SUBMISSION TO THE COMMERCE COMMISSION IN RESPECT OF THE APPLICATIONS OF AIR NEW ZEALAND LIMITED AND QANTAS AIRWAYS LIMITED

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ON BEHALF OF SAVE AIR NEW ZEALAND

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1 INTRODUCTION

The Save Air New Zealand Group ("the Group") was formed in December 2002 when Air New Zealand Limited ("Air New Zealand ") and Government announced the intention to merge Air New Zealand's domestic and international business into a joint venture with its long time competitor Qantas Airways Limited ("Qantas"). With Qantas to also gain a 22.5% stake in Air New Zealand and board representation (jointly in this document called "the Alliance/Investment").

Originally the Group attempted to prod Government and Air New Zealand into allowing a public debate on the national interest issues involved. The Group did not say, "don't do a deal", it said, "lets have an open, informed and inclusive debate". All invitations to debate were rejected and the manner of the Kiwi Share decision left us with the clear conclusion that neither Government nor Air New Zealand was inclined to support open, informed and inclusive debate.

We note this background as it is our perception that the Airlines' application to the Commission and its supporting "evidence" continues in much the same vein.

Government's actions in releasing important information on the transactions and its assessment of the transactions, but not all the relevant information, a day before submissions are due are also consistent with how the information and scrutiny aspects of the transactions have been managed.

In consequence, those with an interest in the transactions are greatly reliant on the Commission to uncover the facts and use them to reach informed and logical conclusions.

In the context of this reliance, this submission is not a detailed critique of the applications. It notes certain points in the Airlines' case and underline, what we see to be the Commission's role in reviewing these points.

This submission also addressed factors the "National Interest" assessment must reflect. The Airlines' submissions used modelling work based on their interpretation of various alternative futures and the effect of the Alliance on those futures. Some matters are not easily reflected in a financial model, but that does not mean that the Commission should ignore them.

2 THE IMPORTANCE OF AIR NEW ZEALAND

Save Air New Zealand was formed because a lot of people see Air New Zealand as more than just a transport company, but even as a transport company they see it as a very important one. Some of those people decided to do something more than just have an opinion and formed the Group and have given time and energy to this issue. Why?

- Because Air New Zealand is a company that makes a big difference to the lives of a great many New Zealanders. The nature of New Zealand and the nature of New Zealanders makes domestic and international air transport service important to a great many people.

  Auckland is full of people from the South Island. Dunedin University is full of students from Wellington. These peoples' lives are made richer and better by being able to take advantage of a good inexpensive domestic air service.

  This is quite independent of all the business and commercial interests dependent on air travel.

  Air New Zealand has recently decreased domestic airfares by 20% and this resulted in a 10% to 20% increase in the number of people flying the relevant routes. It is extremely difficult to put a dollar value (as is intended by the Commission's analysis) on quite what it means to that 10-20% who have taken advantage of the lower cost.

  The Airlines have made it explicit that domestic airfares will rise under the Alliance. The Commission must not underestimate by how much, nor how adverse the consequences will be.

- Air New Zealand is a crucial part of New Zealand's link to the world. It is certain that the Alliance will not remove this link, but it will weaken it:

  ◊ When Ansett Australia failed in 2001, Qantas withdrew aircraft from New Zealand domestic and Tasman services to prioritise Australian services. Air New Zealand would not doubt give New Zealand services exactly the same priority that Qantas give to those of its home country.

  ◊ Air New Zealand is the major marketer of destination New Zealand. Its international success depends on it being able to get people outside of New Zealand to come to New Zealand. Whatever the incentive of the Alliance to market New Zealand it is not as powerful as Air New Zealand's.

  There will be less prioritisation of New Zealand services and the marketing of New Zealand. Neither factor may be very easy to insert into a commercial model, but the Commission's analysis must reflect these costs.

- Air New Zealand is an icon company and brand to New Zealanders in a way that is not true of any other company.

  In part this is no doubt because its brand is that which New Zealanders most commonly see when out of New Zealand. In part it is because Air New Zealand has very proactively marketed itself to achieve this outcome. Will Air New Zealand's brand be damaged by the Alliance? Will Air New Zealand market itself differently?

  The operational and managerial integration contemplated by the Alliance clearly indicates that the icon status of Air New Zealand will be damaged, and changes in the marketing approach will certainly occur.

How should the Commission reflect these changes in its analysis of National Interest? Unfortunately we are not able to give guidance, other than to note that avoiding the issue and not counting the impact would be remiss. Qualitative factors must be reflected in the Commission's analysis, and not just readily quantifiable qualitative factors such as frequency of service.

2.1 RE-NATIONALISATION / GOVERNMENT POLICY

Underlining the importance and status of Air New Zealand was Government's willingness to affect the financial support of the Company in 2001.

It is almost certain that Government could have "picked up the pieces" more cheaply than was the cost of injecting capital to maintain the going concern. At the least, a deal with a liquidator or Statutory Manager would have avoided New Zealand Government funds being paid to extinguish Air New Zealand's liability in respect of Ansett.

These actions, the level of financial commitment, and the willingness to invest public funds to maintain the going concern clearly indicates Government policy on the importance of Air New Zealand. Since then various MPs have made comments to the effect that Government's pockets are not unfathomable. However, the vote of Parliament to support the bail out of Air New Zealand is the actual Governmental action that should guide the Commission in its assessment of the importance of Air New Zealand and the policy of Government.

3 THE PROPOSED ALLIANCE AND INVESTMENT ARE UNDESIRABLE

The airlines proposal will result in short term and long-term deleterious consequences in respect of each of:

- The cost of air travel within and to and from New Zealand.
- The destinations and frequency of services that will pertain for New Zealanders looking to take advantage of air services.
- The quality and reliability of air travel services.
- The focus and investment in marketing New Zealand as a travel destination.
- The icon value of Air New Zealand and the benefits that a wide range of groups derive from support by Air New Zealand in its role as "National Carrier".

4 ASSESSING THE NATIONAL COST / BENEFIT

The Airlines' case for having the Alliance/Investment approved is based on their assessments of how the world will be with and without the transactions.

They conclude that without the transactions the world will be a worse place.

We conclude that there are sufficient flaws in the Airlines' case as to make a virtually opposite conclusion more plausible.

The cost / benefit analysis has been undertaken by economists using models. Such models are intended to reflect a simplified version of reality. In fact they represent nothing of the sort.

It is clear to anyone that modelling has considerable weakness as an analytical and forecasting tool when it is dealing with complex human interactions and a highly uncertain environment. They come to represent one possible course of action occurring in one possible future.

At best they show that outcomes between "XX and YY" are likely. They can never show "XX is most likely".

The modelling work done for the Airlines reflects several fundamental errors of approach and inference:

- The assumptions used are in several instances implausible being based on value destructive behaviour.
- The assumptions take no account of cumulative probabilities, eg. if a coin is tossed ten times, the possibility of ten heads is 1/1024 not 1/2. Yet the inference of the Airlines' modelling is that they have not correctly explained the probabilities of the various outcomes that ascribe to the "with/without" worlds.
- There are omissions of any analysis where the findings are likely to hinder the airlines' case.

4.1 HOW TO APPROACH THE COST / BENEFIT ANALYSIS

Rather than starting with a model and throwing numbers at it, the Commission needs to review the logic of the assumptions, especially those that point to Air New Zealand being doomed if it doesn't progress the Alliance. It needs to map out a number of headings:

1. Is Air New Zealand doomed to withdraw from international services if it doesn't amalgamate with Qantas?
2. Should New Zealand domestic travellers be obliged to forgo competition and endure poorer services at higher cost so that Air New Zealand and Qantas can subsidise the international links?
3. Will Qantas damage its own profitability in an attempt to "grind Air New Zealand into the dust"? Could they do so?

4. Does Air New Zealand have no alternative sources of capital?
5. Is Virgin Blue a credible replacement for the loss of competition between Air New Zealand and Qantas?
6. With the lack of other Australasian airlines and the treaty barriers to new entrants, is there any meaningful prospect of competition?
7. If there is dumping of capacity on international routes, eg. from government subsidised Asian carriers, does that warrant the whole Alliance/Investment transaction as proposed by Air New Zealand and Qantas?

When addressing these topics, the Commission should note the following:

- Internationally passenger numbers to and from New Zealand are up. The number of seats being offered by other airlines is down. The prognosis for profitability on Air New Zealand's international routes is improving.
- Domestically Air New Zealand has found that a 20% reduction in its fares results in an almost immediate 20% increase in passenger numbers. Presumably this means higher profitability?
- Air New Zealand's operating costs per seat/kilometre are less than Qantas's. From figures in the respective annual reports. What is Qantas's competitive advantage in expanding its network at Air New Zealand's expense?
- Air New Zealand offers Qantas an advantage in respect of engineering services. Will Qantas really deny itself this advantage just to harm Air New Zealand?
- The two major global airline alliances are available throughout New Zealand. If one of these alliances were to go, would there not be significant loss of inbound tourists and will there not be costs to those New Zealanders looking to link with international services?
- If Air New Zealand were to withdraw from Star Alliance it is understood that there would be penalties of US$50million. Are these reflected in the cost / benefit analysis.
- Air New Zealand is highly incentivised to encourage and capture international tourists. Will the Alliance have the same degree of incentive?
- Air New Zealand has been very successful at gaining international passengers, will the Alliance? Isn't there a greater incentive for the Alliance to market Australasia rather than New Zealand?
- Over the last decade there has been a duopoly on many of the New Zealand domestic and Tasman routes. There have also been various new-entrant threats. A combination of the two dominant Australasian carriers removes much of the competition and much of the threat, ie. it represents a fundamental change in the competition dynamic.

- Is Virgin Blue a credible threat? Virgin Blue is not a full-service long established airline. It seems to suffer from many of the shortcomings that Air New Zealand claims will lead it (Air New Zealand) to ruin, eg. low capital base, limited international network. It may in time join a major alliance, it may develop a comprehensive New Zealand network, it may offer frequent services, it may offer the package of services that are currently available from both Air New Zealand and Qantas. But the prospects of all these things happening are low.

- There is no other material airline proposition. Virgin Blue is still in its start-up phase. Origin Pacific is a minor regional operation that presumably relies heavily on Qantas. Qantas has been very successful at ensuring it has no meaningful competition in Australia that could realistically offer transtasman or New Zealand domestic services. The treaty barrier to non-Australasian airlines is very high. Virgin Blue is only able to contemplate transtasman services because it found an Australian shareholder to acquire 50% of the company.

- Freedom is anecdotally regarded as lower cost than Virgin Blue. It was set up with advice of one of the Budget Airline pioneers (Ray Webster ex executive of Air New Zealand, current chief executive of EasyJet and consultant to Air New Zealand). This airline has been used ruthlessly by Air New Zealand to attack competition, as opposed to being used to establish a network in its own right. Whether the Alliance/Investment progresses, Virgin Blue is presumably constrained in its ability to enter the Tasman market by the knowledge that Freedom can be deployed on head-to head competition on exactly the market niches that Virgin Blue will be targeting.

5 COSTS FROM THE TRANSACTION

1. The Alliance would eliminate price and service competition on large parts of the New Zealand air transport network. The main objective of the Alliance, as recognised in the Airlines' applications, is to increase their profitability from providing New Zealand air transport services by increasing prices and reducing services.

   The Commerce Commission must take a sceptical view on the scale of increase prices and reduce services that will eventuate.

   (i) New Zealand Department of Statistics figures show:

   ◊ Between March 1990 and December 2002

   International air travel costs rose 10.2%

   Domestic air travel costs rose 68.6%

   ◊ Between March 1990 and September 2002:

   International air travel costs rose 0.2%

   Domestic air travel costs rose 85.2%

◊ Between the September and December quarters of 2002 domestic air travel costs fell 9.0% while international costs rose 10.0%.

The market is volatile and seemingly the costs imposed by the airlines are highly responsive to competition. Over the longer term international costs have remained much more subdued, and stable, than those domestically. Presumably because there has been more international competition, while the domestic market has, at best, been a duopoly over most of the period.

(ii) Australian Bureau of Transport & Regional Economics figures show for domestic travel costs:

◊ Between September 1994 (the earliest figures that are available) and September 2002 (the most recent available figures):

The fares described as “Best Discount” have fallen 10.9%.

Fares described as “Discount” have risen 9%.

Fares described as “Business” have risen 20.7%

◊ As with the New Zealand market, it is apparent that the airlines respond markedly to competition. It is also evidence that airlines have considerable ability to differentiate markets and to charge each market segment to optimise returns.

◊ Over the same period (September 1994 and September 2002):

New Zealand international air travel costs fell 5.2%

New Zealand domestic air travel costs rose 45.5%

(iii) It is understood that Air New Zealand now has 12 domestic fare categories. The focus of the airlines on demand and their ability to price respond should not be underestimated.

(iv) In assessing the magnitude of the price responses to the Alliance/Investment, the Commerce Commission must look at the past data and draw conclusions as to what is likely to occur in future. Price rises over time in the range of 50% are very plausible.

(v) The Alliance is intended to remove competition. The only consumer protection on New Zealand domestic routes (and those on the Tasman that are dominated or exclusively Air New Zealand and Qantas now) is the prospect of Origin Pacific growing markedly and/or Virgin Blue developing a reasonable scale of New Zealand services. There is no reason to believe that either eventuality is likely over the medium term. There are no other competitive threats to the Alliance.

2. The Alliance does not have the same incentive to market New Zealand as a destination as does Air New Zealand and Qantas acting separately.

Further, it is apparent that the existing marketing of New Zealand is highly successful.

(i) Over the period between YE June 1992 and YE June 2002:

International tourist visitors to New Zealand have rise from 952,000 to 1,956,000 an increase of 91%. Australia's inbound tourist numbers were 4,768,000 in YE June 2002, which was up 89% over the decade.

Over the five-year period from 1997 (ie. the second half of the decade) New Zealand's increase was 27% (4.9%pa.) while Australia's was 12% (2.3%pa.).

(ii) There is no reason to believe that Qantas does not already see New Zealand as a growth tourist market that Qantas, as a regional transport/tourism company, would not wish to promote and support for its own benefit. There is no apparent commercial logic to Qantas increasing its spend on promoting New Zealand inbound tourism post the Alliance/Investment.

(iii) Because Air New Zealand's business is New Zealand centric it is difficult to find a reason why Air New Zealand would not already be spending on promoting New Zealand inbound tourism to a level where marginal cost equalled marginal returns.

(iv) Because tourism is a major industry the Commerce Commission must carefully investigate this matter. It should also be wary of accepting the views of industry bodies that receive funding and support from the Airlines. Such views will be shaped by such bodies' relationships with the airlines.

5.1 THERE IS NO PROXY FOR COMPETITION

The various undertakings offered by the Airlines, together with the potential use of regulation or law, to create a proxy for competition should not be given credibility by the Commerce Commission. There is little likelihood of the airlines being bound by any undertakings or meaningfully manageable by any regulations.

Globally the aviation industry is moving away from regulation. Globally this has meant the failure of inefficient, expensive, airlines and a move to lower cost services.

There is unequivocal and ineluctable evidence that regulation and control merely serves to protect inefficient airline activities at the expense of air service users.

6 ADDRESSING THE COUNTERFACTUAL

1. The Airlines' cost / benefit assessment is heavily reliant on a forecast of a number of bad things happening to Air New Zealand without the contemplated transactions.

   Qantas appears to have stage-managed threats, such as the Qantas CEO comments that Qantas will "grind them into the dust", with the intention of setting a scene. But in viewing the alternatives for Air New Zealand, the Commerce Commission must be very sceptical of rhetoric that describes activities that seems commercially unsound.

2. The Airlines describe Air New Zealand as being vulnerable (if not exactly a "failing firm") because it has a low capital base, uncertain profitability on some of its international routes, and the prospect of vigorous competition from low cost airlines and Qantas.

   Apparently Qantas and value airline/s will reduce Air New Zealand' profitability across the board and cause it to retrench to a minor local role. A position where it will presumably be vulnerable to Origin Pacific picking off what is left.

   In fact there is no reason to give such a scenario any more credibility than several others that could see Air New Zealand a very successful company providing services of excellent quality at low cost.

3. Air New Zealand suffers from no intrinsic weakness relative to Qantas.

4. Air New Zealand has shown itself to be a very tough competitor for value airlines (witness KiwiAir). In fact Air New Zealand has its own value airline for which Qantas has no answer.

5. It is more likely that Air New Zealand has advantages over both Qantas and Virgin Blue than the proposition that those two airlines will exert some form of pincer movement on Air New Zealand.

   ◊ Qantas has taken extraordinary steps to politically neuter Air New Zealand. Presumably because it does not see commercially "grinding it into the dust" as that easy.

   ◊ Air New Zealand has a lower cost base and lower cost/seat-kilometre than Qantas.

   ◊ Freedom is reputed to have a lower cost base and lower cost/seat-kilometre than Virgin Blue.

   ◊ Air New Zealand's major and supportive shareholder is the New Zealand Government, which has considerable ability to support the airline into profitable growth if called upon to do so.

   ◊ The New Zealand investing community have indicated a willingness to invest in Air New Zealand.

7. A far more likely future than the "pincher movement" proposed in the Airline's proposal to the Commission, is on-going profit maximising competition. Where airlines add capacity to routes where they believe they will gain a satisfactory return on the capital employed.

Under such a future, Air New Zealand has an advantage where it is the incumbent and will have none of the costs of building a presence. It will only be toppled from this advantage where it's cost base is too high (no one is suggesting this) or it suffers some other relative disadvantage such as being unpopular (quite the contrary), has no funds/stomach to meet competition (it has funds, strong shareholders, and willing investors. It may not have much stomach, but that is more a problem with the current directors than a weakness of the whole company), cannot get passenger feed (Air New Zealand is a member of the world's largest airline alliance).

7 SAVE AIR NEW ZEALAND

This submission has endeavoured to make a number of simple points rather than getting stuck into the detail.

No doubt the Commission will receive a great deal of information on the transaction from other interested parties.

The Save Air New Zealand Group is relying on the Commerce Commission to take advantage of the information it receives to develop an informed opinion on the merits and disadvantages of the Alliance/Investment for New Zealand.

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