

The logo for InterVISTAS Consulting Inc. is located in the top left corner. It consists of the company name in a white, sans-serif font, with 'Inter' in a smaller size and 'VISTAS' in a larger, bold font. Below the name is a red curved line that starts under 'Inter' and sweeps upwards and to the right under 'VISTAS'.

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*Strategic
transportation
business
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Presentation of Dr. Michael Tretheway

*Presentation to
the New Zealand Commerce Commission
18 August 2003*

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Outline

- ➔ **The emergence, growth and impact of Low Cost Carriers (LCCs)**
- ➔ **Comments on the NZCC Factual and Counterfactual**

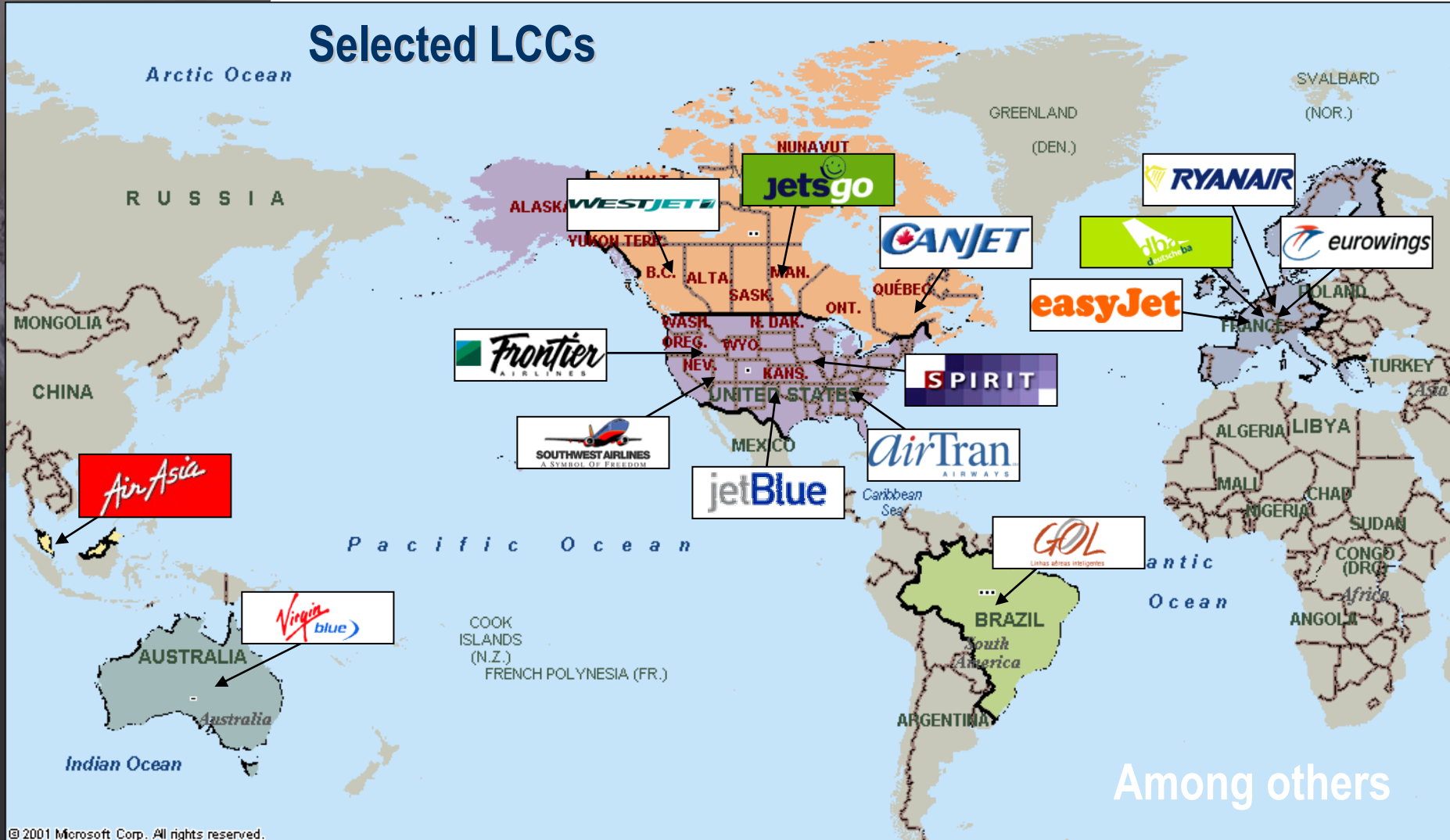
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The Emergence, Growth and Impact of Low Cost Carriers (LCCs)

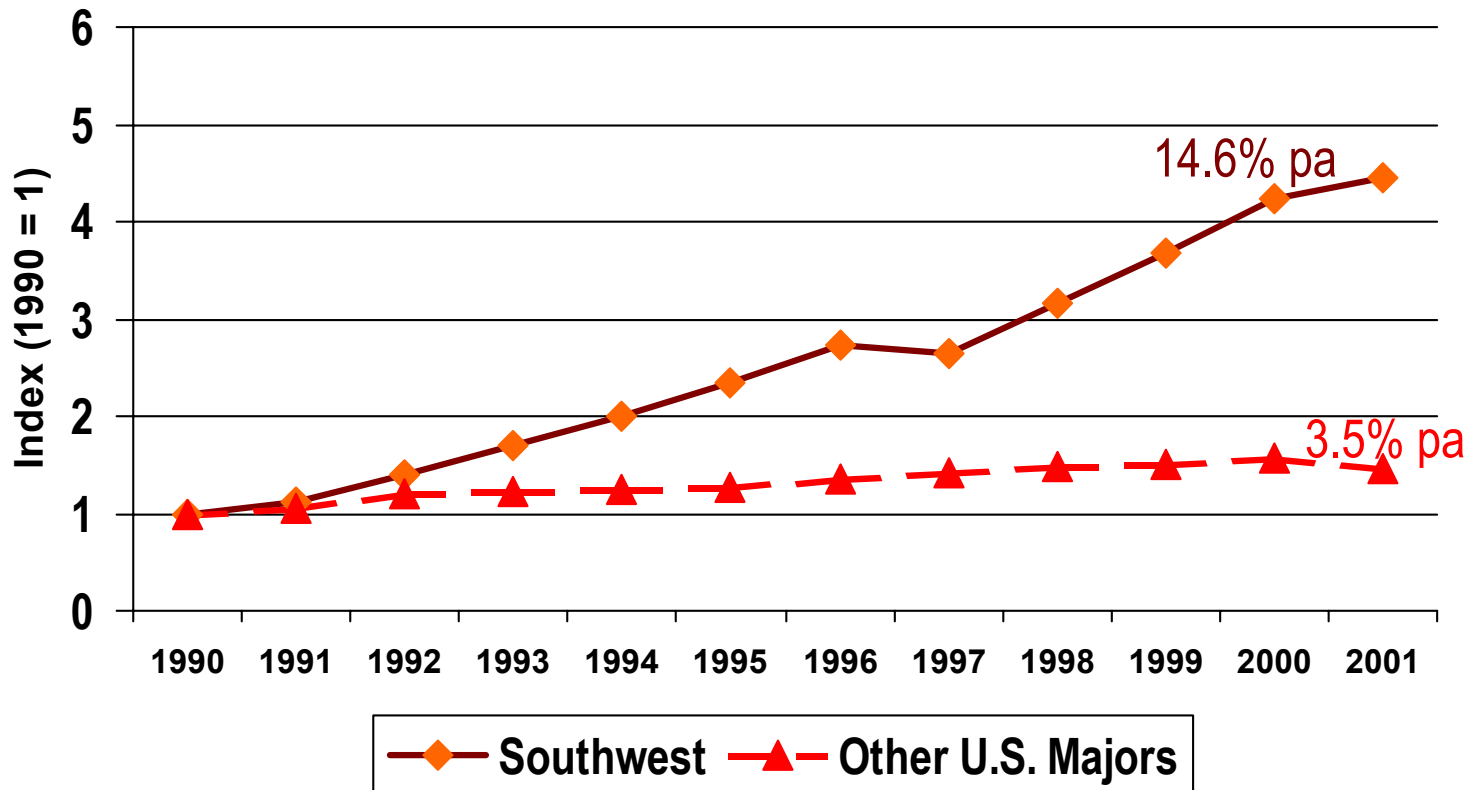
LCCs Today: A Global Phenomena

Selected LCCs



US Growth: SW vs. Other Majors

Index of Southwest RPMs vs.
Other U.S. Majors

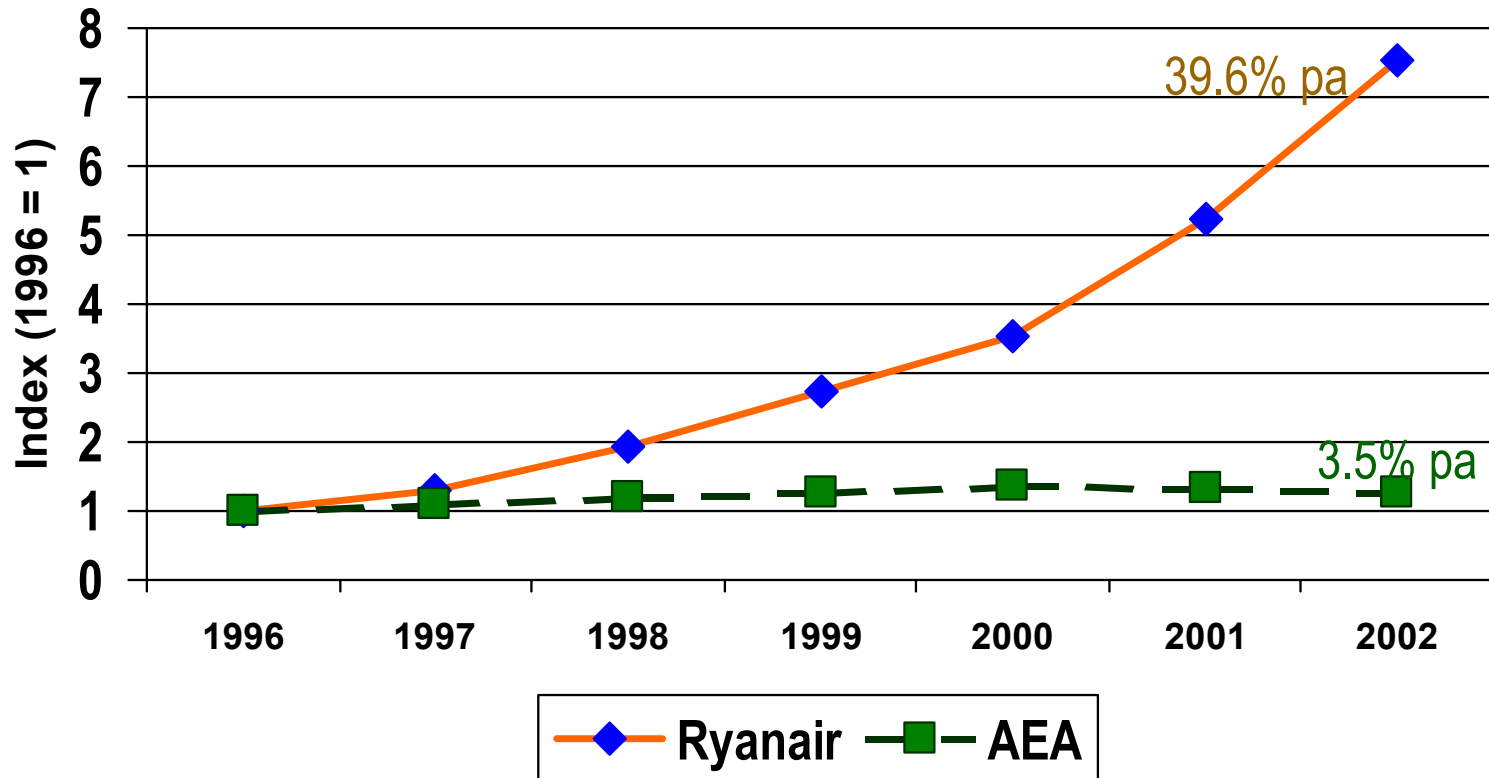


Note: Other U.S. Major air carriers include: American Airlines, Continental Airlines, Delta Airlines, Northwest Airlines, U.S. Airways and United Airlines.

European Growth: Ryanair vs. AEA carriers



Index of Ryanair RPMs vs.
Association of European Airlines (AEA)



Note: AEA (Association of European Airlines) include the following airlines: Adria Airways, Aer Lingus, Air France, Air Malta, Icelandair, Jugoslav Airlines, KLM, Lufthansa, Luxair, Malev Hungarian Airlines, Olympic Airways, Sabena, SAS, Spanair, Swissair, TAP Air Portugal, Tarom - Romanian Air Trans and Turkish Airlines.

Emergence in mid-late 1990s

✈ Deregulation:

- elimination of a critical entry barrier

✈ Airport capacity: slots and alternate airports

- elimination of a critical entry barrier

✈ Understanding the business model

- e.g., earlier attempts were under funded
- e.g., not sufficiently focused on low cost

Today's LCC business model

✈ A successful, sustainable model

- **for passengers**
 - lower fares (VFR, leisure and business)
 - more flexibility
- **for communities**
 - job generation
 - tourism and other business stimulation
- **for shareholders**
 - sustained financial returns

Today's LCCs: High Market Capitalization

Compare LCC market caps to FSAs

Europe	Ryanair	US\$5.1 billion	
	Lufthansa	US\$4.2 billion	Highest FSA

Canada	WestJet	CA\$1.3 billion	
	Air Canada	CA\$0.1 billion	Only FSA (in bankruptcy protection)

US	Southwest	US\$13.2 billion	
	Jet Blue	US\$ 2.7 billion	
	American	US\$ 1.6 billion	Highest FSA



LCCs: Many Aircraft on Order

→ High market capitalisations of LCCS enabling them to significantly expand fleets

- at a time when aircraft markets are weak and LCCs can obtain significant discounts

→ 9 selected LCCs

- 633 aircraft on firm order
- 616 aircraft on option
- most LCC airline orders are incremental, not replacement

Where will the LCC Model go next?

✈ US

- LCCs currently carry 24% of domestic pax
- Future:
 - 35-40% in 5 years
 - 50% in 10 years
 - basis:
 - sustained higher growth rates (15% vs 3.2%), enabled by
 - a large number of aircraft on order by LCCs while FSAs have limited orders, and
 - LCC access to additional equity capital



Impact of LCCs on FSAs

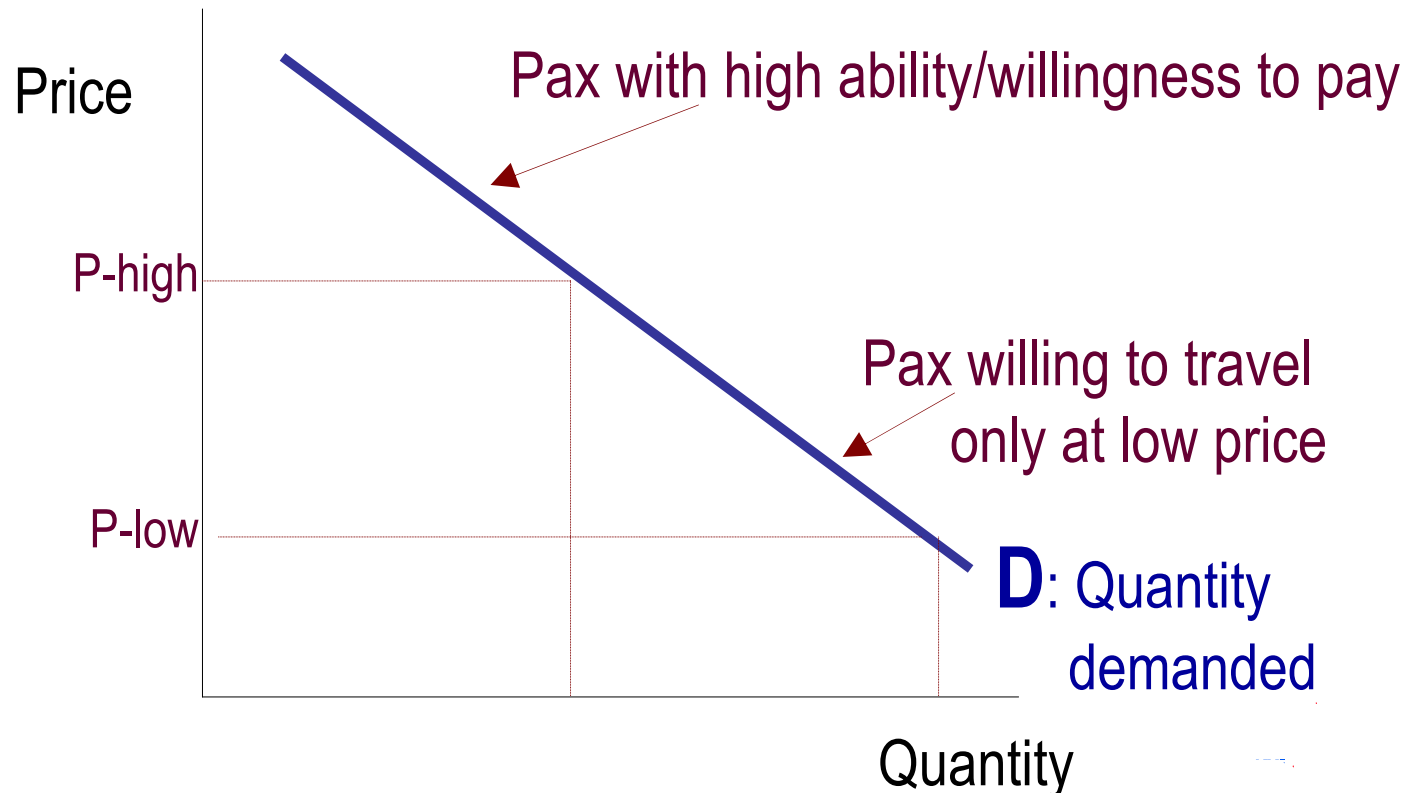
- ✈ LCCs have undermined much of the price discrimination ability of FSAs

Impact : Price Discrimination

- *While FSA fare differences are due in part to different service qualities, FSAs utilize price discrimination*
 - **FSAs recognized high Willingness-To-Pay of certain customers**
 - **researched and discovered a restriction to prevent them from accessing lower price**
 - **e.g., return ticket with Saturday stayover**
 - **Price discrimination supported high cost operation**

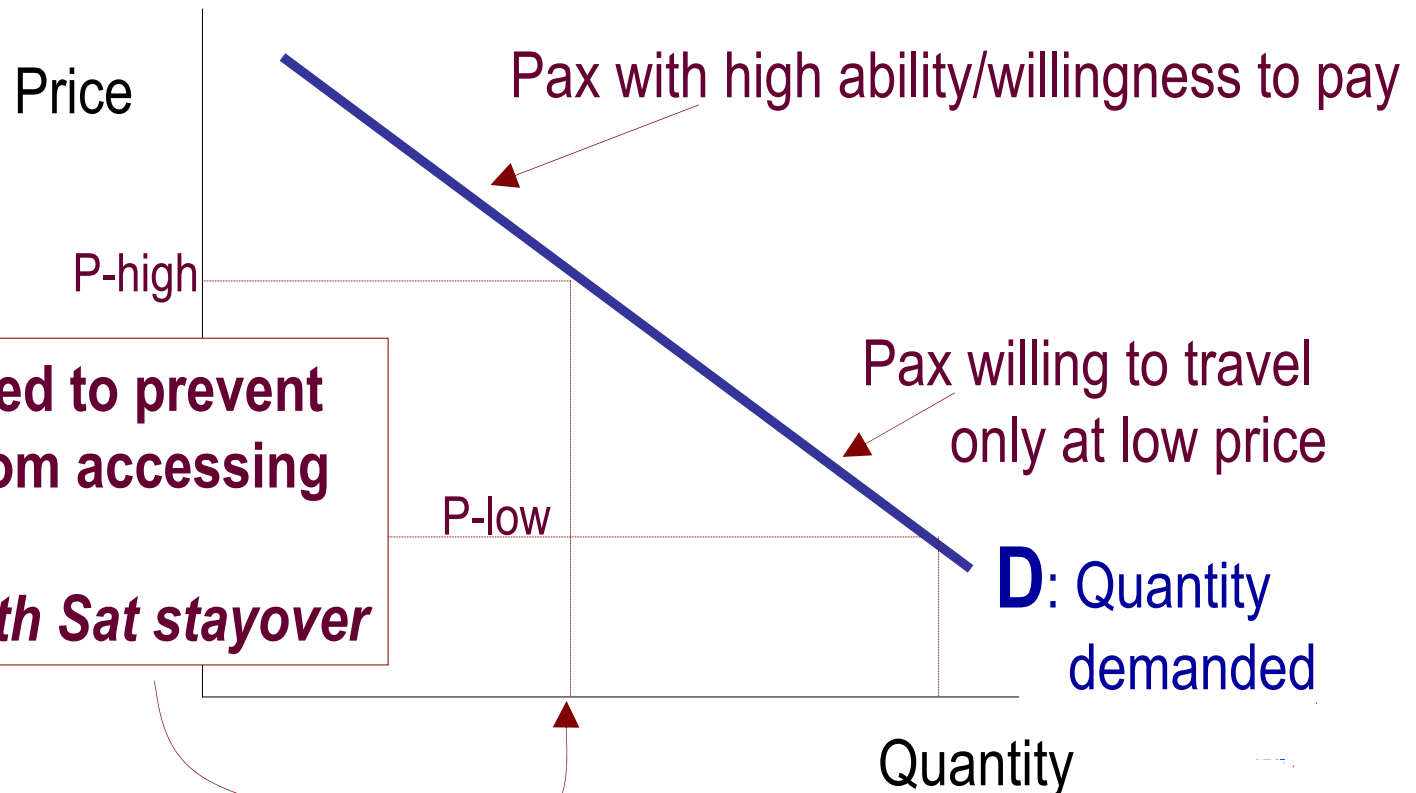
Impact: Price Discrimination

- ✈️ LCCs have undermined much of the price discrimination ability of FSAs



Impact : Price Discrimination


✈️ LCCs have undermined much of the price discrimination ability of FSAs



Impact : Price Discrimination

- LCCs have undermined much of the price discrimination ability of FSAs
 - LCCs have low costs and thus do not need same degree of price discrimination
 - offered one way fares
 - hence high WTP pax need not stay over Sat.
 - While high WTP pax was willing to pay for some extra service, the price gap was too large, and extra services not worth the huge price gap

Undermining Price Discrimination

- 
- Traditional FSA pricing practices are impractical when LCC is present
 - The LCCs pricing practices have induced significant benefits for travelers on the FSAs
 - major reductions in fares paid by travelers
 - including business travelers even those with multi-stop itineraries

FSA Dilemma

✈ FSA choices:

- match LCC prices
without addressing costs:
 - not sustainable with FSA cost structure
- reduce costs,
and change price discrimination
to that of LCCs

FSA Cost reductions

- ✈ FSAAs have been able to reduce some costs
 - simplify service offering
 - aircraft reconfiguration to higher density
 - labour productivity and cost
 - financial restructuring

FSA Cost reductions

- ✈ But cannot get costs down to levels of LCCs
- network connectivity requires investments in systems and higher service costs
 - higher service quality and service redundancy imposes high costs
 - historical relationship with labour limits productivity gains and wage rate reductions
 - sustained poor performance raises capital costs

Competition: FSA vs LCC

→ FSA vs. FSA

Costly to
provide

- extensive network connectivity
- value added in-flight on-ground services
- high last minute seat availability
- match pricing & use nearly identical price discrimination

→ LCC vs. FSA

- simple product
- simple price discrimination
- low cost

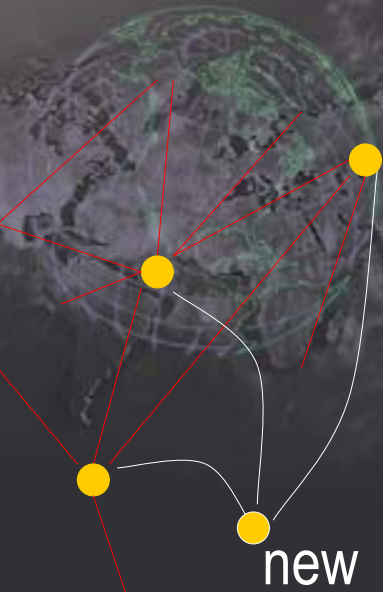
LCCs and Tasman/NZ Domestic

- ➔ LCCs elsewhere have entered markets of this size
- ➔ Normal pattern:
LCC expands from an existing well developed traffic base
- ➔ Airport access no longer an issue
 - and, Applicants willing to facilitate airport access at AKL to make LCC entry easier and faster

LCCs and Tasman/NZ Domestic

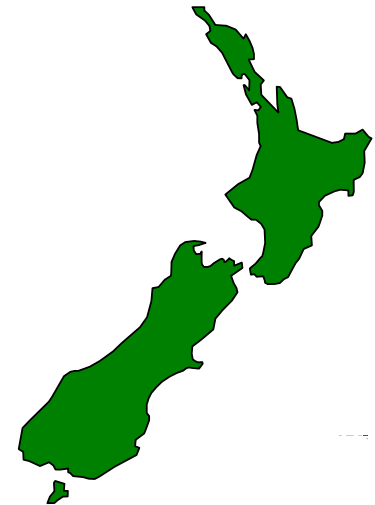
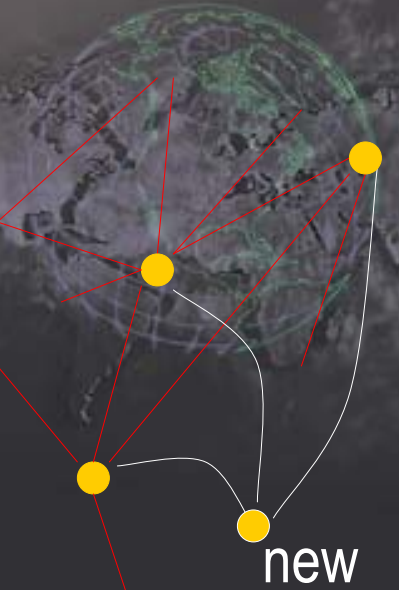
✈ LCCs often connect points in their network together

- example, Ryanair, SW, EasyJet often add a new destination and connect it to a number of existing points
- LCCs fill in connections in their network



LCCs and Tasman/NZ Domestic

- ✈ An LCC is highly likely to enter the Tasman on more than one route
- ✈ The standard LCC connect-the-dots business practice makes it highly likely that it will also enter NZ domestic



Virgin Blue



- ➔ Serves 24 of top 30 Australian city pairs
- ➔ Has 10 aircraft on order plus 40 options
- ➔ Fleet has range to operate Tasman
- ➔ Expansion outside of Australia virtually inevitable
 - given its fleet expansion
 - consistent with its business model

Conclusion 1

5.2.2 The LCCs have had ...

**the largest impact on price
competition in airline markets
in the past 25 years,**

**much larger than
any competition between FSAs.**

**LCC
Price
Impact**

Conclusion 2

5.2.3 The expansion of LCCs is undermining the viability of some FSAs, especially small FSAs.

The large number of FSAs in the world is a consequence of government policies restricting foreign ownership of airlines ... the FSAs will need to consolidate, and outside of the U.S., air carrier consolidation will need to involve some form of cross border transaction.

LCCs are undermining viability of some FSAs

FSAs will need to consolidate

Conclusion 3

5.2.4 LCC entry into Trans Tasman and domestic New Zealand is inevitable, in my opinion, regardless of whether the Applicants' request for authorization of the alliance is granted.

The Applicants are willing to facilitate airport access at AKL to ease and speed this entry

**LCC entry
onto
Tasman &
NZ domestic**

Conclusion 4

5.2.5 The LCCs have induced benefits for travelers on the FSAs.

- **The impracticality in the presence of LCCs of the traditional FSA pricing practices has resulted in major reductions in fares paid by travelers**
- **including business travelers, even those with multi-stop itineraries.**

LCC entry
benefits
travelers



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The NZCC Factual and Counterfactual

NZCC: No LCC Entry in Factual

✈ LCC entry

- throughout world
- in small markets
- with single and multiple FSAs
- and where FSAs were merged (Canada)



✈ Tasman / NZ domestic

- conditions for LCC entry present
- successful LCC present, well capitalized
- Applicants willing to provide undertakings

Small markets
•Newquay-STD
•Gander-YOW
•Spokane-SLC

NZCC: The Counterfactual Market is Perfectly Competitive

✈ It would be incorrect to model the cf. as perfectly competitive and the factual as monopoly

- No airline markets has sufficient carriers to be considered as perfectly competitive
- In any airline market today, the key *competitive* element is presence of an LCC
 - LCCs have had the most important price impact in the past 25 years

Incorrect
to model
counterfactual
as perfectly
competitive

Likely Counterfactual Evolution

- ➔ CF begins with two FSAs
- ➔ QF expands domestic NZ
 - a rational expansion of its network especially as it evolves its new domestic business model in response to LCC
- ➔ Significant FSA 5th freedom entry and capacity

Likely Counterfactual Evolution

- cont.

- LCC enters
 - undermines revenues of FSAs
- Smaller FSA driven out of market
- Outcome eventually the same in factual and counterfactual
 - One FSA competing against financially strong LCC

Conclusion 5

5.3.2 The assumption that there would be a monopoly with the requested alliance (the factual) is unrealistic.

Entry by a LCC is inevitable.

The requested alliance provides conditions which can facilitate and speed entry by a LCC.

**Assuming
Factual is
a monopoly:
unrealistic**

**LCC entry
inevitable**

Conclusion 6

5.3.3 The assumption that without the alliance, markets would be perfectly competitive is also unrealistic.

LCC entry and expansion undermines the ability of markets to support multiple FSAs in domestic NZ.

LCC entry inevitable even without Alliance

Undermines ability to support two FSAs

Conclusion 6 cont.

- ✈ For New Zealand in particular, the virtual inability of Air New Zealand to earn its cost of capital on long haul international services makes its continued financial viability doubtful as an LCC enters the domestic market.

Air NZ
financial
viability
doubtful
as LCC enters
domestic



Conclusion 6 cont.

- ✈ **The inevitable domestic revenue erosion means that Air New Zealand will need to dramatically reduce its cost and/or exit the industry.**
- ✈ **It is my opinion, that if the requested alliance were denied, an LCC would eventually enter the market and Air New Zealand will eventually exit the industry.**

Conclusion 6

5.3.4 The Counterfactual does not lead to any outcome that is more competitive than the Factual.

The only issue is the path to get there:

- **slow and painful without the alliance, or**
- **quickly, while maintaining and enhancing both the Air New Zealand and Qantas marketing brands.**

F and CF eventually have same competitive outcomes

Only path varies



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Thank You !