

EXECUTIVE SUMMARY

QANTAS / AIR NZ

Proposed Alliance

1. On 9 December 2002 the Commerce Commission (the Commission) received two interrelated applications from Qantas Airways Limited (Qantas) and Air New Zealand (Air NZ) (together, the Applicants).
2. The first application relates to a proposed acquisition of 22.5% of the voting equity in Air NZ. The second application relates to a strategic alliance agreement between Air NZ and Qantas. This would involve the two airlines coordinating their pricing, schedules and capacity, and profit-sharing, on all flights operated by Air NZ, and all Qantas-operated flights within, to and from New Zealand. The second application also envisages that coordination may be extended beyond these markets.
3. The two applications are interrelated in that the Applicants state that neither would proceed without the other. Together they may be referred to as the “proposed Alliance”. In these circumstances, the Commission, in exercising its discretion, is of the view that it is appropriate to analyse the combined impact of the two applications.

Framework for Consideration

4. The Commission is responsible for deciding whether to authorise the applications under the relevant provisions of the Commerce Act 1986 (the Act).
5. In brief, the Commission must determine whether the proposed Alliance would result in a substantial lessening of competition in any of the markets affected and, if so, whether the detriments flowing from this lessening of competition are outweighed by the public benefits claimed to flow from the Alliance. The Commission considers that a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. If the Commission is satisfied that the public benefits outweigh the detriment, it may authorise the proposed Alliance.

Commission Process

6. In preparing this draft determination, the Commission has fully considered and given weight to information and analysis from a wide range of sources. It has:
 - reviewed the substantial amount of information and analysis in the Applications, including the economic model submitted by the Applicants’ economic experts;
 - sought further information and clarification from the Applicants on a range of points;

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

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

The Factual and Counterfactual

8. The factual is what would happen if the proposed Alliance proceeds. In order to assess the competition effects, as well as the detriments and benefits, the Commission compares the factual to the counterfactual, or what would likely happen in the absence of the proposed Alliance. A counterfactual will not necessarily be a continuation of the status quo, but rather encapsulates a pragmatic and commercial assessment of what is likely to happen in the absence of the factual.
9. The factual and counterfactual give rise to different states of competition in each of the relevant markets. A comparison between them allows a judgment to be made as to whether competition in the factual is likely to be substantially lessened relative to the counterfactual.

The Factual

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

The Counterfactual

11. The Applicants considered six alternative counterfactuals, but their preferred counterfactual involved aggressive capacity competition by Qantas and Air NZ, a so-called “war of attrition”.
12. The Commission, after considering a range of factors—the external environment, Air NZ’s ability to attract investor funding, its profitability and financial projections, the likely strategic behaviour of Qantas, the prospect of new airline entry, and scope for an alternative alliance—reached the preliminary conclusion that the counterfactual would have the following characteristics:
- a gradual recovery in the financial position of Air NZ and ongoing financial viability;

- a continuation of the present support by the Government for Air NZ, but with a question mark over whether sufficient capital in addition to retained earnings, would, if necessary, be forthcoming to pursue its preferred network strategy;
- in the short-run a continuation of competition from Qantas on the Tasman and domestic New Zealand routes, but with capacity being expanded in line with market growth, not accelerated to produce a “war of attrition”;
- Air NZ standing alone in the short term, while seeking, and perhaps in the medium term gaining, an alternative alliance with another airline; and
- incremental entry by Virgin Blue being likely on the Tasman, with possible expansion onto the New Zealand main trunk.

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

Market Definition and Competition Analysis

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

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

- the following passenger air service markets:
 - New Zealand main trunk and provincial markets,
 - Tasman market,
 - New Zealand / Pacific market,
 - New Zealand / Asia market,
 - New Zealand / USA market.
- the following freight markets:
 - Tasman belly hold air freight services market,
 - international air freight services market,
 - the domestic air freight services market,
- the national wholesale travel distribution services market.

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

- the factual, where competition between Air NZ and Qantas would be lost, other competitors would generally offer limited competition, and there would be no significant value based airline (VBA) entry; and
- the counterfactual, where competition between Air NZ and Qantas would be preserved, and may be augmented on Tasman markets by the entry of a VBA.

Detriment

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

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

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

- allocative efficiency: the deadweight losses and transfer effects caused by the higher prices in some markets;
- productive efficiency: reduced competition through the erosion of competitive incentives to keep costs down; and
- dynamic efficiency: the impact the proposed Alliance would have both in deterring VBA entry, with the subsequent loss of innovative, lower cost, services, and the potential losses from global alliance competition should Air NZ switch from the Star Alliance to the oneworld Alliance.

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

Benefits

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

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

23. The Applicants argued that benefits arise from:

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

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

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

- Cost savings of \$32.4 million. The Commission adopted a counterfactual that does not involve wasteful capacity expansion, and a model that generates higher fare increases from those assumed by the Applicants.
- Tourism benefits of between -\$2.6 million to \$13.5 million. The Commission has used a measure of the economic effects of tourism that expresses the welfare gain as the gross tourist expenditure less the opportunity cost of the resources employed to provide tourism services. In addition, the Commission expects that the higher prices resulting from the proposed Alliance could result in fewer tourists than anticipated by the Applicants, to the extent that current tourist numbers could be reduced.
- Other benefits of \$0.36m. The Commission found few additional benefits that would accrue only as a consequence of the proposed Alliance.

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

Net Effect

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

TABLE 1
Summary of Annual Net Benefits (\$m)

	Applicants¹	Commission
Detriments	-10.3m	-202m to -432m
Benefits	236.3m ²	30.2m to 46.3m
Net Benefits	226.0m	-155.7m to -401.8m

Conditions

28. The Commission is able to accept divestment undertakings and/or impose conditions on an authorisation and is seeking submissions on whether such undertakings or conditions would result in a benefit to the public such that the proposed Alliance might be authorised.
29. The Applicants have provided the Commission with suggested undertakings that might eventually be considered by the Commission as conditions to be included in any authorisation. At this stage, the Commission has not completed a full analysis of potential conditions as it is necessary to first identify the impact of the proposed Alliance.

Draft Determination

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

Next Steps

31. The Commission is now seeking submissions from interested parties in respect of the preliminary conclusions it has reached in the Draft Determination. The deadline for submissions to be received by the Commission is 9 May 2003.
32. The Commission proposes to hold a four-day conference in Wellington over the period 20-23 May 2003. The purpose of the conference is to enable the Commission to ask questions of interested parties in relation to their submissions on the Draft Determination.
33. The Commission intends to release its final Determination on the Applications by the end of June 2003.

¹ The Applicants figures for detriments and benefits are as at year 3.

² Ibid