5 March 2003

Janet Whiteside
Chief Advisor
Market Structure Group
Commerce Commission
PO Box 2351
Wellington, New Zealand

Dear Ms Whiteside,

Revised NECG Model

Accompanying this letter is the revised version of the NECG model. The model incorporates the changes detailed in NECG's letter of 21 January 2003 as well as changes following from the withdrawal of United from the AKL-LAX sector. There have also been a number of relatively minor changes to the model reflecting issues raised by the ACCC in its letter dated 10 February 2003.

The recent withdrawal of United from the AKL-LAX sector requires a number of changes to the factual and counterfactual schedules. These changes include a withdrawal of Air NZ from SYD-LAX, addition of capacity on AKL-LAX by Qantas and Air NZ and a change in the composition of flights operated by Qantas on AKL-SYD. The Qantas changes on AKL-SYD reflect the fact that the additional Qantas capacity operated on AKL-LAX would all be provided via Sydney (ie SYD-AKL-LAX). To provide additional 744 capacity on AKL-LAX, Qantas would increase its 744 SYD-AKL-LAX capacity and reduce its 743 SYD-AKL capacity. Changes were also made to the Qantas fleet composition to accommodate these schedule changes.

We believe that in the future with the Alliance, the AKL-LAX sector would be operated by the Alliance and one other airline by year 3 of the Alliance. This other airline would most likely be United, consistent with its statements regarding its strategy of lowering costs and rebuilding its network. The price increases predicted by the model without the operation of a second airline would also make re-entry attractive. While the model does assume that the second airline operating on AKL-LAX in years 3 to 5 would be United, the same results would be obtained if the airline were Singapore or another US operator (New Zealand has open-skies agreements with the US and Singapore). In the counterfactual, we assume that United would continue to codeshare with Air NZ.

We have also corrected a number of errors in the model identified by the ACCC and our own revisions. These changes are:

- *Counterfactual weighted average marginal cost of the Alliance for calculation of DWL*. See ***Analysis*** tab. We have amended the calculation of the weighted average marginal cost for the Alliance airlines, as the formula was linking to the incorrect cells for the Qantas weights. We also changed the weights from passenger shares to capacity shares, although this has no impact on the results, as passengers are allocated on the basis of capacity shares.

- *Allocation of transfers to Freedom*. See ***Alloc*** tab. We have now included transfers to Freedom as transfers to New Zealand producers. Previously, these had been allocated to foreigners.

- *Air NZ number of aircraft. See **CapCost** tab.* As a result of queries raised by the ACCC in its letter dated 10 February 2003, we identified an error in the Air NZ aircraft fleet. Aircraft scheduled to operate Freedom services had previously been included in the Air NZ fleet, but the Freedom blockhours had been excluded in unitising aircraft costs. The Freedom aircraft have now been removed from the Air NZ fleet tables. The reason that Freedom aircraft can be removed from the Air NZ fleet is because the Freedom schedules on the affected routes are identical in the factual and counterfactual and hence no cost savings arise as a result of Freedom's operations.

- *Air New Zealand block hours. See **CapCost** tab*. As a result of the query raised by the ACCC in Question 17 of their letter dated 10 February 2003 we identified an omission in B733A blockhours in year 1 of the model. This has been corrected.

- *Block hours. See the **BHrs** tab.* As explained in the response to the ACCC's letter dated 10 February 2003, the blockhours for 763 aircraft for AKL-NGO were incorrectly set to zero in the model, as was the 744 blockhours for AKL-MEL and 767 blockhours for WLG-BNE. This has been amended.

- *Deadweight loss calculation. See the* ***SUM*** *tab.* In its letter dated 10 February 2003 the ACCC identified that NECG's DWL formula for Australia omitted 4 Tasman sectors. This has been updated to capture all sectors.

- *Deadweight loss allocation. See* ***Alloc*** *and* ***Analysis*** *tabs.* In response to question 8 of the ACCC's letter of 10 February 2002, we have adopted the proposed approach of allocating DWL by decomposing the total DWL into changes in consumer and producer surplus and then allocating the former on the basis of passenger shares and the latter on the basis of capacity and the benefit sharing arrangements agreed between the parties.

- *WACC assumption. See* ***Control*** *tab.* As set out in NECG's paper providing details of the modelling approach, sent to the Commission on 4 February, the capital charge was not calculated using a CAPM WACC. Rather, NECG adopted the same capital charge as used in the commercial analysis of the Alliance. However, a revisiting of this commercial analysis has clarified that this capital charge only reflected an interest charge, not the full opportunity cost of capital. It is our view that a WACC of 12% is a closer reflection of the CAPM WACC than the capital charge of 8% previously used in the model (Qantas has a target WACC of **[confidential]**% and Air New Zealand has a target WACC of **[confidential]**%). Conservatively, we have adopted a WACC of 12% in the revised model.

- *Promotional expenditure. See* ***Tourism sum*** *tab.* In our letter dated 21 January 2003 we noted that the promotional expenditure associated with additional tourism had not been deducted in our analysis. However, the multipliers that are used to value the additional tourists already account for these costs, hence our revised model does not deduct promotional expenditure.

The combined impacts of these changes on the modelling results are set out in Schedule 1 attached (the same exchange rate was used as in the earlier version of NECG's model).

Sincerely,

Henry Ergas

Managing Director

Schedule 1: Revised Model Results

Net Benefits Australia (NZ$ millions)									
			Benefits				Detriments		Net Benefits
Year	Cost Savings	Scheduling	New Direct	Tourism	E & M	Freight	Dead-weight	Net Transfer	
1	$50	$10	$0	$37	$0	-$3	$31	-$29	$92
2	$85	$4	$7	$65	$0	-$1	$16	-$10	$154
3	$89	$2	$8	$99	$0	$3	$31	-$20	$190
4	$84	$2	$8	$93	$0	$2	$30	-$19	$179
5	$79	$1	$7	$87	$0	$2	$29	-$19	$167
5yr Total	$388	$18	$30	$381	$0	$3	$137	-$97	$781

Net Benefits New Zealand (NZ$ millions)									
			Benefits				Detriments		Net Benefits
Year	Cost Savings	Scheduling	New Direct	Tourism	E & M	Freight	Dead-weight	Net Transfer	
1	$47	$12	$0	$80	$39	-$3	$57	$14	$104
2	$92	$5	$7	$167	$37	-$1	$22	$7	$278
3	$86	$2	$8	$138	$35	$3	$36	-$16	$251
4	$81	$2	$8	$127	$33	$2	$35	-$15	$233
5	$76	$2	$7	$118	$31	$2	$34	-$15	$217
5 yr Total	$383	$23	$30	$631	$174	$3	$185	-$25	$1,084

Net Benefits Aggregate (NZ$ millions)									
			Benefits				Detriments		Net Benefits
Year	Cost Savings	Scheduling	New Direct	Tourism	E & M	Freight	Dead-weight	Net Transfer	
1	$97	$22	$0	$117	$39	-$6	$88	-$15	$196
2	$177	$9	$14	$232	$37	-$2	$38	-$3	$432
3	$175	$4	$16	$237	$35	$5	$67	-$36	$441
4	$165	$4	$15	$221	$33	$5	$65	-$35	$412
5	$156	$3	$15	$205	$31	$4	$64	-$34	$384
5 yr Total	$770	$41	$60	$1,012	$174	$6	$322	-$122	$1,865