# CHAPTER 6

# CONFIDENTIAL AIR NEW ZEALAND COUNTERFACTUAL SUBMISSION

**INTRODUCTION** ...............................................................................................

**SUMMARY** .......................................................................................................

**Air New Zealand's view** ........................................................................

**Commission's preliminary view** ..........................................................

**Evidence** ...............................................................................................

**AIR NEW ZEALAND'S RECENT HISTORY** ...........................................................

**Overview** ...............................................................................................

**The domestic New Zealand market** ........................................................

**Ansett Australia** ....................................................................................

**The recapitalisation process** ..............................................................

**The change in the competitive environment that emerged in 2002** ...........

**Initiatives undertaken during 2002** ..........................................................

**Financial performance since recapitalisation** ...............................................

**ANALYSIS OF AIR NEW ZEALAND'S CURRENT FINANCIAL POSITION AND PROSPECTS** ...............................................................................................

**Profitability under the Applicants' Counterfactual** .......................................

**VBA Entry on key Domestic New Zealand routes** ........................................

**Effect of increased competitive conduct and vulnerability to shocks** .......

**IMPLICATIONS FOR AIR NEW ZEALAND BOARD** .................................................

**Overview**

**[Confidential]** .........................................................................................

**Implications if Alliance is not authorised** ......................................................

**WELFARE EFFECTS** .............................................................................................

## INTRODUCTION

6.1 This Chapter contains:

- Air New Zealand's confidential submissions on the likely financial implications for Air New Zealand of the Applicants' Counterfactual as described in the original Applications (and which is addressed separately in detail in chapter 5); and

- Submissions on the welfare implications, including the implications for tourism in New Zealand.

6.2 The Chapter provides additional empirical support for the views previously expressed by Air New Zealand in relation to its financial position and prospects if the Alliance is not authorised. It draws extensively on analysis undertaken by PricewaterhouseCoopers of the consequences of the competitive conditions Air New Zealand is likely to face if the Alliance is not authorised.

## SUMMARY

### Air New Zealand's view

6.7 **[Confidential]**

(c) Though the initiatives undertaken by Air New Zealand during 2002 have had a positive effect on Air New Zealand's trading performance, the achievements cannot be overstated. The gains made are heavily influenced by factors beyond Air New Zealand's control and on which Air New Zealand cannot safely rely. These include reduced fuel costs, positive exchange rate movements and the withdrawal of United Airlines' AKL-LAX service. Air New Zealand's strength in its domestic market also remains favourably assisted by the collapse of Tasman Pacific Airlines and the delays by Qantas in moving to more closely match Air New Zealand's capacity and frequency. This strength will not persist once Qantas scales up its competitive presence in the domestic New Zealand market or when capacity is added by Virgin Blue's entry into the domestic New Zealand market.

### Commission's preliminary view

6.13 The Commission's Draft Determination discounted both the Applicants' claims that the likely counterfactual would involve a substantial increase in Qantas' capacity from 5 to 8 aircraft in the domestic New Zealand market and Air New Zealand's claims about its poor financial position and prospects. Instead, the Commission reached the preliminary conclusions that:

- in the short run, there would be a continuation in competition from Qantas on the Tasman and domestic New Zealand routes, but with capacity expanded in line with market growth, not accelerated to produce a "war of attrition";

- there would be incremental entry by Virgin Blue on the Tasman with possible expansion in the New Zealand domestic main trunks;

- nevertheless, Air New Zealand would show a gradual recovery in its financial position and ongoing financial viability;

- there would be a continuation in the present support by the Government for Air New Zealand; and

- Air New Zealand would continue to stand alone in the short term, while seeking and perhaps in the medium term, gaining, an alternative alliance with another airline.

6.14 As a result, the Commission did not directly address Air New Zealand's views set out in Confidential Appendix F to the NECG Report.

6.15 Air New Zealand considers there are a number of errors in the Commission's analysis. These are addressed in Chapter 5. Accordingly, the analysis in this Chapter proceeds on the basis that Qantas will proceed with its expansion plans, and that the competitive environment for Air New Zealand will reflect that set out in the Applicants' Counterfactual.

## AIR NEW ZEALAND'S RECENT HISTORY

### Overview

6.17 The forces of deregulation, globalisation and VBA competition described elsewhere in this submission within the aviation industry have had a significant impact on Air New Zealand's recent trading performance.

### The domestic New Zealand market

6.21 Air New Zealand relies heavily on its earnings from its domestic New Zealand operations. It has faced competition in its core domestic New Zealand market since July 1987, when Ansett New Zealand began operations. In 2000 Ansett New Zealand was acquired by Tasman Pacific Airlines, trading as Qantas New Zealand Limited under a franchise agreement with Qantas. Following the appointment of receivers to Tasman Pacific Airlines in April 2001, Qantas commenced operations in its place. However, the main trunk domestic New Zealand market has consistently been unable to sustain two FSAs. Ansett New Zealand recorded profits in only three years ($2.6 million in 1995, $9.1 million in 1996 and $7.0 million in 1997) in its 14 years of operations. Accumulated losses up to the time of sale to Tasman Pacific Airlines are reported to have been in excess of $250 million. When Tasman Pacific Airlines was placed into receivership in April 2001, it had reported losses of $40 million. In the period since then, Air New Zealand believes Qantas has also continued to incur losses on its domestic New Zealand operations.

6.22 In achieving its own results, Air New Zealand has relied on its significant network advantage[1] in its core domestic New Zealand markets compared with its competitors – successively Ansett New Zealand Limited, Tasman Pacific Airlines and – at least to date – Qantas. Over the same period Air New Zealand has not faced any VBA competition on its core domestic New Zealand routes.

---

[1] "Network advantage" arises where an airline has greater "city presence" and "connectivity". "City presence" represents the additional revenue beyond fair revenue share that is earned by the market leading carrier in a city. The additional revenue represents a premium for factors such as providing more capacity, frequency, and/or breadth of service out of a city. In general, a carrier accrues a revenue advantage once it is established as the clear number 1 carrier in a city. "Connectivity" refers to the ability for a carrier to supplement local passengers on a given sector with passengers that connect at the origin or destination city.

## Ansett Australia

6.23 Air New Zealand has recognised for more than a decade that liberalisation of Australian aviation markets would make it vulnerable to competition from its larger rivals in Australia, with their stronger networks. As the Commission noted in paragraphs 95 to 99 of the Draft Determination, the Memorandum of Understanding (**MOU**) negotiated in 1992 was the first step towards the Single Aviation Market , and was undertaken as part of the existing Closer Economic Relations Agreement. Additional arrangements were agreed in 1996 which created, for Australasian Single Aviation Market airlines, a single market between Australia and New Zealand.

6.24 The Single Aviation Market created the risk – if not likelihood – of Australasian Single Aviation Market airlines operating on all major routes within the Single Aviation Market.

6.25 In response to these anticipated regulatory changes, in the early 1990s the Air New Zealand Board resolved to expand Air New Zealand's network into the Australian market to avoid the risk of being swamped or at least marginalised by its larger trans-Tasman competitors. Direct access to the Australian air services market was rightly seen as necessary to enable Air New Zealand to come closer to matching the feeder/network benefits on the Tasman and beyond available to Qantas, and thus enable it to compete effectively with its larger Australian rivals.

6.26 This resulted in Air New Zealand attempting to commence a low-cost domestic airline in Australia. This was thwarted by the Australian Government's last minute decision in 1992 not to implement the MOU introducing the Open Skies Policy, which had been agreed between the Australian and New Zealand Governments. Air New Zealand was left having to acquire 50% of Ansett Australia as its only option for obtaining access to an Australian domestic network.

6.27 The unexpected difficulties which Air New Zealand encountered as it moved to exercise control over Ansett Australia, and integrate Ansett Australia operationally and financially following its acquisition of the balance of Ansett Australia in 2000, have been well publicised.

6.28 Ansett Australia's difficulties continued through late 2000 and into 2001, but were overtaken in their significance by the deteriorating economic and competitive environment. These included unprecedented high fuel prices, adverse foreign exchange movements, fierce competition in the Australian domestic market from the VBAs (Virgin Blue and Impulse) and the vigorous competitive strategy of Qantas (which had a particularly serious impact on Ansett's market share).

6.29 Despite Ansett Australia being apparently profitable on an accounting basis, as late as early 2001, by August 2001 it could not present a viable business plan. When Air New Zealand's major shareholders rejected proposals for the recapitalisation of Air New Zealand, and the Australian Government rejected a proposal for the restructuring of Ansett Australia, the Air New Zealand directors were left with no alternative other than to place Ansett Australia into Voluntary Administration, and to write off Air New Zealand's investment in the Ansett Group . The failure of Ansett Australia not only threatened Air New Zealand's own survival, it also left Air New Zealand without the Australian network coverage it needed to compete successfully in the Australasian market.

**The change in the competitive environment that emerged in 2002**

6.32 As matters turned out, it became clear in the period following the recapitalisation that Air New Zealand would not have the luxury of the stable commercial environment in which to re-establish its commercial strength.

6.33 In particular, in early 2002 Qantas signalled publicly that it intended to substantially increase its capacity in the domestic New Zealand market in the short term from five to eight aircraft.

6.34 This was a matter of serious concern to Air New Zealand. The prospect of Qantas increasing capacity and frequencies to more closely match Air New Zealand's posed a substantially greater challenge than Air New Zealand had ever faced in the past. Until Qantas, Air New Zealand's domestic competitors were substantially weaker, both in financial terms and network strength. Both Ansett New Zealand and Tasman Pacific Airlines operated a fleet inferior to Air New Zealand's, had higher costs, and offered substantially lower connectivity and city presence. The inroads they could make into domestic profitability were therefore limited, and Air New Zealand could rely on those earnings to assist its substantially less profitable operations overseas.

6.35 This was not (and is not) the case with the competitive threat posed by Qantas, with its much greater Australasian network strength, greater size, higher growth rates, and with few, if any, obstacles to continued expansion in Air New Zealand's core domestic market. Qantas has much to gain from a strategy of increased capacity. In Air New Zealand's view, it is a logical and wholly commercial move and one which matches the way FSAs compete throughout the world.

6.36 Air New Zealand does not believe that, all other things being equal, it is a sustainable position for a FSA (Air New Zealand) to compete with another FSA (Qantas) which:

- entirely envelopes its main service territory;
- has greater overall network reach; and
- more than matches the overall quality it can provide.

6.37 [**Confidential**

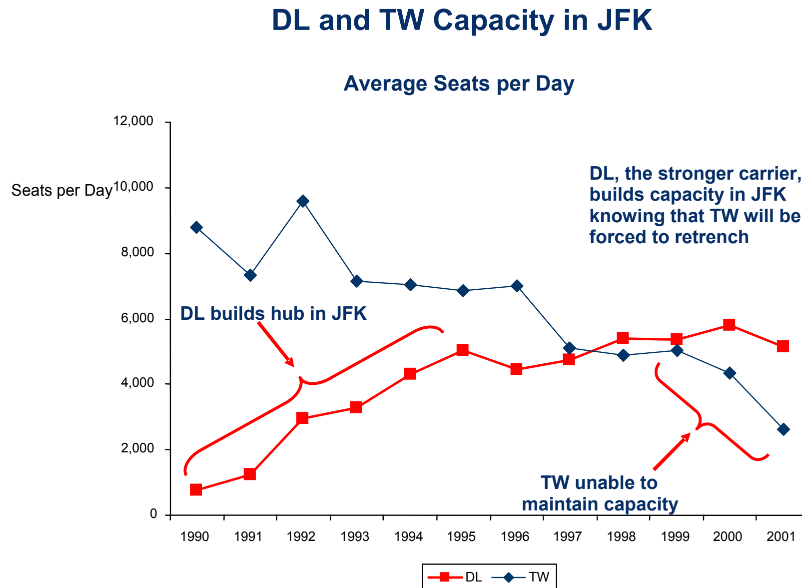
]

6.38 At the same time, there are no realistic options for Air New Zealand to establish a viable presence in Australia. Qantas can therefore draw on far greater resources – not only financial, but also of network strength – in competing for Air New Zealand's customer base. The inevitable result of Qantas' network advantage is that it will be likely to capture more and more of Air New Zealand's revenue base, thereby reducing Air New Zealand's load factors and yield and, ultimately, Air New Zealand's competitiveness.

6.39 Experience internationally has shown time and again that an airline with the advantage of greater network strength will be successful in competing with a weaker competitor for customers. The case studies below illustrate two well known examples of this.

6.40 The first case study relates to competition between Delta Airlines and TWA at JFK International Airport in New York. The graph shows that when Delta, the larger FSA, began to overlap TWA's network at JFK Airport in New York, TWA was not able to remain competitive and gradually contracted its capacity.

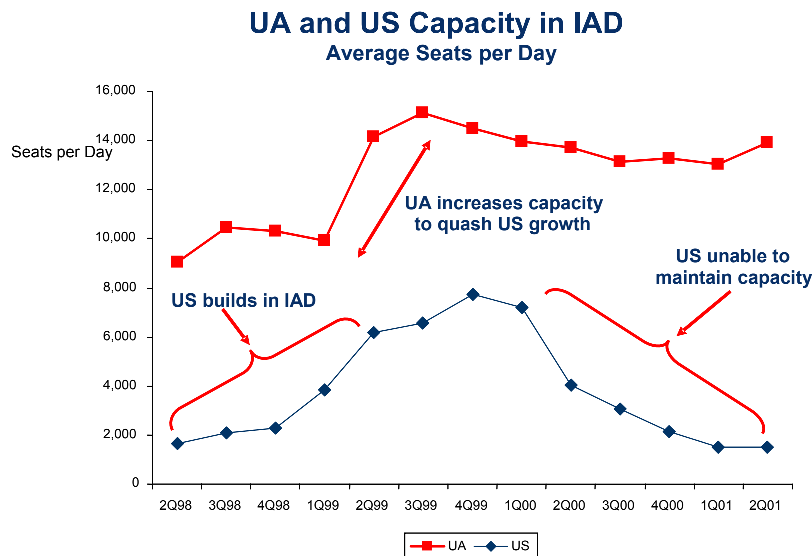
**Figure 1 Delta Airlines/TWA at JFK Airport**




Source: US Department of Transport.

6.41 The second case study relates to the competition between United Airlines and US Airways at Washington's Dulles International Airport (**IAD**). It shows that United Airlines, with its greater network strengths and depth, was able to fight off an attempt by the smaller US Airways from capturing market share at IAD.

**Figure 2 United Airlines/US Airways at Washington Dulles Airport (IAD)**




Source: US Department of Transport.

6.42 During the early months of 2002, Virgin Blue also made a number of public statements about its intention to enter the domestic New Zealand market during 2002.[2] As a result, the risk emerged during 2002 that Air New Zealand could become effectively "squeezed" in its core domestic New Zealand markets between the expected expansion of both Qantas and Virgin Blue. . This created the prospect of three airlines competing for survival in a market which has historically sustained only one. As a result, the earnings base which Air New Zealand has historically enjoyed would be in jeopardy as a "war of attrition" proceeded.

6.43 These competitive forces involve clear parallels with the dynamics that ultimately destroyed Ansett Australia. Indeed, the collapse of Ansett Australia can be seen as a classic example of the forces of deregulation and VBA competition in operation. While it might be suggested that management decisions and the instability of its shareholding structure contributed to Ansett Australia's failure, there can be little doubt that the structural factor of deregulation and VBA competition were highly influential. Ansett Australia sought to compete in the domestic Australian market as an FSA with a rival (Qantas) whose network entirely enveloped its own and with greater city presence. Even before Virgin Blue entered the domestic Australian market, Ansett Australia faced serious difficulties in competing profitably with a stronger rival that was capable of contesting every segment of its customer base, and with the added advantage of a substantial international network offering greater connectivity. For example, in 1998, Ansett Australia carried 48% of solely domestic travellers, but only 26% of domestic travellers connecting to or from an international flight. As a result, Ansett Australia did not make an economic profit over the five year period preceding its collapse. It was this which forced

---

[2] Refer Chapter 3, Schedule A and Virgin Blue's submission to the Commission.

Ansett Australia to rely on an out-dated and increasingly unreliable fleet, driving its operating costs up, reducing market appeal and precipitating the groundings it suffered.

6.44 Ansett Australia's position – despite its at times successful attempts at cost-cutting and launching new services – was therefore structurally highly vulnerable when VBA entry occurred in the second half of 2000. That VBA entry, while increasing the industry's cost base, left aggregate revenues virtually unchanged – the increases in volumes being matched by the falling fares as is typically the case in the aviation market. The margins which had previously allowed Ansett Australia to operate on a cash-positive basis were therefore no longer there. "Squeezed" between a lower cost carrier and a carrier with a substantially greater network reach, Ansett's situation, despite a strong brand and a large and loyal customer base, quickly became unsustainable. The outcome of that "squeeze" is a situation of which Air New Zealand is now acutely aware – an FSA winner "Qantas", a VBA winner (Virgin Blue), and an FSA loser (Ansett Australia). **[Confidential]**

### Financial performance since recapitalisation

6.49 Although the impact of the September 11 attacks and, more recently, the Bali bombing, the Iraq war and the SARS outbreak have affected international passenger numbers, by good fortune Air New Zealand's geographic position and network configuration have so far meant that it has been less affected by these influences than some of its competitors (although it has decreased its international capacity by 8% in response to the impact of SARS).

6.50 Air New Zealand's strength in the domestic New Zealand market also remains favourably assisted by the collapse of Tasman Pacific Airlines' operations in 2001. Although Qantas subsequently entered the market, and its aircraft numbers have grown from 5 to 6 aircraft since earlier this year, it has not yet completed its growth in capacity and frequency. As a result, Air New Zealand has continued to enjoy a significant network advantage in its core domestic New Zealand market. Further, the introduction to the domestic market of the "Air New Zealand Express" service has allowed costs to be reduced without any loss of share in the high yield market segments. These gains will not persist once Qantas scales up its competitive presence in the segments by providing capacity and frequency that closely matches Air New Zealand's.

## ANALYSIS OR AIR NEW ZEALAND'S CURRENT FINANCIAL POSITION AND PROSPECTS

### Profitability under the Applicants' Counterfactual

6.51 Air New Zealand engaged PricewaterhouseCoopers to model Air New Zealand's financial position and prospects using the Cameron & Co base model provided to the Commission at the time of the Commission's initial consideration of the Applications. The model was produced to demonstrate the benefits of the Alliance for consideration by the Air New Zealand board. The counterfactual assumptions to the model erred on the side of optimism to ensure that a conservative picture of the benefits of the Alliance was presented to the Air New Zealand board. PricewaterhouseCoopers have tested the model and are satisfied with its outputs under a variety of input assumptions[3].

---

[3] Refer PricewaterhouseCoopers Report, paragraphs 5.1 to 5.3.

## IMPLICATIONS FOR AIR NEW ZEALAND BOARD

6.83 In its discussion on alternative alliances the Commission referred to the possibility of an alliance with either Singapore Airlines or Virgin Blue. Air New Zealand does not believe that these represent credible alliances. Singapore Airlines is an existing shareholder in Air New Zealand. It first invested in early 2000. It invested a total of NZ$426 million for a 25% stake. It did so because of its well publicised interest in the Australian domestic market network operated by Ansett Australia. Following Air New Zealand's acquisition of 100% of Ansett Australia, investment in Air New Zealand was Singapore Airlines' only option to access the Australian domestic market. There has been no suggestion that it is willing to reinvest in Air New Zealand. **[Confidential]**

6.85 Virgin Blue is also referred to by the Commerce Commission as a possible alternative alliance [**Confidential**

] However, Air New Zealand does not believe Virgin Blue as an alliance partner can deliver sufficient benefits to make Air New Zealand sustainable in the face of aggressive competition from Qantas.

### Benefits of Alliance

6.94 The level of financial improvement achieved under the Alliance will address Air New Zealand's business performance inadequacies sufficiently to enable Air New Zealand to access the capital it needs to ensure it can continue as an effective competitor in the markets in which it operates.

## WELFARE EFFECTS

6.99 At the same time, the Alliance avoids what will otherwise be substantial social costs, most particularly associated with the loss of tourism likely to result from a contraction by Air New Zealand of its international operations (including loss of Air New Zealand's presence in Europe due to the complete withdrawal of its services from Los Angeles to London).

6.100 As the national flag carrier, Air New Zealand accounts for 90% of the expenditure by all airlines on promoting New Zealand on the main markets it serves, while its seat capacity into New Zealand is around 42%. Air New Zealand's expenditure promoting New Zealand internationally will be approximately $71 million for the 2003 financial year.

6.101 In addition to the significant commitment Air New Zealand makes to promotion of New Zealand in offshore markets, Air New Zealand also provides:

- industry support to offshore wholesale and retail partners for travel to New Zealand on staff familiarisations, trade conferences, purchasing trips, and product and training seminars;
- support to local inbound wholesalers and tourism plant operators with industry travel for their selling trips offshore to promote destination New Zealand;
- industry travel for Tourism New Zealand trade missions e.g. Kiwilink and Kia Ora; and

- support to the International Media Program, which brings key media and journalists (usually around 300 people annually) to New Zealand to write articles and produce films and documentaries on New Zealand.

If the Alliance did not proceed and Air New Zealand was forced to shed its international operation, this investment by Air New Zealand in helping create greater destination knowledge and familiarisation would be lost.

6.102 A contraction of Air New Zealand's international operations will result in a substantial reduction in Air New Zealand's promotion of New Zealand. That is likely to result in a substantial loss of tourism and, consequently, welfare. The Tourism Industry Association of New Zealand has estimated that without Air New Zealand's international marketing efforts in promoting New Zealand, the budget for Tourism New Zealand would need to be increased to $150 million per annum[4]. Air New Zealand considers that this is likely to underestimate the level of expenditure that would be required.

6.103 At the same time contraction will raise welfare consequences associated with price and capacity changes. The implications for price and capacity changes depend on the response of other airlines to Air New Zealand's weakened position. If other airlines move quickly to replace the capacity of Air New Zealand, then there may be limited detriment in terms of available capacity. The impact on price will depend on which airline fills the Air New Zealand void. For example, if Qantas moves to fill any reduction in Air New Zealand capacity, then the outcome for consumers is likely to be very close to the outcome of the Alliance, but without an international airline dedicated to New Zealand. This is more likely to be the case on the Tasman, domestic New Zealand and Pacific routes (via Air Pacific). If another airline moves to fill the vacated capacity, such as Singapore Airlines, United Airlines or a VBA, then there may be little difference in the level of competition between this counterfactual and the increased competition counterfactual, the only difference being that the competition is provided by other airlines, not Air New Zealand. One consequence of even full replacement is that any producer surplus that might be earned will not accrue to New Zealand.

6.104 In addition, there are likely to be further welfare losses associated with the inevitable shrinkage of Air New Zealand's engineering operations which will further weaken Air New Zealand as the national flag carrier.

6.105 Of these effects, the losses associated with a reduction in tourism will be very significant.

[4] TIANZ submission to the Commission February 2003, p6, estimating the present value of the "public good" arising from Air New Zealand's promotion of New Zealand at $1.4 billion.