SUBMISSION TO

NEW ZEALAND COMMERCE COMMISSION

on application by

AIR NEW ZEALAND LIMITED
&
QANTAS AIRWAYS LIMITED

Seeking Authorisation of Certain Restrictive Trade Practices and of a Proposed Business Acquisition

18/02/2003
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1 SUMMARY OF SUBMISSION

1.1 The Parties to this Submission agree with the Applicants that New Zealand and Australia need robust, locally based international airlines, and that conditions in the global airline services market are threatening to them and likely to remain so for the next five years.

1.2 The Alliance represents a means of strengthening the global market competitiveness of the two dominant, locally based international carriers, but – in the form proposed - it would do so to the substantial detriment of competition in the airline and related services markets of and between New Zealand and Australia.

1.3 Public benefits claimed for the proposed Alliance by the Applicants and their consultants, the Network Economics Consulting Group (NECG) are excessive and competitive detriments are undervalued in the publicly available material they have provided.

1.4 The Applicants' claim that "one of the most significant impacts of the Transactions is that they are likely to increase the spread of in-flight service quality in the market, by hastening the entry and expansion of a VBA service." *(Application, p103)* is particularly difficult to accept.

1.5 The undertakings offered by the Applicants to diminish anti-competitive detriments created by their Alliance and to facilitate new entry by a VBA competitor are minimal and ineffectual.

1.6 Structural changes to the operations of the Applicants in the airline services and travel distribution services markets are needed before detriments will be reduced to a level where public benefits merit authorisation of restrictive trade practices which are an inherent part of the proposed Alliance's operation. These changes include the divestment of certain businesses such as the Freedom airline and wholesale and retail travel operations.

1.7 The Parties to this Submission are prepared to participate in the process of facilitating such structural change as potential purchasers of business operations which are to be divested to reduce competitive detriments to acceptable levels and to secure the public benefits of the proposed Alliance. .

2 INTERESTS OF PARTIES

2.1` The parties to this submission are United Travel Limited, which operates in the New Zealand retail travel market, and the Biztrav Business Travel group , which operates in the New Zealand corporate travel market.

2.2 Formed 30 years ago, United Travel has over 95 locations under the United Travel Franchise Group umbrella and 69 of these are branded United Travel, with members in every major centre through New Zealand. The Group provides Gullivers Holidays with more than 40% of its wholesale and consolidation business. Overall the group secures more than 30% of all travel revenues from New Zealand.

2.3 Biztrav BusinessTravel comprises of a group of more than 25 independent travel agencies specialising in the provision of corporate travel services throughout New Zealand and who together secure the business and leisure travel requirements of more than 30% of the corporate travel market.

2.4 The two organisations are also parties to a broader submission by a Travel Agents Group which is also being made to the Commission. However, United Travel and Biztrav have a particular and separate interest in the Application under consideration by the Commission.

2.5 The parties to this submission are interested in acquiring or establishing a VBA carrier, with a potential to operate competitively in the New Zealand domestic, trans-Tasman, and short-haul international markets.

2.6 The parties see this development as an opportunity to sustain their business against trends that are affecting their prospects as stand-alone enterprises in the travel product and services distribution sector.

2.7 The parties to this Submission also support submissions that have been presented to the Commission on behalf of:

- The Travel Agents' Group (Gullivers Pacific Group, Gullivers Pacific, Holiday Shoppe, United Travel, Biztrav, Atlantic Pacific Radius, Signature Travel, and Synergi Travel)
- The Travel Agencies Association of New Zealand; and
- the New Zealand Inbound Tour Operators' Council.

2.8 The parties to this submission request that all correspondence and notices in respect of this submission be directed in the first instance to

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3. CLAIMED BENEFITS & DETRIMENTS OF ALLIANCE

3.1 Public benefits claimed for the proposed Alliance appear to be exaggerated and detriments have been undervalued in the publicly available Submissions made by the Applicants. We address the claimed benefits first.

3.2 Increased tourism

3.2.1 The major benefits claimed for the Alliance by the Applicants arise from claims that it would increase the volume of inbound tourism to New Zealand that can be generated by additional dual destinational (New Zealand – Australia) marketing activity to be carried out by Qantas Holidays.

3.2.2 Recent trends which see the New Zealand inbound tourism market growing faster than the Australian inbound tourism market do not suggest that Qantas Holidays has more ability than the current New Zealand inbound tourism marketers.

3.2.3 With or without the Alliance, Qantas Holidays has the opportunity and incentive to promote dual destination travel to New Zealand and Australia. Qantas already has trans Tasman and New Zealand airline operations to feed.

3.2.4 The Applicants' claim that this is an additional benefit that would be created by their Alliance cannot be sustained.

3.3 Increased engineering services contracting

3.3.1 With an Alliance, Qantas agrees that Air NZ will be its preferred supplier for sub-contracted heavy maintenance work, with the "likely" result that Air NZ's engineering business would receive 80% of such work, compared to 78% at present.

3.3.2 Without an Alliance, the Applicants claim Qantas is most likely to seek out the most cost-effective heavy maintenance arrangements available in the region. As a result, the Air NZ engineering division's share of sub-contracted heavy maintenance work is likely to fall from 78% in 2002/03 to as low as 10% in subsequent years.

3.3.3 The Applicants' consultants NECG state (p152):

> *"Thus the Alliance could provide annual exports of engineering maintenance services to New Zealand of about $45 million*

compared to $6 million without the Alliance. This is an annual benefit of approximately $39 million.

3.3.4 This analysis exaggerates the additional value of the benefit to New Zealand. The additional value of the benefit is essentially the value of the growth of Air NZ engineering activity from 78% of the work sub-contracted by Qantas today to 80% in future – not the difference between 10% and 80%.

3.3.5 The work currently being undertaken for Qantas by Air NZ was won without an Alliance, and in the face of international competition from other tenderers.

3.3.6 Provided the current international competitiveness of engineering services offered by Air NZ is sustained, there seems little logic to the suggestion that its share of the work would diminish without the Alliance.

3.3.7 It could only diminish if Qantas decided to deny itself a price, time or quality advantage and place its sub-contracted heavy maintenance work with other suppliers, and, presumably. with other suppliers that are associated with other airlines which also compete with Qantas.

3.3.8 Equally, there seems little logic to the sugggestion that a 22.5% interest in Air NZ would cause Qantas to ignore price, time or quality advantages offered by other heavy maintenance suppliers over the services offered by Air NZ's engineering division.

3.3.9 If the arrangement proposed in the Transaction results in Qantas giving preference to a less efficient supplier for its heavy maintenance sub-contracting, or if it leads to an easing of pressure on Air NZ to maintain the international competitiveness of its heavy maintenance operations, then it would be to the detriment of both Australia and New Zealand as a whole

3.3.10 Diminished efficiency in Air NZ engineering services would also affect New Zealand to a greater extent than Australia. It would impact on all Air NZ services and only affect a comparatively small part of the Qantas airline operation.

3.3.11 The potential detriment of diminished efficiency at Air NZ does not figure in the calculations of the Applicants. If they do not see this as a risk, then the diversion of contracted engineering work by Qantas to other suppliers would be at additional cost to Qantas and would undermine the efficiency of its operations in competition with Air NZ.

3.4 Increased freight capacity benefits

3.4.1 The Applicants' suggest that additional benefits of $3.3 million per annum will be derived from improved freight operations that will be made possible by the proposed Transaction and their alliance.

3.4.2 These additional benefits appear to be generated from two sources:
(a) The introduction of Qantas B744ER equipment on routes between Australia, New Zealand and the United States; and
(b) The introduction of "back of the clock" trans-Tasman flying utilising Boeing 767 aircraft that are currently idle overnight in Melbourne.

3.4.3 Two questions arise. First, are either of these benefits created by the proposed Alliance? The answer appears to be no. Second, is it possible for these operations to be introduced without the proposed Alliance? The answer would appear to be yes. Therefore, this development cannot be claimed as an additional benefit created by the Alliance.

3.5 Cost savings benefits

3.5.1 The Applicants submit (p108) that substantial cost saving benefits in the order of $363 million per annum (split between Australia and New Zealand) will arise from Year 3 of the Alliance, if the Transaction is authorised.

3.5.2 They submit cost saving benefits arise from:
(a) economies of scale; and
(b) more cost efficient aircraft selection.

3.5.3 In terms of economies of scale, the Applicants' consultants NECG submit *(NECG Report, p127*) that "reliably predicting the extent of such efficiencies would be extremely difficult." They adopt the view that "the net impact of scale economies will be neutral once the cost of securing those economies is taken into account." Consequently, no benefit from economies of scale is claimed in their calcuation of benefits. This seems wise, as they are unlikely to occur.

3.5.4 In terms of cost savings from synergies and the elimination of duplicated activities, the proposed Alliance between Qantas and Air NZ is subject to review after five years of operation. The Applicants expect that it would take three to five years to recoup the cost of any steps taken to integrate their operations.

3.5.5 At the end of five years what was done at substantial cost to achieve integration might then have to be undone at further significant cost.

3.5.6 This analysis suggests that significant benefits from integration of activities and the elimination of duplication are unlikely to be achieved.

3.5.7 Indeed, the New Zealand Government has signalled its concern to ensure that any integration should not compromise Air NZ's ability to return to independent operation.

3.5.8 On 18 December 2002, the Cabinet Business Committee invited

"…the Minister of Finance to write to the Air New Zealand Board setting out the principal shareholder's expectation that Air New Zealand will retain the capacity to operate autonomously in the event the Alliance terminates.". *(Cabinet Business Committee Minute (02) 11/8)*

The Minister of Finance subsequently advised the Chairman of Air NZ:

"I know the Board is keenly aware of the need to preserve Air New Zealand's autonomy and to consistently safeguard Air New Zealand's ability to quit the Alliance at minimal cost. I fully support the Board in this view as I agree it is necessary to protect the best interests of Air New Zealand and of all its shareholders. I therefore expect the Board will ensure that direct and indirect costs to Air New Zealand from any future termination of the Alliance are minimised and that, in the event of termination, Air NZ will be able to operate independently from Qantas within a reasonable period of time." *(Letter from Minister of Finance, Dr Michael Cullen, to Chairman of Air New Zealand, Mr John Palmer, 20.12.02)*

3.5.9 In terms of scale benefits that might arise from joint purchases by the Air NZ / Qantas Alliance, it would seem difficult – if not impossible – to calculate them with any accuracy because of the volatile state of the global airline industry which is likely to continue over the next five years. Given the relatively small scale of the proposed Alliance in global terms, its ability to generate significant additional benefits from joint purchasing will also be small.

3.5.10 The same difficulty arises in terms of calculating the benefits that might arise from more cost-efficient aircraft selection achieved by reallocating aircraft across sectors and from aircraft rationalisation.

3.5.11 The calculation of more cost-efficient aircraft selection benefits amounting to $363 million per annum (split between New Zealand and Australia) by Year 3 of the operation of the Alliance requires acceptance of two points:

- the schedules developed for the factual and counter-factual assessments are the actual schedules that will be flown over the next three to five years; and

- the Applicants have the ability to identify market demand, competitor activity, the optimum match between aircraft type and market demand, and then to identify and utilise the higher margin provider of the particular aircraft type - to the degree required to generate the outcomes suggested by the NECG models.

3.5.12 It requires a considerable act of faith to conclude that the two conditions outlined above will be achieved by anyone other than a monopoly supplier of airline services across the Australia-New Zealand market. That is not the position that the Applicants will be in if the proposed Transaction is authorised and their Allliance proceeds.

3.5.13 Schedules will be subject to change at six monthly intervals over the next three to five years, and the prospects of delivering an optimal match between aircraft type and route requirements are limited to the extent that only a small proportion of Qantas Airways' capacity will be committed to the JAO operation.

3.5.14 Essentially, Air NZ already has the bulk of the opportunity to optimise the aircraft/ route match at its disposal without the Alliance. In view of this, the claimed benefit from more cost-efficient aircraft selection appears excessive.

3.6 New fares, network connectivity and loyalty programme integration

3.6.1 The Travel Agents Group submission, with which United Travel is associated, provides a comprehensive critique of the Applicants' claims that additional benefits will be generated for New Zealand by activity in these areas by the proposed Alliance.

3.6.2 No further comment is required here. Again, potential additional benefits from the Alliance have been exaggerated and potential detriments have been under-valued.

3.7 Capital related efficiencies

3.7.1 Capital related efficiency benefits have not been quantified by the Applicants or their consultants NECG. However, the Applicants assert that they will arise in three ways:

- The introduction of a new shareholder will strengthen the incentives for management and Board to perform well;

- Financing Air NZ will cost less because Qantas will pick up a share of required additional investment and reduce the call on Government capital which has a higher opportunity cost than private capital; and
- The current taxation environment facing Australian investors in New Zealand firms.

3.7.2 In regard to the first point, It is hard to see why the Government, faced with higher opportunity costs in committing its capital, should be any less interested than a private investor in providing the strongest possible incentive for Air NZ management and Board to perform well.

3.7.3 It is equally hard to see how Qantas as a minority shareholder in Air NZ with only two of directors on the Board would be in a position to provide stronger incentives to perform well than the majority of directors elected to the Board by the majority shareholder.

3.7.4 In regard to the Applicants' claims concerning reduced funding costs arising from the Alliance, there is no evidence in the publicly available material submitted by the Applicants that the deadweight cost of taxation to fund the Government's shareholding in Air NZ will be affected by the Transaction. This could only occur to the degree that the New Zealand Government sells down its existing shareholding in Air NZ at a price sufficient to recover its initial costs and its opportunity costs.

3.7.5 The claim of benefits from improved financing efficiency depends upon the degree to which there is a call on Air NZ shareholders for additional equity capital over the next five years. The likely scale of such a call is not indicated in the publicly available material provided by the Applicants.

3.7.6 As the majority shareholder, the New Zealand Government has stated that there will be a limit to the additional capital it is prepared to invest in shares in Air NZ. That in turn limits the benefit to be derived from financing efficiencies in terms of equity raising.

3.7.7 It also must be recognised that while the opportunity cost of Government capital is higher than private capital, Qantas must also consider the opportunity costs that arises from the diversion of its capital resources to advance the prospects of Air NZ, an airline which is currently performing less profitably than Qantas and in which Qantas would have only a minority interest.

3.7.8 In regard to the current taxation environment facing Australian investors in New Zealand, the potential benefit claimed here is not explained by the Applicants and receives no mention in the accompanying analysis by their consultants NECG.

3.8 Increased global competitiveness

3.8.1 The Applicants suggest (*Application, P117*) that significant benefits will arise from the Transaction in terms of the increased global competitiveness of a more robust and viable international airline operation located in Australasia.

3.8.2 These benefits are not quantified by the Applicants and their consultants NECG. Given the volatile nature of the global airline services market, it would be difficult to do so with any degree of accuracy.

3.8.3 The global competitivess of Qantas and Air NZ in their proposed Alliance will be tempered by the impact that this Alliance has on their ability to participate in global airline alliances. The tolerance of the oneworld and Star alliances of the proposed Transaction between two members of these competing alliances is yet to be tested.

3.8.4 If the proposed Alliance proceeds, the most likely outcome in terms of global alliance participation is that Air NZ will switch from the Star Alliance Network to the oneworld network favoured by Qantas. The Travel Agents' Group Submission, to which United Travel is a party, points out the detriments of this switch and that these detriments will be more adverse to New Zealand than Australia.

3.9 Preservation of a New Zealand national flag carrier

3.9.1 The Applicants suggest that the Transaction will reduce the risk of loss of the national New Zealand flag carrier. They elabourate on this issue in a confidential Appendix to their submission which is not available to the Parties to this submission.

3.9.2 However, the Parties to this submission can identify one possible outcome from the proposed Transaction that generates risk for the national New Zealand flag carrier.

3.9.3 The proposed transaction will place all Air NZ international operations in a Joint Airline Operation (JAO) and under the oversight of a Strategic Alliance Advisory Group on which the Australian flag carrier has equal representation. It also envisages the secondment of Qantas staff to the Joint Airline Operation and the appointment of two Directors to the Board of Air NZ.

3.9.4 A question then arises as to whether Air NZ international operations are under “effective New Zealand control” in terms of the requirements of bilateral air services agreements that the New Zealand Government has negotiated with other countries.

3.9.5 The significance of this issue is emphasised by the analysis of governance impacts of the proposed Alliance on Air NZ that has been provided to the New Zealand Treasury by consultants Charles River Associates.

> “The management are likely to acquire greater autonomy from the Board, and in particular, from the directions of the representatives of the majority owner. These representatives, particularly if less singularly focussed, may place weight on strategies proposed by the shareholder with the strongest direct commercial interest – Qantas – and management may consider that the interests of Air New Zealand will be best advanced by the strategies espoused by this shareholder. The management of Air New Zealand will have the option of appealing to the Qantas representatives for support in any disputes with the representatives of the majority owner. Once the Alliance is fully implemented, and facing the costs of exit , the views of the Qantas directors may possibly carry more weight than their actual voting rights would imply. (*Charles River Associates Report, 10.12.02, p9)*

3.9.5 The overall conclusion in the Charles River Report is that

> “the risks of effective-control passing to Qantas, misalignment of interests and the costs of exit from the Alliance are material, but potentially manageable within the framework of the proposal” (*Charles River Associates Report, 10.12.02, p.3)*

3.9.6 Questions are likely to be raised regarding effective New Zealand control of Air NZ by the flag carriers of other nations who could see their own competitive position in the New Zealand and/or Australian markets diminished by the creation of an Alliance and JAO networks by the flag carriers of Australia and New Zealand.

3.9.7 Further, the Applicants envisage initiating jointly operated, triangulated services to and from other origin market nations, where Qantas does not currently have the ability to operate such services in its own right as an Australian flag carrier under existing Australian bilateral air services agreements.

3.9.8 The risk of a foreign flag carrier’s challenge being taken up by its designating Government is elevated to the extent that the Air NZ/Qantas alliance is seen as a means of circumventing existing provisions of air services agreements between the foreign flag carrier’s home nation and Australia.

3.9.9 Retaliatory actions could include suspension of a bilateral international air service agreement and/or the inclusion of new restrictions in any subsequent agreement that might be negotiated.

3.9.10 Because the proposed JAO networks embrace all Air NZ international operations, and only a minority of the international services operated by Qantas, it follows that the threat of retaliatory action from any foreign government is stronger to the national flag carrier of New Zealand than it is to the national flag carrier of Australia.

3.9.11 The potential detriment arising from new limits to access by Air NZ to third nation markets, or curtailment of access altogether, must also be taken into account when any benefit in the form of preservation of the national flag carrier of New Zealand is calculated.

4 IMPACTS ON MARKETS IF AUTHORISATION IS GRANTED

4.1 The Alliance and formation of the JAO are comparatively easy options for both the Applicants – but they are not easy options for New Zealand as a whole.

4.2 Qantas wants the Alliance and Qantas seems to be the only willing new investor and airline partner on offer to Air New Zealand.

4.3 However, the Qantas ambition to achieve the JAO with Air New Zealand is more easily explained in terms of benefits to Qantas, than it is in terms of public benefits to New Zealand.

4.4 The JAO provides Qantas with the best opportunity to eliminate the substantial losses it must currently be sustaining on its New Zealand domestic operation. These losses could be described as a benefit to New Zealand, as they are an expense to an Australian-based business and constitute a transfer of wealth from Australia to New Zealand. Eliminating them would be a benefit to Australia and a detriment to New Zealand.

4.5 The JAO also eliminates the most likely source of additional competition in the Australian domestic market. As a JAO partner, Air NZ would not be able to re-enter the Australian domestic market in its own right to compete with Qantas, or as a partner with anyone else, despite Air NZ's eligibility to do so under the terms of the Australia-New Zealand bilateral air services agreement. Equally, the JAO would prevent entry by the New Zealand-based VBA Freedom without Qantas's consent.

4.6 The JAO ehances Qantas's capacity to limit the growth of its major domestic rival, Virgin Blue. The JAO would have the ability to use Freedom to guard likely points of Virgin Blue entry to the trans-Tasman and New Zealand markets. By mutual consent, the proposed Alliance could selectively deploy Freedom against Virgin Blue on any Australian domestic route where a VBA carrier has competitive advantage over the FSA competition currently mounted by Qantas.

4.7 The JAO also enhances Qantas's international position as a member of the oneworld airline alliance, by precluding direct domestic and international competition from the closest, most strongly motivated and best qualfied member of the Star Alliance network.

4.8 It is just as easy to see why the JAO would be the preferred option for Air NZ. It provides a simple answer to some of its pressing problems in Australia; eliminates competition from its most powerful rival in New

Zealand, on the Tasman, and on other international routes operated or potentially operated out of New Zealand by Qantas; and it secures some additional capital for a business that has recently required recapitalisation by the New Zealand Government.

4.9 However, it would be a mistake to conclude that the JAO is the only viable option for Air NZ, and that other options do not exist for Air NZ. They may not be the best option available to Air NZ from the company's perspective, but they may be better for New Zealand than the Applicants' preferred option.

4.10 If Air NZ pursued another option, it would enable New Zealand (and Australia) to continue to enjoy the benefits of competition between Air NZ and Qantas in the markets that would have been covered or affected by the operation of their proposed JAO. It would also lower the barrier to entry by new competitors who would otherwise be deterred or limited by the establishment of the Air NZ/Qantas JAO.

4.11 It is necessary to determine just how rigorous Air NZ has really been in its efforts to identify other options, which may be of smaller benefit to Air NZ but of larger benefit to New Zealand. Some of the other possible options for Air NZ are outlined in the submission to the Commission in the Travel Agents Group, to which United Travel is also a Party.

4.12 Now that the full nature of the proposed Air NZ / Qantas Alliance has been revealed, it is possible that new interest has been created among potential partners who could provide Air NZ with an alternative to the proposed JAO.

4.13 In any event, the Applicants have made it clear that a refusal to authorise their proposed Alliance would not inevitably lead to failure by one of them.

4 IMPACTS ON MARKETS IF AUTHORISATION IS REFUSED

5.1 The Applicants see two main public detriments arising if their Alliance is not authorised. First, it will inevitably lead to a war of attrition in markets contested by Air NZ and Qantas. Second, it will make it more difficult for a VBA carrier to enter those markets. The second point is addressed in the following section of this Submission.

5.2 The likelihood of a war of attrition and the claim that Air is not well-placed to win such a war are both dubious propositions.

5.3 The war of attrition

5.3.1 There will be limits to Qantas's ability to wage a war of attrition in New Zealand. The scale of its international operation is significantly greater than Air New Zealand. Its exposure to competition in the New Zealand, trans-Tasman and beyond New Zealand sectors of the global aviation market is small by comparison with the competitive threats likely to confront Qantas in its home market and in the global aviation market.

5.3.2 Pressures on Qantas's core markets – domestic Australia and other major offshore markets beyond Australia – are likely to be more of a threat to Qantas than intensifying competition to its operations to, from, within and beyond New Zealand. The New Zealand-related operations are a comparitively small part of its business. In the face of more threatening (and likely) growth in competition in its core markets, Qantas is unlikely to divert significant resources to a war of attrition with Air NZ in the New Zealand market.

5.3.3 Further, a fare war between Air New Zealand and Qantas in the New Zealand market is not necessarily a bad thing. It contributes both public benefits and increased competition. If the contest in the New Zealand air services market is firmly based on the comparative efficiencies of rival providers, it is not in New Zealand's interests to constrain that competition by authorising the rivals to co-ordinate their operations in an all-embracing strategic partnership.

5.3.4 However, a war of attrition between Air NZ and Qantas could be waged on an unfair basis, which could see one carrier providing its services at less than real cost, or another enjoying forms of external subsidisation or protection which are not available to its rival. At that point, it should fall to the competition regulators to find remedies that ensure the rivals return to a state of fair and sustainable competition.

5.5 Air NZ’s inherent strengths and opportunities

5.5.1 As pointed out in the Travel Agents Group submission, Air NZ is in a strong position to defend itself in any war of attrition with Qantas in the New Zealand domestic, trans-Tasman, and short-haul Pacific markets.

5.5.2 Its current weakness lies in its positioning as a Full Service Airline in the long-haul international markets for travel between New Zealand, Asia, the Americas, and Europe.

5.5.3 Air NZ states that its current long haul international product is no longer competitive by current full-service airline standards, and substantial investment will be required to upgrade in-flight customer service infrastructure, such as seats and in-flight entertainment systems aboard its aircraft.

5.5.4 Before this is accepted as a detriment arising if the proposed Alliance is not authorised, two questions must be answered.

- First, to what degree would this disadvantage be addressed if the Commission authorises the formation of the Alliance?

- Second, is the current prescription for full-service airline service right for an international travel market where price and schedules are becoming increasingly important determinants of airline choice?

5.5.5 Full-service airlines (FSAs) that have focused on the attraction of premium fare-paying, convenience-seeking business travellers are the airlines that are currently recording the industry’s largest losses.

5.5.6 On Air NZ’s currently unprofitable and marginal long haul routes, an Express Class-type conversion to a low-fare, single class service configuration - offering some premium service options on a user-pays basis - is a viable development option. This option would not require the substantial investment currently needed to upgrade Air NZ’s long haul service offering to competitive, full-service international airline standards.

5.5.7 The introduction of a long haul, low-fare, single class service by Air NZ is likely to accelerate the growth of inbound leisure travel to New Zealand from some key origin markets – particularly in Asia - where competition from other destinations is strong, price and travel time are important influences on travel decisions, and the demand for business and first class cabin services is low.

5.5.8 Qantas has already demonstrated the potential for selective application of this approach to long haul international operation with the recent establishment of its new international airline subsidiary, Australian Airlines.

5.6 Impact of Alliance on competition

5.6.1 Air NZ and Qantas have histories of seeing off reasonably established rivals in their home markets. History seems likely to repeat itself with or without their proposed JAO Alliance – unless there are other structural changes in the trans Tasman and New Zealand airline services markets.

5.6.2 Qantas purchased Australian Airlines, routed Compass I and Compass II, acquired and absorbed Impulse, and crushed Ansett Australia with out-of-scale increases in capacity and comprehensive fare reductions ostensibly to counter the growth of Virgin Blue and Impulse in the Australian domestic market.

5.6.3 Air NZ has purchased rivals like Mount Cook and Newman Air, contained Ansett New Zealand in a loss-making situation, and routed the Tasman Pacific operation that succeeded it – as well as the last new entry on trans-Tasman routes, Kiwi International.

5.6.4 The creation of an Alliance and a JAO by Air NZ and Qantas will enhance their power to limit the growth of existing competition and to deter new entrants from the Australasian airline services market, and the New Zealand markets in particular.

5.6.5 The contest on the the Tasman and in the New Zealand domestic main trunk market will not be a battle between a Full Service airline (FSA) Alliance and a VBA entrant (in the factual) or a three-way fight between two competing FSA operators and a VBA entrant (in the counter-factual).

5.6.6 The factual and counter-factual cases the Applicants have presented to the Commission do not take into account the real, existing capacities of the incumbent airlines to address new VBA competition.

5.6.7 Air NZ already has a highly competitive VBA of its own (Freedom) in the trans Tasman market, and has demonstrated the ability to switch it into the New Zealand domestic main trunk market in a matter of seven days. Air NZ has also reconfigured its domestic jet fleet into a VBA+ configuration, and could readily expand this style of operation onto the Tasman with its planned introduction of new A320 family aircraft on international short-haul routes.

5.6.8 Qantas has the core of a trans Tasman or domestic VBA in the remnants of the failed Impulse airline operation that it has absorbed. It has also developed a VBA+ operation for longer haul international routes by establishing Australian Airlines.

5.6.9 Together, or separately, the incumbents in the trans Tasman and domestic New Zealand markets have more capability of countering or deterring a VBA start-up than the conventional FSA operations they represent themselves to be in both the factual and counter-factual cases.

5.6.10 The major incumbents' strategy to deter Australian-based VBA entry to the trans-Tasman airline market is evident in the Application.

5.6.11 One of their first co-operative actions will be to close obvious gaps in their trans-Tasman networks by initiating joint airline operations on routes between Adelaide and Auckland, Canberra and Auckland and Wellington, and Hobart and Auckland. Such gaps in incumbents' networks have been convenient points of entry for VBA carriers elsewhere.

5.6.12 Air NZ has also successfully used its own VBA Freedom as a blocking weapon to limit the growth of new trans-Tasman operations by Kiwi International, to deter a threatened domestic VBA start-up in New Zealand by Jump, to deter Virgin Blue from entering the New Zealand domestic market while it re-engineered its main domestic jet fleet to operate profitably at lower cost and on lower fares, and while it completed its negotiations for an Alliance and Joint Airline Operation with Qantas.

5.6.13 With the introduction of Air New Zealand Express Class domestic service, Freedom has been redeployed to cover routes between Virgin Blue's Australian home base, Brisbane, and the main New Zealand international ports of Auckland, Wellington, and Christchurch.

5.6.14 Freedom now protects Air NZ's interests at Virgin Blue's most convenient and likely point of entry to the trans-Tasman and New Zealand domestic markets.

5.6.15 The world offers little evidence that a new entrant VBA carrier will survive and prosper operating on the same routes in competition with an established VBA carrier.

> "No-frills operators may be aware that head-to-head competition among them is bad news for profitability: by the middle of 2002, they competed on only 17 routes, compared with 111 destinations with only one low-cost player."
> *(McKinsey Quarterly, 2002, Number Four, article by Urs Binggeli. consultan.t and Lucio Pompeo, principal, in McKinsey's Zurich office)*

5.6.16 The Applicants' claim *(Application, p103)* that "one of the most significant impacts of the Transactions is that they are likely to increase the spread of in-flight service quality in the market, by hastening the entry and expansion of a VBA service" is particularly difficult to accept when Qantas and Air New Zealand already each have their own VBA ready to roll out against any VBA entrant, or intended entry, at seven days' notice.

4.6.17 The most likely VBA entrant to the trans Tasman and New Zealand domestic market (Virgin Blue) has already indicated its concern about the capabilities available to the proposed Alliance beyond its conventional FSA operations.

5.6.17 While Virgin Blue has confirmed its interest in entry to both the trans Tasman and New Zealand domestic markets, it advances powerful argument in its submission as to why VBA entry and competition would be more likely to occur without the Alliance than with it. *(Virgin Submission to the Commerce Commission, p35).*

5.6.18 It is also clear from Virgin Blue's submission that the timing and scale of its intended entry will be affected by two main considerations:

> "….access to facilities (including for example, Sydney, Auckland and Christchurch airports) and commercial agreements for necessary ground support and handling. Air New Zealand and Qantas, through existing arrangements with airports, control key capacity at these and other airports….; and
>
> "the threat of strategic capacity and pricing conduct by Air New Zealand and Qantas, <u>particularly through their low cost operations, Freedom Air, Australian Airlines and entities within the Qantas brand with low cost structures such as Impulse and Jet Connect."</u>
> *(Virgin Blue Submission to NZ Commerce Commission, p1 – emphasis added)*

5.6.19 Virgin Blue has pointed out existing constraints on the availability of essential services at Sydney, Auckland, and Christchurch airports, but it does not appear to have recognised the frequency of peak time congestion and weather disruption at Wellington Airport as another constraint confronting a new entrant.

5.6.20 Availability of landing slots, airport gates, efficient ground-handling, baggage and check-in facilities – particularly in peak times – are essential to successful VBA operation, since the business model is based on higher aircraft utilisation and more rapid turnaround times than FSA carriers normally achieve.

5.6.21 Unlike Australia, New Zealand has no established systems securing access to essential aviation services for new entrants and to counter advantage that has been secured by major, well-established incumbents.

It will be a significant challenge for a competition regulator to develop such systems.

5.6.22 Further, the current JOA proposal offers little prospect that the current competition from Origin Pacific on main trunk and provincial routes will be sustained in the medium term as a two year limit is to be placed on current arrangements for passenger feed exchanges between Origin Pacific and Qantas if the proposed Alliance proceeds.

5.6.23 The subsequent absence of real competition between Qantas and Air New Zealand or between their JAO and another significant carrier on main trunk routes will deter new entrants from competing with Air NZ Link carriers to provide regional air services and exchange passenger feed with the JAO network. This will create new opportunities for monopoly pricing of fares for travel on uncontested routes in provincial New Zealand.

5.6.24 The establishment of an Air NZ / Qantas Alliance - without any constraint on its operation - would be a particularly powerful deterrent to the entry of new operators and is most likely to diminish existing competition from other operators already in the New Zealand market.

7 UNDERTAKINGS OFFERED BY THE APPLICANTS

7.1 The Applicants recognise that the unlimited suppression of competition in the markets to be operated or affected by their JAO Alliance is not a price that should or will be paid for a solution to the challenges they confront in the global market.

7.2 They have offered a series of undertakings to preserve competition and facilitate entry by new competitors. These are outlined in a submission to the Australian Competition and Consumers Commission. (*Air New Zealand Limited & Qantas Airways Limited - Strategic Alliance- Undertakings to be Provided to the ACCC, 24.1.03)*

7.3 The acceptability to the New Zealand Commerce Commission of such undertakings, their real worth, their monitoring and their enforcement are all matters that must be considered by the Commission. Behavioural undertakings do not appear to fit established framework by which the Commission tests the merit of authorising an otherwise restrictive trade practice.

7.4 If such undertakings are to be given serious weight in the calculation of the benefits and detriments arising from the Alliance proposal, then it seems wise for the Parties to this Submission to comment on what has been offered – and what should be considered.

7.5 The undertakings offered seem to be minimal, conditional and ineffective in terms of reducing competitive detriments and barriers to entry arising from the proposed Air NZ / Qantas Alliance.

7.6 No undertaking is offered in regard to facilitating access for new entrants to peak time landing slots at airports where they are in short supply.

7.7 In terms of access for new trans Tasman entrants to other essential facilities such as airport gates, airport counter facilities, maintenance services and baggage handling services, there is an undertaking that they will be provided for a maximum of a year at a price which provides an appropriate margin for the provider. However, this undertaking will not apply where the facility could be obtained from another source, or where such facilities are not effectively controlled by Air New Zealand or Qantas; or cannot be reasonably provided by Air New Zealand or Qantas, having regard to existing schedules, operational or safety considerations, or legitimate business justifications.

7.8 In the New Zealand domestic main trunk market, no undertaking is offered in regard to access to gates, counter facilities, maintenance services and baggage handling services for new entrants or developing competitors.

7.9 In terms of trans Tasman routes where the proposed JAO would be the sole operator a very limited "capacity ceiling" undertaking is offered to facilitate a new entry.

"The parties would be willing to undertake not to increase combined capacity beyond natural growth on an existing trans-Tasman route operated by a new entrant for a period of one year after the date on which the new entrant announces its intention to commence operating on that route."

"Air New Zealand and Qantas will not increase combined capacity by more than the greater of:

- 5% per scheduling season;
- one return flight per week; or
- 25% of the capacity operated by the new entrant on the route;"

However, this undertaking would be suspended "during periods of abnormal demand."

7.10 In regard to New Zealand domestic routes, no capacity ceiling undertaking is offered for routes where the proposed JAO would operate against limited existing competition (ie Origin Pacific on Christchurch-Wellington) or where it would be the sole operator.

7.11 In terms of trans Tasman routes where the proposed JAO would be the sole operator, a "capacity floor" undertaking is offered to prevent the Alliance carriers from restricting output and increasing prices. Again, the undertaking is both minimal and conditional, applying for only two years and terminating where load factors for a rolling three month period are below specific historic load factors.

7,12 In regard to New Zealand domestic routes, no capacity floor undertaking is offered for routes where the proposed JAO would be the sole operator and that would be a a significant number of provincial routes.

7.13 This analysis demonstrates that constraints on the ability of the proposed Alliance to exercise anti-competitive power need to be significantly stronger than the undertakings offered if competitive detriments are to be outweighed by public benefits of the Alliance, and entry to the trans Tasman and New Zealand markets by a new VBA competitor is to be facilitated.

8 CONCLUSIONS AND RECOMMENDATIONS

8.1 In summary, Parties to this Submission conclude that

- The Alliance has merit in strengthening the ability of robust, locally-based international carriers to compete in the extremely difficult conditions that are likely to prevail in the market for global airline services over the next five years;

- The Alliance would introduce very significant and unnecessary detriments to competition in the New Zealand and Australian airline services markets and the related travel distribution services markets.

- Public benefits claimed for the proposed Alliance are significantly over-stated and detriments to competition are under-valued in the analysis provided by the Applicants and their consultants NECG

- .The suggestion that the establishment of the Alliance would accelerate new entry by a VBA competitor is without foundation.

- Undertakings offered by the Applicants to facilitate entry by a new VBA competitor are minimal and ineffectual.

8.2 Structural changes to the operations of the Applicants in the airline services and travel distribution services markets are needed before detriments will be reduced to a level where public benefits merit authorisation of the restrictive trade practices which are an inherent part of the proposed Alliance's operation.

8.3 Parties to this Submission support the application of the constraints to the Alliance that are recommended in submissions from the Travel Agents Group, in regard to the airline services and travel distribution services markets.

8..4 In particular, we support the submissions and recommendations of constraints to facilitate VBA entry by

- Securing access to essential aviation services;

- Limits to price and capacity changes by incumbents on routes where competition is introduced by a new entrant and on routes where the Alliance is established as the sole operator; and

- Divestment by Air NZ of its subsidiary VBA carrier Freedom.

8.4 However, we do not see divestment of Freedom to Virgin Blue, or simply to facilitate the entry of Virgin Blue to the trans Tasman and New Zealand markets as necessarily the best outcome from New Zealand's perspective.

8.5 This would expand Australian ownership and control of New Zealand airline services beyond the level that will be introduced by the Transaction and the formation of the Air NZ / Qantas Alliance and JAO.

8.6 This would see more of the profits on airline operations in the New Zealand market transferred to Australia to the detriment of New Zealand.

8.7 Acquisition and operation of Freedom by Virgin Blue, or its closure as a means of facilitating market entry by Virgin Blue, would be to the detriment of New Zealand as a whole.

8.8 Freedom, in independent New Zealand ownership, retains for New Zealand the benefits of

- profits and employment generated by the New Zealand-based VBA carrier;

- competition and the threat of competition for the JAO in the New Zealand domestic and trans Tasman markets; and

- the opportunity for an independent New Zealand owned and controlled carrier to enter the Australian domestic market, the Australasian short-haul international markets, and, ultimately, even the long-haul Australasian international markets in its own right or via alliances competing with the Air NZ / Qantas alliance and alliance partnerships.

- reduced risk to New Zealand in the event that other nations consider retaliatory action for joint Air NZ / Qantas operations in their air services markets that the Australian flag carrier is currently barred from operating in its own right.

8.9 Freedom, in independent New Zealand ownership, would not impair the ability of the proposed Alliance to deliver benefits to New Zealand and Australia from its strengthened participation in the global airline and travel services market.

8.10 Freedom, in independent New Zealand ownership, would not impair Virgin Blue's ability to develop its competitive position in the Australian market in the face of stronger competition from the Alliance.

8.11 Freedom, in independent New Zealand ownership, could present the Australian-based VBA with a lower risk means of accessing the trans Tasman and New Zealand domestic markets in the face of stronger competition from the Alliance in these markets.

8.12 The Parties to this Submission stand ready to facilitate the divestment of Freedom into independent New Zealand ownership and operation, as interested purchasers.