceptional. But did I understand you to make a stronger point that we can only incorporate into our judgment things that have been quantified and we should put the -- what you term the "qualitative" factors to one side.

MR PETERSON: No, I don't think the position is that extreme, and I hope I didn't convey that impression, but the -- the force of our submission is principally directed at the fact that there is a primary obligation to endeavour to quantify the benefits and detriments. Inevitably there will be qualitative elements that will and should be taken into account, but the principle obligation is to quantify in so far as they can be.

MR CURTIN: Thank you.

MS BATES QC: I think that ends my questioning, but I think that

Dr Berry has one or two questions for you.

DR BERRY: I just have one for clarification. The Draft Determination reaches a conclusion that Qantas and Air New Zealand, through the partial acquisition coupled with the alliance arrangements, will end up being in essence one person in the market. I think I'm right in saying that there hasn't been a response to that conclusion.

Can I just get clarification that you accept that, post implementation of these arrangements, that the two companies would be associated persons for the purposes of s.47?

MR PETERSON: Yes.

DR BERRY: I just have a follow-up question on one of Commissioner Bates' questions. The scheme of the Act has the ability to rectify anti-competitive mergers through undertakings to make divestments, mergers involving permanent restructuring of markets. And I just wonder to what extent it is possible to remedy an anti-competitive merger through conditions attached to an interconnected Trade Practices application simply because the parties say it is interconnected?

Bear in mind that conditions attached to trade practice applications have ongoing monitoring problems; there's sunset clauses on them, and then once that time expires you then have the consequences of the permanent restructuring of the market.

It just seems to me, following on from that, if the Commission in this case accepts this approach, that you can remedy an anti-competitive merger by trade practice conditions, that something of a little industry could emerge amongst legal and other practitioners whereby, every time we're looking to advise a client that we've got problems with this merger, we'll say that something is interconnected and because we say it is, therefore the Commission has to bring these public benefits in through the back door to rectify the problem.

It just seems to me that there's a real problem looking at the scheme of the Act, and in a blanket way accepting the approach that you are advocating. I just wonder whether you might want to expand further on that point if you don't think you've already covered it?

MR PETERSON: I guess my -- and it's a bit off the top of my head response, so I apologise for that, but if we are developing the market, then we're delighted to do so, but I think that the position is really -- could be categorised as the conditions in so far as the Commission wishes to impose them in relation to the restrictive trade practices or the strategic alliance part of this proposal, can properly be seen as part of the structure of the market when the Commission is making its overall assessment on the transaction. So, I guess we don't see anything at odds with that particular approach, and I think at the moment that's where our view rests.

I take your point about the permanence of the equity application, or an equity application, but at the same point the structure or the features of the market may well have changed quite significantly after a particular period of time. So, it would be dangerous to draw conclusions about what the market might look like at the end, if you like, of a behavioural arrangement which might be several years in the future.

DR BERRY: What happens though if the anti-competitive concern that was there today isn't remedied say by 3 to 5 years time? I accept that many markets will be in flux and circumstances change, but is there any ability to undo the transaction in 3 to 5 years time?

MR PETERSON: I think ultimately each situation will have to turn on its own facts. Did that answer your question? I mean, there may be situations here for example --

DR BERRY: Perhaps if I can respond to that. It's not the circumstance where with a trade practice application if there is a change in market circumstances the Commission has legislative power to address the problem. No parallel provision as I recall would attach to the actual structural merger application.

MR P TAYLOR: I think perhaps if I could add to that, in terms of a difficulty in the Trade Practices application that led the Commission to reconsider and effectively remove the authorisation, then I don't think then necessarily the shareholding by itself would necessarily be considered anti-competitive, or that the parties would therefore necessarily be in an associated persons status. That would be for a matter of consideration at the time, but I don't believe -- I think my friend was -- when he said that he agreed with an associated person test at the moment, he was talking in terms of a shareholding and the alliance working in conjunction, if the alliance fell away, then the shareholding would sit there alone and that would be a question then, but I would have a pretty good go at arguing that the terms of it as it sits would not necessarily result in an associated person test.

DR BERRY: It would still have to be a strong prospect that in 3 to 5 years time, once the conditions expire, that the organisations could still be associated. That prospect

Applicants (cont)

would still have to remain, given the presence on the board and all the other arrangements over pricing and scheduling that would have happened over some period of time.

MR PETERSON: Can I just clarify that remark: The conditions expire or the transaction expires?

DR BERRY: I'm assuming the 22.5 has been acquired, so we've got the lock-in of the shares, and then as I recall the conditions, they have 3 or 5 years timing attached to them.

MR PETERSON: But we're not talking about the end of the strategic alliance because, by the time the conditions expire, the market may well be significantly competitive. The dynamics of the market may well be quite different, and the Commission of course, as Mr Taylor's pointed out, of course has the ability to revisit and change circumstances.

DR BERRY: Doesn't have a chance to revisit the 22.5% acquisition; the reason that that has been justified is because you're using conditions attached to a Trade Practice application.

MR PETERSON: No, that's not right at all. The conditions that we're talking about here are merely proposed to facilitate entry in so far as that's necessary, assuming for the moment that entry occurs, and that the market is substantially competitive, significantly competitive as the Applicants' firmly believe will be the case, long before 3 years, then I don't see, with respect, what difference to the competitive landscape it would make if the conditions fell away.

DR BERRY: I accept on that factual scenario that there would not end up then a problem, but I'm standing back looking at the structure of the Act and thinking of general principles and thinking of the worst-case scenario where, but for the conditions, the Commission would not have authorised this deal.

MR P TAYLOR: I think the added feature is that we would expect that -- we'd rather like the Commission to consider an authorisation that went on forever of the alliance, but we anticipate that there will be some timeframe put on it. The conditions will probably have disappeared anyway during that timeframe; the alliance then would need to seek re-authorisation. That's the opportunity for the Commission then to reconsider conditions or whatever.

MR PETERSON: That is, of course, a possibility, but the Commission may at the same time, it clearly has jurisdiction to grant authorisation once and for all, both under the Restricted Trade Practices provisions and also under the Business Acquisition provisions.

MR AINSWORTH: I'd like to ask a question about your answer to question 39 in the Draft Determination, which concerns the deemed substantial lessening of competition effect of s.30.

Now, you provided the answer that as a matter of law the effect, if any, in a particular case of a price fixing agreement on competition, depends on all the circumstances and cannot automatically be assumed to effect competition. Now, I'd just like to read you something else, which Elias J wrote in the 1999 High Court case of *Commerce Commission v Caltex New Zealand*:

"An arrangement or understanding which comes within the terms of s.31 is deemed to have the purpose or to have, or to be likely to have the effect of substantially lessening competition in a market. Whether in fact it has that effect is irrelevant.”

So, I suppose my question is, given the state of law as stated by Elias J, is your answer to question 39 wrong?

MR P TAYLOR: Personally, I'd like to think about that one a little bit longer.

MR PETERSON: You're referring to a submission by the -- the Applicants' refer to the -- these are the comments of the ACCC, is that?

MR AINSWORTH: Well, I think actually what I've just read out appears to be your editorial comment, because it's not in the ACCC's decision. I can show that to you later on if you want to.

CHAIR: Why don't we let you follow-up up the source of that and you can come back to us on that, if you would, please.

I'd just like to check with our own advisors and Commissioners if there are any other questions at this point on procedural matters? [**No comments**].

Okay, I will close this session on those matters at this time and we will now return to the agenda which has the issue of tourism benefits of the alliance as the next item, and I'll ask the Applicants to introduce the speakers in this session, and can I ask the speakers to bear in mind that we have read all of the submissions and we're looking for summaries of key points.

MR PARTRIDGE: Madam Chair, can I start by introducing Mr Norm Thompson, Air New Zealand's Senior Vice-president Sales Distribution Regional Airlines and Cargo on my immediate right, and to his right Mr Shane Warbrick, who you've had before you before, Air New Zealand's Chief Financial Officer.

MR PETERSON: If I could take the opportunity to introduce two new face s to the Commission; this is Mr Simon Bernardi, who is the Chief Operating Officer of Qantas Holidays, and next to Simon is Mr Arthur Hoffman. Arthur is GM Strategy and IT of Qantas Holidays.

CHAIR: Thank you and welcome to some of the new faces around the table, and please begin with your summary.

MR THOMPSON: Thank you Madam Chair and Commissioners. We've heard a lot about tourism this afternoon, and certainly the Applicants firmly believe that this alliance will bring a very strong and positive impact to tourism in New Zealand. The reasons and our views are well set out in the submission and certainly the supporting expert evidence.

This evening I'd certainly like to address Air New Zealand's perspective, and the very real benefits the alliance will provide us as the national flag carrier to significantly -- to significantly increase in-bound tourism to New Zealand. The benefits as we see them fall into three categories. There's network benefits, there's distribution enhancements, and there's system improvements. These benefits to Air New Zealand support the evidence you will hear from Qantas about, the benefits of Qantas Holidays and Air New Zealand Holidays will bring the New Zealand tourism industry under this alliance.

As you know, we have claimed in our submission that the alliance will increase tourism by 60,000 tourists per annum. I certainly have no doubt about this, and personally believe that the figure is conservative.

A little bit of background. Firstly, Air New Zealand is certainly the main source of in-bound tourism and domestic tourism in New Zealand, and we talked earlier on today about that investment, particularly in off-shore markets, and I can share with you that the investment that Air New Zealand has in off-shore markets is in the vicinity of $71 million, and that figure is primarily made up of the investment that

Applicants (cont)

we have in sales and marketing staff, plus also our sales and promotional budgets that we spend off-shore.

Clearly this figure makes us the single largest source of promotional investment to New Zealand. Without this alliance, and Air New Zealand being squeezed as has been discussed earlier on today, the ability to have this commitment ongoing is certainly seriously under threat. We're also aware, or shared with you earlier on today that Air New Zealand provides 40% of the seats into New Zealand. By far, certainly the largest contributor of seats into this country. No other carrier has the brand linkage to New Zealand, or indeed the interest in New Zealand or the commitment to promoting New Zealand.

We have seen carriers come and go from this country. Some very icon carriers such as British Airways, United Airlines, Japan Airlines, American Airlines, Continental Airlines, all have been to New Zealand and departed. There is also no other carrier in New Zealand that provides the domestic network that Air New Zealand provides, and also the international bilaterals.

I think we should just reflect for one moment on the domestic network. Air New Zealand flies to 24 destinations and is very much focused on promoting and improving regional tourism. There wouldn't be too many people interested in investing in airlines to fly to places such as Kaitaia, Westport, Wanganui or Gisborne, or helping developing up-and-coming regional markets such as Hawkes Bay, Marlborough. These things are all part of our promotional activity and in bringing tourists into the country.

With the alliance there is an exciting and unique opportunity to enhance the promotion of New Zealand.

Applicants (cont)

Certainly, Air New Zealand is singularly focused on New Zealand, but we do have network, systems and distribution constraints.

The proposed Quantas/Air New Zealand alliance is the only alliance that resolves these particular issues. Improved productivity from promotional spend but one example. Rather than having rivalrous promotion, the two carriers working together can spread their budget -- spread their marketing activity to focus on improving the numbers rather than competing for the same passenger.

We will discuss in a moment further opportunities that will see us being able to show and demonstrate increase in tourism. The result is certainly significant.

Let's, however, just for a moment reflect on just how big New Zealand is as a destination from some key markets. We are, in some respects, a minnow. If we take the United Kingdom as an example: Tourism to New Zealand represents 0.4%, 0.4% of the total out-bound market from the United Kingdom. If we were just to look at the long haul market from the United Kingdom, New Zealand represents 20.3% of the out-bound market. Just think if we could extend that to being 3%, there would be an additional 80,000 tourists coming to New Zealand per annum.

You can see from the points that I've raised here, Singapore, Hong Kong, the United States, New Zealand represents less than 1% of the out-bound tourists flows from those countries. Interestingly, Japan has just broken the 1% barrier. It is the only market in which Air New Zealand has its own dedicated holidays programme through a company called Blue Pacific Tours, which we own 1%. And I'll come back to that point in just a moment. We also own Blue

Applicants (cont)

Pacific 100%.

Let's just address the network weaknesses that we have for a moment. Air New Zealand currently faces a number of network weaknesses. We have no relationship with a domestic Australian carrier. This has certainly been a real challenge since the demise of Ansett, and we are certainly unable to remedy the situation. We certainly do not have the economic capability to be able to start up a domestic operation in Australia.

It was interesting yesterday hearing Mr Dixon make the point, the importance of domestic New Zealand to Qantas to ensure that they have connectivity to their international operations. We feel very weak in Australia in that we don't have that connectivity at the moment, which is our largest international market.

We're also limited when it comes to dual destination marketing, and in particular the United Kingdom, Europe, and the United States, which are prime dual destination markets. Unfortunately, we struggle to get our share of it because we do not have that domestic network in Australia which many tourists wanting dual destination visitation require domestic travel within Australia.

We are also suffering from not being able to grow certain markets because of bilateral constraints, and I refer to our United Kingdom bilateral as an example, where we currently today fly daily services through to London with a service stopping off in Los Angeles on the way. Our bilateral as it stands today constrains us from offering Fifth Freedom traffic between Los Angeles and London and thereby not making it viable for us to add additional services to London.

Similarly, looking at it the other way; over Asian routes we have the approval of Hong Kong to be able to fly from Hong Kong-London but the UK authorities will not give us the rights to fly into London. Consequently we are restricted to a daily operation to our second largest market. The alliance will certainly help us with that, and we'll talk about that in just a moment.

European tourists, we also suffer from not being able to get connectivity and particularly since the withdrawal of our Frankfurt-Los Angeles service, we've seen the German market decline, and although we have an alliance partner, Lufthansa, regrettably the importance Air New Zealand is to Lufthansa is not that great, as they tend to concentrate more on connecting with carriers such as United Airlines or indeed focusing on higher yielding markets between the United States and Germany, or indeed Asian points and Germany.

MR CURTIN: Mr Thompson, I wonder if I could just ask there on your last point; if that connection in Europe is so important to the European tourists, why did you cut it out?

MR THOMPSON: Because, with the services that we had, which were three a week, were that uneconomic it was certainly not adding any value to the company; it was value destroying. In all the time that we were flying to Germany we struggled to make a dollar.

MR CURTIN: Are tourists a good thing or a bad thing for you?

MR THOMPSON: They are our life blood, Commissioner Curtin.

MR CURTIN: Then why have you cut-off your access to the European ones?

MR THOMPSON: Because, in the case of Frankfurt, operating three times a week is not that economic; most carriers like to fly at least a daily operation. We struggled with three, we did cut back to two; the bottom line actually got worse, and so we were forced to withdraw because it was destroying the value of the airline. It was very very unprofitable for us, and we went in to Star; we were hopeful of being able to get connectivity with Lufthansa out of the German market, but unfortunately our customers have to wait something like five and a half hours in Los Angeles and thereby it does not make the routing down to New Zealand very attractive having that sort of stop-over time in places like Los Angeles.

MR CURTIN: I'll just stay in a cloud of confusion here for a while and perhaps you can move on.

MR THOMPSON: The alliance network benefits: These weaknesses, we believe, can be considerably eliminated with working with Qantas, where we can move to having on-line flights with Qantas and looking at great connectivity opportunities. Working with Qantas certainly expands immediately our network.

If you think with regards to Air New Zealand, we gain the benefit of course of the domestic operation of Qantas in Australia, or indeed Qantas gains the benefit of our non-stop services that we have from points that they don't fly, such as to Queenstown out of Sydney, Singapore-Auckland, Perth-Auckland, Cairns-Auckland and also our Japan services, just to name a few.

We also, by working with Qantas under an alliance, will be able to provide improved seamless travel experiences and certainly work towards fixing the issue that we have in our European markets at the moment where it is difficult to compete with some of the on-line carriers all the way through to New Zealand, but also to be able to go back into that market and stimulate tourism by having connectivity with Qantas over Singapore.

The other key point is that, before we start discussing any schedule co-ordination, just if we mesh the two schedules as we have them today, it would bring about 1250 new directional on-line routes for the alliance.

What does this mean to the consumer? It means that their travel time will be reduced by something in the order of 10%. It means that their on-line itineraries will see an improvement in cost of travel for consumers. It can be in some cases up to 25%. It also means seamless improved travel experience through seamless travel, and of course the generation and stimulation of new traffic with the larger network.

There are also new network opportunities in itineraries such as from the United Kingdom where we are constrained by our bilateral; it would provide us with daily connectivity over Singapore where Qantas fly daily operations from London to Singapore and meeting our daily operation from Singapore to New Zealand. It creates a new opportunity for us out of France, where we actually have no Star Alliance partner in France at the moment, but with Quantas' on-line services from Paris to Singapore connecting with Air New Zealand and Singapore, that creates a new opportunity for us. They're a daily operation from Frankfurt to Singapore, again puts us back in the German market with a daily operation with connectivity over Singapore and similarly with New York.

We also look to, as a -- as the alliance work together to introduce new services such as Adelaide non-stop, Canberra non-stop and Hobart non-stop. For either carrier to do that in their own right and compete against one

Applicants (cont)

another it would probably not be economically viable, but by the two carriers working together we can make those sort of operations work and be economic for both.

The obvious advantage from these new network opportunities is indeed tourism, and we see other opportunities as well, such as emerging markets like India. It also could justify Air New Zealand up-gauging its aircraft on the Singapore-Auckland route where today we fly a 767 operation, by looking at the opportunities that the new European connectivity gives us, plus being able to work new and emerging markets together, we could see an increase in capacity on the Singapore-Auckland route, thereby again increasing tourism; that would mean an additional 59,000 seats per week. We could also improve ad hoc opportunities for the country.

I cite the example of Japan charters as being just one example, whereby there are opportunities through from November to March each year operating charters from Japan to New Zealand for markets such as Fukuoka where today or this year unfortunately we simply do not have the capacity in our own right available to be able to operate such charter opportunities and thereby the market is going to be left behind.

With the alliance and being able to work schedule activity together, we would be able to, I'm sure, find this additional capacity required to take up such opportunities. And then there are the special interest events as well that, by working together, we can create new market opportunities for tourism.

We also would like to exploit new market opportunities such as South America and China and again, by working together, we can make those happen, but individually they would be a challenge.

I come back to Australia: Quite clearly our largest in-bound market where we have no alliance, and we have no on-line partner. Air New Zealand is indeed limited to Brisbane, Melbourne, Sydney, Cairns and Perth markets. Madam Commissioner, this market is a third of our in-bound market. The alliance will help solve our issue of access beyond these gateways in the Australian market and probably our most important market.

Similarly with the UK, our second largest in-bound market where Air New Zealand has no long haul effective alliance out of the UK. Yes, we do have Singapore Airlines as part of Star, but unfortunately Singapore Airlines does not connect with our services, northbound or southbound. They connect with their own certainly, but we do not connect with them providing a seamless connection for our customers.

MR CURTIN: Sorry, excuse me: Why is that, if they can connect with one of their flights in Singapore? What's preventing you connecting with that flight?

MR THOMPSON: They're looking after certainly their own markets, their own traffic, but also the timings are prime timings as well, and they have third and fourth freedom traffic; that's Singapore-UK traffic they would prefer to look after before they accept our feed, which is lower yielding.

So, essentially Commissioner Curtin, they're effectively looking after themselves; looking after number one before they're prepared to accept our particular traffic. We have a connection on their following flight, but not on the immediate connecting flight.

MR CURTIN: Thank you.

Applicants (cont)

MR THOMPSON: So the United Kingdom and Europe is 20% of our in-bound market and we do not have really an effective partner in the Europe UK market. UK alone is 13% of our in-bound tourism market. So again, by working with Qantas in this alliance, we believe that we can improve the size of the market from UK to New Zealand by having greater access to capacity.

In the UK -- just staying on the UK for a moment, we are the primary airline promoting New Zealand. As I said, the bilateral at the moment has us currently capacity constrained. The alliance gives us that ability to grow, but because of the situation with our high load factors at the moment, we are in a maintenance position in the UK; rather than investing further dollars to effectively potentially put customers on other airlines, we are effectively marketing in the UK and holding our own because we simply do not have the additional capacity to be able to take the growth that's there that the potential is there to make out of the UK market.

Moving on to systems and the distribution benefits: Currently Air New Zealand does not have the means to create package holidays anywhere outside of New Zealand, other than Japan, and I referred to that previously as a company called Blue Pacific Holidays which we own 100%. The service is out-sourced in Australia using very old technology. For the three key in-bound markets, Australia, the United Kingdom, the United States, Air New Zealand unfortunately does not have the system and therefore the ability to create packages in its own right out of these markets.

Air New Zealand: The development of Air New Zealand Holidays will grow the tourism market to New Zealand by using Qantas Holidays distribution and IT platforms to grow in-bound tourism.

How will this work? Air New Zealand will own and control the Air New Zealand Holidays brand. However, Qantas Holidays will be able to develop, produce and market the product just as they do today for their own Qantas holiday product. There will be separate Air New Zealand holiday brochures and on-line products. They'll be developed and obviously sold through the respective distribution channels that we are associated with. Air New Zealand will certainly continue to have the final say as far as product approval is concerned.

Qantas Holidays will promote the product via its distribution network, which is extensive, and my colleague in a moment will share with you just how extensive that is.

Air New Zealand will also market and distribute the product via its own distribution network. What will be the roles of each brand? Air New Zealand Holidays will be the main brand used in foreign markets exclusively for New Zealand itineraries. It will be one of the two brands in foreign markets for dual destination New Zealand and Australia itineraries. I repeat; that's particularly important for the UK, Europe markets and the American market. Qantas Holidays will be the main brand used in foreign markets, exclusively for Australian itineraries, and will also be one of the two brands in foreign markets for dual destination New Zealand and Australia itineraries.

Access to Qantas Holidays' booking engine and it's array of land packages to create Air New Zealand Holidays is key to the ability to be able to have access to this IT system. It would take years and significant costs to replicate this system. It's gone through something like 47 modifications to get to where it is today, and it is an outstanding system. For Air New Zealand to try and replicate this is simply just not possible and creates a significant opportunity for Air New Zealand.

I just want to come back to dual destination for a moment because it is very important; that by not having access to the Australian domestic market we are certainly hamstrung in markets such as USA and UK. I illustrate here for you that 50% of the US market visiting New Zealand also visits Australia. Similarly out of the UK market; 48% of the market out of UK coming to New Zealand also goes on to visit Australia. So, having that Australian network is very very important, not only for the promotion of dual destination but significantly important for Air New Zealand because we are essentially cut out of it at the moment. When we did have Ansett, we received from Ansett; Ansett fed us something in the order of 100,000 sector passengers per annum. Today without Ansett we are receiving less than 50% of that feed from an Australian domestic carrier.

Air New Zealand Holidays will certainly have a greater ability and will be certainly motivated to fill the shoulders and off-peak periods. This is a significant challenge in working with operators off-shore at the moment who have a very small focus on this part of the world. Filling the shoulders and off-peak periods improves infrastructure opportunities, not only for the airlines but for tourism infrastructure as well. The reason why independent tour operators will not focus on New Zealand in the shoulders and off-peak is, quite simply, they have peak markets to also market to and that's where they get the numbers during peak seasons.

MR PJN TAYLOR: Could I just take you back to a point you just made a minute ago, please. I've just been thinking about it. The 100,000 feed you got from Ansett reducing to 50, would a fair bit of the difference be brought to New Zealand now by Qantas?

MR THOMPSON: Only if the customer was persuaded to buy a Qantas itinerary.

MR PJN TAYLOR: Do you know whether that's so? Have you done any research?

MR THOMPSON: I do not know that.

MR PJN TAYLOR: Okay, thank you.

MR THOMPSON: We've said, Air New Zealand lacks a strong global distribution for its holiday product, and certainly Qantas Holidays offers us a significant opportunity. It has the economies of scale and, as I've said before, we certainly could not replicate that. It has presence in 25 countries, and access to 37,000 outlets around the globe. Air New Zealand would be presented -- Air New Zealand Holidays would be presented with the opportunity to market through those 37,000 outlets. The IT system of Calypso we simply again could not replicate. They have the infrastructure in place in these markets and they could take on the Air New Zealand Holidays product as a further product in their kit in these markets giving New Zealand a huge opportunity to improve tourism.

The promotional activities go without saying, and the abilities to build brand, not just the Air New Zealand Holidays brand but the creation of greater awareness of New Zealand is the opportunity that this presents us. Just to show you where the representation currently is; from this

Applicants (cont)

map you can see they have a significant representation and you'll note on the map two korus; one in Japan and one in Australia. Madam Commissioner, Madam Chairperson and Commissioners, that is the only place in which we have our own owned 100% product, is where you see those two korus. Where you see the red triangles is where Qantas Holidays is represented and where Air New Zealand Holidays can be expanded to under this alliance. In particular, it brings us huge opportunities in markets such as the Middle East, Europe and the growing existing markets.

Getting the attention for New Zealand is sometimes very difficult, and I share with you just here the key operators that we work with in the United Kingdom. Our largest operator, Trailfinders, which is a significant operator, a very good operator, but New Zealand only represents 2.4%; 2.4% of their business. Air New Zealand Holidays operating in this market with the people who would be supporting it would obviously have 100% focus on New Zealand.

I share with you here our other owned operation, Blue Pacific Tours, as to just exactly what an owned operation can achieve. The question I asked was, has Blue Pacific Tours, our only owned off-shore wholesale operation, has it created additional demand to New Zealand? And the answer is, unequivocally yes.

Currently, as I've said, New Zealand only represents 1% of the total out-bound market from Japan. Better than most other long haul markets, in fact significantly better than most other long haul markets, the Blue Pacific staff -- Blue Pacific Tours staff are specialists in New Zealand; they don't sell any other destination. 1% of our major agents in Japan -- sorry, our major agents in Japan only sell 1% of their business to New Zealand; Blue Pacific Tours sells 100%. By having a focus in New Zealand, we're able to create and stimulate special interest opportunities such as golf, rugby, fishing; segments of the market that an independent operator is not necessarily interested in investing with us in.

We develop a very close relationship in Japan with special interest organisations such as sister cities organisations, again developing tourism between points in Japan and New Zealand through our very own owned 100% Blue Pacific Tours operation. It's these sort of opportunities that presents us by having our own owned operation.

Tourism New Zealand also works very closely with Blue Pacific Tours, because primarily of its dedication to New Zealand. Blue Pacific Tours also has a very strong role in educating key agents in Japan on how to and what to promote in New Zealand. Clearly, a dedicated wholesaler creates a much stronger focus in New Zealand.

MR CURTIN: One small question. What's the ID? You mentioned that you don't have a dedicated ID holiday system. How do you handle the business from Blue Pacific Tours?

MR THOMPSON: Very complicated way, we have a very old IT system in Japan as well, Commissioner Curtin, which quite frankly very much needs replacing but we have not been able to replace it because of the significant investment that it's required to replace. It is also a system, to be fair, that is very much tailored for the Japan market as well, Japan language etc, etc, it was developed when we first put Blue Pacific Tours together. So, it's not one that could be used or expanded upon in other markets, it's very specific to Japan.

Applicants (cont)

A commitment under the alliance is to further invest in the marketplace, and with the alliance approved, both parties have agreed to spend a further $5.4 million Australian on promotion of New Zealand under the Air New Zealand Holidays banner. This is targeted at moving markets from other parts of the world, or the rest of the world I should say, not just a shift share from existing tour operators who are already promoting New Zealand. We quite clearly want to increase the size of the market, it's not a matter of just moving share around. As I said, we want to focus a lot of that activity in the shoulders and the off-peak seasons.

MS BATES QC: That's about a 10th of what you're currently spending, an increase of about a 10th, is that right?

MR THOMPSON: No, the 71 million, Commissioner Bates, also included my staffing costs of -- sales and marketing costs in the off-shore markets as well. So if you would include the staffing costs, yes, it is just under a 10th, but it is a more significant number than that on real dollars invested in the market.

MS BATES QC: Because you won't have to increase the staff, right?

MR THOMPSON: We will definitely not be increasing staff.

The 60,000 tourists that we talk about increasing under the alliance won't just come from Air New Zealand Holidays. As we invest further in the market and promote and have more collateral out there, independent wholesalers, we believe, will also grow in their business to New Zealand.

How will that occur? It will occur because we're offering significant enhancements to the network, we're offering more economic itineraries, we're making New Zealand significantly more attractive and of course with the additional promotional spend in activity and having two significant sales forces such as Qantas Holidays and Air New Zealand promoting the destination, we believe that destination awareness will increase quite significantly.

So to summarise, the alliance will expand New Zealand tourism, it will expand tourism by the enhanced network that we offer, and I cite for you the extra 1,250 connections that if we were to bring both schedules together today that that connectivity brings 1,250 additional connections.

The new on-line opportunities which would not occur absent the alliance; Adelaide, Hobart, Canberra and the emerging markets. Raising the awareness of New Zealand, a significant part of this alliance's activity. Enhanced global distribution of Air New Zealand brand, supported by the dedicated and focused sales force who will be totally focused on Australasia. Engaging in dual destination opportunities, a market that we have been absent in since the demise of Ansett, a market that is still very very important, particularly out of those key markets of UK, Europe and the United States. Improving visitation in the shoulder and off-peak seasons, a very very important point. Additional promotion and expenditure being committed to raise the awareness and improve tourism.

The alliance, I believe, will certainly deliver in excess of 60,000 additional tourists. However, none of this will happen absent the alliance.

MS REBSTOCK: Can I just -- thank you for that presentation. What I propose to do at this time, because we have ten minutes left today, is I'd like to take the questions on your presentation in the morning. There is one matter that

Applicants (cont)

the Commission would like to deal with today and we do need to finish at a quarter to, so unless there's any questions Mr Peterson?

MR PETERSON: Madam Chair, Mr Bernardi also has a presentation.

CHAIR: I understand that.

MR PETERSON: We will take that in the morning?

MS REBSTOCK: Yes, we'll do the questions on this presentation first and then we'll do the presentation from Qantas Holidays.

There is a matter that we wish to raise in relation to the letter that you have provided to us, and I would like to ask Mr Rennie to put the questions to you that we have. But I just want to confirm that there is not an issue of confidentiality around that letter?

MR P TAYLOR: There is really, certainly in terms of the response not in terms of the --

CHAIR: The questions that might be put.

MR P TAYLOR: That's right. I didn't keep a copy of it myself, Madam Chair. There is confidentiality, if you want to --

CHAIR: I would like to then go into a confidential session. We do need to cover this today, so I will ask anyone who has not signed a confidentiality undertaking, or is not associated, I believe with Air New Zealand in this case, to leave the room at this time, thank you. Can I just say before you leave that we are starting at 8 o'clock in the morning.

Hearing held in confidential session from 6.35 pm to 6.50 pm

Resuming Wednesday, 20 August 200

[**Confidential session held from 1.45 pm to 5.20 pm**]

Resuming Wednesday, 20 August 2003 at 8.00 am

***