COMMERCE ACT 1986: RESTRICTIVE TRADE PRACTICE
SECTION 58: NOTICE SEEKING AUTHORISATION

Date: 9 December 2002

The Registrar
Business Acquisitions and Authorisations
Commerce Commission
PO Box 2351
WELLINGTON

AIR NEW ZEALAND LIMITED AND QANTAS AIRWAYS LIMITED

Pursuant to s 58 of the Commerce Act 1986 notice is hereby given seeking **authorisation** of certain restrictive trade practices.

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EXECUTIVE SUMMARY

The Application

This is an Application by Air New Zealand Limited and Qantas Airways Limited seeking authorisation to implement the terms of a Strategic Alliance arrangement. A separate Application seeking authorisation for Qantas to subscribe for up to 22.5% of Air New Zealand's voting equity is filed simultaneously with this Application. The documents underlying each application are inter-conditional.

Associated with the transactions is the right for Qantas to have up to two directors on the board of directors of Air New Zealand. In turn, Air New Zealand will be entitled to have one director on the board of Qantas, notwithstanding that it is not subscribing for shares in that company. This recognises that the Strategic Alliance will require clear and open communication between the parties. It also indicates the willingness of both airlines to take all steps to achieve the best outcome from their shared vision for the future.

The Strategic Alliance

The Strategic Alliance creates a Joint Airline Operation network (the JAO Networks) which, once fully implemented, will be commercially managed by Air New Zealand. However, the day to day flying operations will remain the responsibility of each airline. All Air New Zealand flights will be part of the JAO Networks, together with all Qantas flights into, within and departing from New Zealand. There are also extensive reciprocal rights for codesharing on each other's services. By way of example, this will enable Air New Zealand to obtain feeder traffic from codesharing on connecting flights on Qantas' Australian domestic and international networks.

In respect of the JAO Networks, the parties will co-ordinate pricing, capacity and all other aspects of the normal business operations of an airline. The two airlines also agree, as part of the Strategic Alliance, that where it is effective and efficient for them to do so, they will also co-ordinate on their non-JAO networks.

Air New Zealand's management of the JAO Networks will be supported by a Strategic Alliance Advisory Group that comprises three representatives appointed by each airline. The decisions of that group are required to be unanimous. In simple terms, a recommendation of the Strategic Alliance Advisory Group will only result in a change in management direction when both Air New Zealand and Qantas agree that such a change should take place.

After taking into account the capacity of Air New Zealand and Qantas, each airline's net financial performance for the JAO Networks is compared to allow for the equitable allocation of benefits.

The Aviation Environment

The arrangements between Air New Zealand and Qantas are proposed at a time of unprecedented turmoil and mounting pressure for restructuring and consolidation in the international aviation industry.

Losses

2001 was only the second year in the modern history of civil aviation in which international air traffic declined. In 2001, member airlines of the International Air Transport Association (IATA) recorded a collective loss of some US$18 billion. The prospect for 2002 is for significant losses to continue. The events of 11 September 2001, which resulted in the US Government providing $US billions in loans and grants to the US industry only exacerbated already material pressures on the long-term profitability of the aviation industry. The European industry has experienced similar pressures. Together those two markets have already seen the bankruptcy of Sabena, Swissair and US Airways. There is still substantial fallout to follow, with United Airlines expected to file imminently for Chapter 11 bankruptcy protection. Other countries also have been forced to provide substantial financial support in order to maintain the viability of their flag carriers, including New Zealand (NZ$885 million to date). Air New Zealand's re-capitalisation was a direct result of these global pressures and the failure of Ansett, but was not directly related to the events of September 11. In this global environment, Air New Zealand and Qantas are individually small players; even together they represent less than 4% of the global aviation market.

Value Based Airlines (VBAs)

The ultimate failure of Ansett Australia is an example of the pressure full service airlines (FSAs) are facing from the dramatic growth of low cost, "no frills", point to point airlines such as Southwest, easyJet, Ryanair and Virgin Blue, operating on short haul routes.

Airlines such as Air New Zealand and Qantas operate a network business, in which impacts on individual routes have flow-on effects throughout the entire network. The network generally comprises a profitable "core" with less profitable fringes that are tolerated because of the contribution they make to the core. These "network effects" make traditional network airlines particularly susceptible to VBA entry, because the VBA enters as a "greenfield" operation with

no legacy costs, “cherry picks” the most profitable and busiest routes and, with costs already very low, commences competition with the incumbent FSA.

Despite best efforts by FSAs to reduce costs in order to compete with the VBA model, they have generally been unsuccessful; many costs are entrenched and others are essential to compete on long haul routes and to maintain a full network. The FSA finds itself losing market share on the very routes that are integral to the viability of its overall network.

The VBA has become an extremely successful business model in Europe and North America, and also in Australia where Virgin Blue’s entry precipitated the failure of the incumbent, long established and well-branded Ansett Australia.

In summary, the lesson to be taken from the global experience is that the VBA model will inevitably find its way onto the New Zealand domestic and trans-Tasman routes. The low barriers facing VBA entry into or expansion in Australasia, particularly in the context of the Single Aviation Market, undoubtedly support this message. Further, absent the Strategic Alliance, in a battle between two FSAs and a VBA, the Ansett Australia experience graphically demonstrates that in Australasia, the weaker FSA will quickly surrender its position in the market – it is impossible to fight the battle on both fronts.

Australasia

In September 1996, the Australian and New Zealand Governments entered into an “open skies” Memorandum of Understanding creating a Single Aviation Market for Australasia. As a result, the airlines that operate within Australasia see their home market as encompassing Australia, New Zealand and the trans-Tasman. However, this market is relatively small and neither of the local geographic regions can sustain two FSAs. Despite Air New Zealand recently restructuring its domestic operations in New Zealand as “NZ Express”, Air New Zealand still remains overall a full service airline and NZ Express is still in many respects a full service operation, but with some costs taken out. Any attempt to remove the remaining costs, i.e. to downsize “NZ Express” to a full VBA model, would be totally incompatible with the remainder of Air New Zealand’s international network, rendering that remainder unsustainable. From a business perspective, the international network is reliant on the domestic network. In that circumstance, and despite its New Zealand cost base being relatively efficient by international standards, Air New Zealand would cease to be the flag carrier promoting and supporting New Zealand’s tourism (6.6% of GDP) and export industries – both crucial to New Zealand’s economy.

Why the transaction?

Qantas and Air New Zealand, absent the Strategic Alliance, face a lengthy war of attrition for supremacy of the New Zealand based networks (i.e. domestic and key international routes from New Zealand). Air New Zealand is of the view that it cannot afford to surrender its domestic network without facing ultimate failure. Its domestic base is the core of its profitability, with most of its international routes feeding traffic to that domestic network. However, the international routes are inadequately profitable other than as part of the overall network. Absent the Strategic Alliance, the war of attrition would be unavoidable. While Air New Zealand's domestic New Zealand routes are profitable (assisted by international feed), those of Qantas presently are not (on a standalone basis). In order to reverse that position, Qantas must increase its capacity in domestic New Zealand in order to provide frequency for the higher yield passengers – expansion by Qantas is commercially rational.

The increase in capacity and resulting battle for customers will ultimately result in one of the two FSAs leaving the New Zealand market. There is an insufficient customer base to allow two FSAs to survive. Air New Zealand is not well placed to win that battle nor does it have the financial resources to signal to Qantas that it can successfully engage in a long-term fight for market share.

The Strategic Alliance, while undoubtedly having competitive impacts in domestic New Zealand and on the trans-Tasman, will avoid the need for, and the consequences of, a war of attrition. The Strategic Alliance will enable Air New Zealand to maintain its operations both domestically and internationally. It will place both carriers on a more secure foundation from which to manage external "shocks", ranging from international conflicts to fuel price increases or foreign exchange fluctuations.

A one-off equity injection, absent a robust strategy that resolves the industry problems for Air New Zealand, does not provide an answer. Nor does an alliance with another airline, which simply expands Air New Zealand's international network outside of Australasia. The problem lies much closer to home. The Strategic Alliance provides the only solution. The Strategic Alliance avoids a wasteful duplication of resources and achieves material benefits for New Zealand. In contrast, the war of attrition and its consequences deny New Zealand the major benefits that flow from the Strategic Alliance. Those benefits include the retention of a viable New Zealand majority owned and controlled flag carrier.

The Benefits

There is anti-competitive detriment associated with the Strategic Alliance. It is for that very reason that the two airlines now seek authorisation from the Commission. However, the

Strategic Alliance will create substantial and demonstrable net benefits overall. The benefits to New Zealand from the Strategic Alliance, assuming VBA entry, exceed the detriment by over NZ$1.4 billion over five years. Even assuming no VBA entry, the net benefits to New Zealand over the same period are in excess of NZ$1.2 billion. Those benefits, tested against the future world without the transaction (and not the world as it now is), flow from:

- increased tourism;
- increased engineering services;
- increased freight capacity;
- cost savings;
- new direct flights; and
- enhanced connectivity.

The benefits and detriments have been modelled and extensively tested in a report prepared by Network Economics Consulting Group Pty Limited, an expert Canberra-based economic consulting group with considerable experience in network industries. The benefits disclosed in that report clearly overwhelm the modelled detriment. On that basis, the Applicants request the Commission to grant authorisation as sought.

PART I: APPLICATION DETAILS

Applicants

1. This is an application by Air New Zealand Limited (**Air New Zealand**) and Qantas Airways Limited (**Qantas**), (together the **Applicants**) to enter into the Strategic Alliance Agreement and certain Related Agreements (as defined in the Glossary) and to give effect to the provisions of those agreements (together the Strategic Alliance Agreement and the Related Agreements called the **Transactions**), but excluding the Related Agreements and their provisions to the extent that they relate solely to the acquisition of equity interests in Air New Zealand by Qantas and which are the subject of a separate application for authorisation under section 67 of the Commerce Act 1986 (the **Equity Proposal**). This application being referred to as the **Application**.

   The Transactions include practices of a kind described in section 58 of the Commerce Act 1986 (the **Commerce Act**).

2. The Applicants request that all correspondence and notices in respect of this application be directed in the first instance to:

For Air New Zealand -	For Qantas -
Bell Gully	Minter Ellison Rudd Watts
Royal & SunAlliance Centre	Bank of New Zealand Tower
48 Shortland Street	125 Queen St
PO Box 4199	PO Box 3798
Auckland	Auckland
Telephone: (09) 916 8800	Telephone: (09) 353 9700
Facsimile: (09) 916 8801	Facsimile: (09) 353 9701
Attention: Phil Taylor / Torrin Crowther	Attention: Andrew Peterson / Andrew Matthews
DDI: (09) 916 8940 / (09) 916 8621	DDI: (09) 353 9976 / (09) 353 9847
phil.taylor@bellgully.com torrin.crowther@bellgully.com	andrew.peterson@minterellison.co.nz andrew.matthews@minterellison.co.nz

The contact details of Air New Zealand are as follows:	The contact details of Qantas are as follows:
Air New Zealand Limited	Qantas Airways Limited
19th Floor, Quay Towers	Qantas Central Building A/9
Corner Lower Albert & Customs Street	203 Coward Street
Private Bag 92007	Mascot NSW 2020
Auckland	Australia
Telephone: (09) 336 2400	Telephone: (+61) 2 9691 3456
Facsimile: (09) 336 2765	Facsimile: (+61) 2 9691 3339
Attention: John Blair, General Counsel and Company Secretary	Attention: Brett Johnson, General Counsel and Company Secretary

Introduction

Application for Authorisation

3. This application is made pursuant to section 58 of the Commerce Act 1986 seeking authorisation for the Applicants to enter into and give effect to the provisions of the collaborative arrangements more particularly described in paragraphs 18-29 below (the **Strategic Alliance**).

4. A further application for clearance or authorisation of the acquisition by Qantas of ordinary shares comprising up to 22.5% of the voting equity interest in Air New Zealand (the **Equity Proposal**) accompanies this application. The Strategic Alliance and the Equity Proposal together are referred to as the **Transactions**.

5. The public benefits from the Transactions are substantial, and significantly outweigh any competitive detriment. A detailed economic analysis of the public benefits is set out in the NECG Report dated 8 December 2002. The Transactions therefore qualify for authorisation under section 58 of the Commerce Act.

Scope and Terms of Authorisation

6. The Transactions combine the long-term Strategic Alliance with the Equity Proposal. Given that equity relationship and therefore the over-riding structural nature of the arrangements, the Applicants propose that there not be a time limitation placed on the authorisation of the Strategic Alliance.

7. The Strategic Alliance has no contractual prescribed termination date. Rather, it provides a right for the parties to terminate the agreement, but not before the expiry of four years from the date on which the Strategic Alliance is authorised, and only then on twelve months' notice from the expiry of the minimum time period (effectively five years).

8. A time limitation on the authorisation would restrict the ability of the parties to drive for long term efficiencies (beyond the initial five-year period discussed above).

Affected Parties

Directly Affected Parties

9. The companies directly affected by the trade practices are Air New Zealand and Qantas, and their respective subsidiaries.

10. The business operations and organisation structure of Air New Zealand and of Qantas are described in Schedules 1 and 2 respectively. The 2002 Annual Reports of Air New Zealand and Qantas are available at www.airnz.co.nz and www.qantas.com.au respectively.

11. Any effect on participants in the markets and associated industries are discussed in the Application and supporting evidence.

Other Affected Parties

12. There are no other parties likely to be affected by the trade practices (in terms of section 58B(2) of the Commerce Act).

Conditionality

13. Section 59 of the Commerce Act does not prevent the Commerce Commission (the **Commission**) from granting this application.

14. The Strategic Alliance Agreement is conditional (inter alia) upon:

    (a) authorisation being granted by the Commission and the Australian Competition and Consumer Commission (the **ACCC**) for performance of the Strategic Alliance;

    (b) obtaining Kiwi Shareholder approval (as required by Air New Zealand's Constitution); and

    (c) the Subscription Agreement becoming unconditional (clause 8.1(c)) in all respects including clearance or authorisation being granted by the Commission and the ACCC (together the **Commissions**) for the acquisition by Qantas of convertible notes and ordinary shares comprising in total, a voting equity interest in Air New Zealand not exceeding 22.5% of Air New Zealand's enlarged voting equity in accordance with the Subscription Agreement. The Subscription Agreement is more fully described in the application for authorisation of Equity Proposal by the Commission filed jointly with this Application and the Strategic Alliance Agreement authorisation application filed with the ACCC.

15. Implementation of the Strategic Alliance Agreement is also subject to:

    (a) the Treasurer of Australia consenting to the Applicants' entry into the Transactions under the Foreign Acquisitions and Takeovers Act 1975 of Australia or the Treasurer ceasing to become empowered to make any order under Part II of

Foreign Acquisitions and Takeovers Act in relation to the Applicants' entry into the transactions because of lapse of time (Clause 8.1(b)); and

(b) Air New Zealand obtaining Air New Zealand Shareholder approval. (Clause 8.1(e))

16. Some aspects of the implementation of some parts of the Transactions may give rise to competition issues in other jurisdictions and applications, where necessary, will be filed in respect of those jurisdictions.

Commission Jurisdiction

17. The Commission has jurisdiction to determine this Application. This is because the Transactions give rise to a lessening of competition due to their competition effects in certain markets and because they provide for activity which, absent authorisation, would be a deemed breach of section 27 via section 30 of the Commerce Act.

Transactions

Strategic Alliance Agreement

18. Under the Strategic Alliance Agreement, the Applicants agree to form a strategic alliance under which they will co-operate and co-ordinate various aspects of their respective businesses. The primary provisions of the Strategic Alliance Agreement contain an agreement by Air New Zealand and Qantas to implement Joint Airline Operations (**JAO**) under which they will co-ordinate pricing and scheduling activities in respect of all flights operated by Air New Zealand (both domestic New Zealand and international) and all Qantas operated flights that arrive in, depart from or operate within New Zealand (together, the **JAO Networks**). Currently, the parties do not intend to co-ordinate their sales, marketing and customer service operations, although the agreement provides for co-ordination to extend to these functions.

19. Once certain operational conditions are satisfied, Air New Zealand will manage the commercial aspects of the JAO Networks in accordance with agreed governance principles set out in the Strategic Alliance Agreement. However, each Applicant remains responsible for the day-to-day flight operations of its respective network that forms part of the JAO Networks. Qantas will participate in the management of the JAO Networks through its representation on a Strategic Alliance Advisory Group (**SAAG**) and four to six Qantas secondees to Air New Zealand commercial management teams. The SAAG will consist of three representatives from each Applicant and will review and endorse for reference to the Chief Executive Officers of each Applicant the commercial planning,

operations and performance of the JAO Networks and provide advice to Air New Zealand as manager of the JAO Networks. All decisions of the SAAG require the unanimous agreement of those representatives from each airline present at each meeting. A quorum requires a minimum of two representatives from each airline. (Clauses 4.2 and 4.3)

20. One of the objectives of Air New Zealand as commercial manager of the JAO Networks is to make the parties equitably profitable (after allowing for agreed capacity charges for each party) in relation to the JAO Networks. Air New Zealand may be entitled to a management fee from, or be required to make an adjustment payment to, Qantas, depending on the outcome of Air NZ's commercial management of the JAO Networks, as determined in accordance with a specified formula. (Clause 4.4 and Schedule 3)

21. The Strategic Alliance Agreement includes restrictive covenants under which Air New Zealand agrees not to operate flights on any sectors that arrive at or depart from airports in Australia (other than trans-Tasman flights and its existing Sydney-Los Angeles service) and Qantas agrees not to operate flights on any sectors that arrive at or depart from airports in New Zealand (in either case) except as part of the JAO Networks. Outside of these restrictions, either Applicant may operate freely provided that where one Applicant wants to commence operating on a sector already flown by the other, it must first discuss its intentions with the other Applicant through SAAG. (Clauses 10.1 and 10.2)

22. Air New Zealand and Qantas may, in time, move to become members of the same global airline alliance.

23. The Strategic Alliance Agreement is for a term of not less than five years following the later of either the "Effective Date" (essentially the date on which Air New Zealand shareholder approval is received, or the date on which Air New Zealand is no longer subject to the provisions of certain agreements between it and United Airlines (the **United Agreements**), including a 12 month termination period (clause 11.6, and side letter between the Applicants dated 27 November 2002)

24. No aspects of the Strategic Alliance Agreement will be implemented if to do so amounts to a breach by Air New Zealand of its obligations under alliance agreements with other airlines.

Co-ordination of JAO Networks

25. Qantas and Air New Zealand will co-ordinate the following services and activities in respect of the JAO Networks:

(a) All aspects of the pricing of the Applicants' passenger and freight services, including setting fares, rebates, levies and promotions, level of service fees, development of new fare products, pricing and promotions of holiday destinations, commissions and agency incentives and joint tendering for corporate and government accounts. The Applicants will also co-ordinate procedures for pricing and inventory management. (Clause 5.2)

(b) Exchange of information on schedules, financial information, pricing, yields, seat availability, sales and other information to enable co-ordination of the aspects of the parties respective businesses referred to in (i) above. (Clause 5.3)

(c) Operations, routing, capacity, frequencies, aircraft types, connection requirements and range of times for any service provided as part of the JAO Networks. (Clause 5.4)

(d) Reciprocal Codeshare rights with each other for flights operated as part of the JAO Networks. Air New Zealand will also be able to codeshare on flights operated by Qantas that are not part of the JAO Networks where such flights reasonably connect to JAO Network flights. (Clause 5.5)

(e) Enter into Special Pro Rate Agreements on terms no less favourable than the terms offered by an Applicant to a member of the global airline alliance of which that Applicant is a member, or, in the case of Freedom Air, until Freedom Air's business model permits a Pro Rate Agreement, the provision of blocked space seats on Freedom Air flights on terms no less favourable than offered by Freedom Air to third parties. (Clause 5.6)

(f) Facilitate Qantas Holidays' maximising the provision of new tourism products which utilise the JAO Networks and promote New Zealand and Australia as a dual destination. (Clause 5.7)

(g) Subject to existing contractual restrictions, co-ordinate respective freight operations to improve the scope and availability of freight services. (Clause 5.8)

(h) Rights for members of each Applicant's frequent flyer programmes to accrue and redeem frequent flyer points on flights operated by the other. (Clause 5.10)

(i) Co-operate and give priority to the display of each other's flights on their respective reservation systems. (Clause 5.11)

26. Currently, the Applicants do not intend to integrate their sales and marketing functions. However, the agreement provides that the parties may also co-ordinate of sales and marketing functions which also may include co-branded offices, co-locating facilities and staff, common general sales agents, joint promotions, co-ordinated incentive programmes, treating all Qantas and Air New Zealand passengers and freight as being equivalent and providing equivalent customer service to the other Applicant's customers in locations and situations where that Applicant is unable to offer customer service facilities. (Clause 5.9)

Alliance Co-operation (Non-JAO business)

27. In addition to the co-operation regarding the JAO Networks, Air New Zealand and Qantas also agree to, where it is efficient and beneficial to do so, co-operate and co-ordinate scheduling and pricing and take any action contemplated by the Strategic Alliance Agreement in relation to non-JAO business. Specifically, the Applicants:

(i) will co-operate in order to deliver additional benefits to each other's customers and frequent flyers (Clause 6.2);

(ii) will co-operate in the identification and development of new consumer benefits, products, services and pricing strategies (Clause 6.4);

(iii) will liase with each other regarding fleet planning, flight operations, strategies (Clause 6.5);

(iv) will develop and implement additional safety and security policies and co-operate on flight disruption and emergency planning and procedures (Clause 6.7);

(v) will explore joint purchasing options and may negotiate with suppliers on behalf of each other as expressly agreed from time to time (Clause 6.8);

(vi) may co-operate in relation to in-flight services (Clause 6.3);

(vii) may co-ordinate in respect of the information technology systems and requirements (Clause 6.6);

(viii) may pursue joint human resource activities (Clause 6.9); and

(ix) subject to any agreement Air New Zealand has with other airlines, may operate joint ground services (such as airport lounges, check-in facilities and baggage handling) (Clause 6.10).

28. A confidential copy of the Strategic Alliance Agreement is attached to this application as Confidential Appendix 1.

Related Agreements

29. The Applicants have also entered into a:

(a) Subscription Agreement, under which Qantas will, subject to the satisfaction of certain conditions, subscribe for up to 22.5% of Air New Zealand's expanded voting equity;

(b) Co-ordination Agreement, which records how the Applicants will co-ordinate the process of obtaining the various approvals and consents required to satisfy the conditions precedent to the Strategic Alliance Agreement and Subscription Agreement;

(c) Sell Down and Voting Restriction Deed, which records certain agreements relating to Qantas' shareholding in Air New Zealand;

(d) Transition Deed, which sets out a process by which the Applicants will agree on, and move to, the same global airline alliance;

(e) Reciprocal Board Representation Deed, which records the rights of each Applicant to nominate directors to the other's board of directors; and

(f) Top-Up Deed, which confers on Qantas the right to participate in issues of securities made by Air New Zealand.

(together the **Related Agreements**).

Attached as Appendix 1 are copies of the Related Agreements.

PART II: MARKET AND COMPETITION CONSIDERATIONS

CONTEXT OF THIS APPLICATION

30. This section details the context in which the Transactions should be considered. The section briefly outlines the global aviation environment with respect to airline industry deregulation, the impact of changing market conditions, and the development of VBAs. It then describes the factors in the Australasian market which have led to the proposed relationship between Air New Zealand and Qantas.

31. By way of background and for the assistance of the Commission, Schedule 3 provides a description of various industry practices and information relating to:

    (a) International "Freedoms" and "Bilaterals";

    (b) Air Services Arrangements;

    (c) Codesharing and the role of the Minister of Transport;

    (d) IATA and international tariff co-ordination;

    (e) Airline booking systems;

    (f) Airline and airport codes;

    (g) Aircraft description and relevant information; and

    (h) Sales methodology and revenue management.

Global Aviation Environment

32. The Applicants are operating in an increasingly competitive and uncertain global environment.

Regulatory Environment

33. Domestic and international air services have traditionally been highly regulated. The *Convention on International Civil Aviation* 1944 (Chicago Convention) enshrines the principles of a nation's sovereignty over its airspace and its right to stop foreign aircraft from entering that airspace. International scheduled commercial air traffic is made possible only by bilateral air services agreements (**Bilaterals**) in which governments

typically exchange air rights (**Freedoms**) for the benefit of their respective carriers. (For a detailed explanation of Bilaterals and Freedoms see Schedule 3(a).)

34. The regulatory requirements in Bilaterals requiring national ownership/control, and the restrictions on the traffic rights of foreign airlines limit any one airline's ability to expand its network and impede the formation of an international route system. The rules on the nationality of ownership of airlines in most cases prevent international mergers/takeovers to link networks, in addition to restricting efficiency enhancing mergers.

35. The Productivity Commission in Australia has commented on the inefficiencies generated by the regulatory system under which airlines operate:[1]

> "The regulatory system affects where, how and when airlines can fly. Thus it affects airlines' ability to operate efficient networks and their revenue... to the extent that airlines cannot use the least cost combinations of aircraft types to carry passengers and freight, the costs of operating existing networks are higher than they otherwise might be (technical inefficiency). Further, they may be prevented from flying the optimum sized and configured network (allocative inefficiency). Thus, costs may be reduced as airlines are able to operate the right aircraft at the right frequencies on an existing route. Airlines, by changing the design of a network and increasing its size, may also be able to decrease costs through economies of scale and scope."[2]

36. The Productivity Commission also commented specifically on the impact that the ownership and control restrictions in bilaterals have on the achievement of airline efficiencies:

> "The major effect of ownership and control restrictions is to prevent the merger and acquisition of international airlines across national boundaries. Consequently, airlines are constrained in achieving the efficiency benefits of operating a large and potentially better integrated business.
>
> "Growth through merger or acquisition enables airlines to achieve economies of scale and scope by consolidating airline functions. The merger of two airlines, for example, may allow them to consolidate their ground handling, maintenance, information technology and various managerial functions.
>
> "Restrictions on foreign investment in airlines and their ability to merge have prompted airlines to seek other ways of achieving the same benefits... The use of alliances and codesharing has grown in recent years as a means of minimising airline costs, extending market reach and increasing airline profitability." [3]

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1 Industry Commission Report, *The Economic Impact of International Alliances*, May 1997

2 Productivity Commission, *International Air Services - Inquiry Report* No. 2 11 September 1998 page 108

3 Productivity Commission, *International Air Services - Inquiry Report* No. 2 11 September 1998 page 108

37. However, significant deregulation and liberalisation has occurred in recent years. In addition to strictly unilateral initiatives, developments such as "open skies" agreements have, at least in some respects, overcome some of the restrictions created by the bilateral system.

Airline Alliances

38. This trend to market liberalisation has been accompanied by a significant structural change in the airline industry, including the emergence of global airline marketing alliances. The intense competition in the aviation industry, combined with international airlines' quest for "presence" on a broad network in light of the restrictive Bilaterals, is the driving force behind most of the co-operative agreements that exist among international airlines.

39. Economies of scale can be achieved when airlines jointly purchase fuel or aircraft, or when jointly owned machinery and other assets are used for more hours each day, thereby reducing the per-hour cost. Cost savings also flow from reducing duplication of facilities by sharing customer lounges, check-in facilities, information technology and ticket offices. A recent analysis by Credit Suisse First Boston concluded that, to date, alliances have placed more emphasis on realising sales and marketing benefits from the alliance rather than achieving cost savings.[4]

40. Alliances also provide airlines with a better ability to satisfy customer needs in terms of services, facilities and network capabilities. The expansion in the number of airline alliances, and the expansion in and co-operation between individual airlines or groups of airlines was explained by Joos Stragier[5] in a paper presented at the 13th Annual Conference of the European Air Law Association as follows:

> "Air carriers in Europe also recognise that they will need to expand beyond their national home markets, through mergers and acquisitions, in order to build up larger networks and gain economies of scale. However, the current system of bilateral agreements for international air services with its nationality restrictions and designation rules and general restrictions as far as foreign ownership of airlines is concerned are clear handicaps for this natural process to take place. In this context airline alliances have come up as a partial and provisional answer to the need for restructuring and consolidation." [6]

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4 Credit Suisse First Boston (May 2002), Airline Alliances, page 26

5 Head of Transport Unit, DG Competition, EC Commission

6 Paper presented by Joos Stragier at the 13th Annual Conference of the European Air Law Association, Zurich, Friday 9 November 2001 (Annexure B)

41. As recognised by the ACCC in its consideration of the Restated Joint Services Agreement between Qantas and British Airways plc (the **RJSA**),[7] it is possible to distinguish between two types of alliance: "marketing" alliances and "integrated" alliances.

42. Marketing alliances are directed at improving the international air service product available to consumers, by linking or combining various services available from each member airline. They usually involve codeshare or interline arrangements, reciprocal frequent flyer and lounge access arrangements. Under a marketing alliance, each member airline continues independently to pursue its own corporate strategy, determine its own prices, schedules and service levels and manage its own yield and capacity levels. The "Star Alliance" and the "**one**world" alliance are both marketing alliances.

43. Integrated alliances are designed to produce fully integrated airline networks. The recent Lufthansa/Austrian Airlines alliance is a case in point. To do this, the airlines must co-ordinate network-wide activities including prices, schedules, service levels and revenue and capacity management. This level of co-ordination enables the member airlines to present a single network that is centrally controlled by the alliance. The Transactions will create an integrated alliance between Air New Zealand and Qantas.

44. Although both marketing and integrated alliances share a common objective, the competitive impact and the benefits that can be derived from the alliances differ, due to the different degrees of co-ordination involved. Integrated alliances, with their close co-ordination, tend to offer greater benefits.

45. Yergin et al (2000) state that while there are significant benefits from all airline alliances, less integrated alliances may not encourage efficient investments or may impose other costs, such as transaction costs, that could be avoided through full integration.[8] Tretheway (1990) agrees that, from an operational point of view, full corporate merger is the optimal form of consolidation.[9] The Applicants appreciate that in this case, a full corporate merger is not possible under the existing environment.

46. While recognising that airline alliances are a valid means of ameliorating the regulatory and legal barriers that remain, commentators such as Yergin et al (2000) believe that consolidation is required in order to achieve economies of scope and scale, and can also

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7 *Joint Services Agreement between Qantas Airways Limited and British Airways Plc* (2000) ATPR (Com) 50-280

8 Yergin et al *Fettered Flight: Globalization And The Airline Industry* unpublished November 2000, page 60

9 Tretheway, "Globalization of the Airline Industry and Implications for Canada" 26 *Logistics and Transportation Review* at 362 and 363 (1990), page 362 Quoted in NECG Report at [**notes 22 and 23]**

facilitate further innovation. Equity participation, in conjunction with an alliance, creates incentives for joint efficiency maximisation. An equity participation in Air New Zealand by Qantas ensures that Qantas has an ongoing interest in the efficient use of Air New Zealand's assets.

47. For a further discussion of the role of equity stakes in strategic alliances, refer to the NECG Report.

Economic Downturn and Fall in Demand

48. Due to the capital intensive and fragmented nature of the aviation industry, operating an airline has traditionally been a high cost/low margin enterprise and profitability has been an issue for participants.[10] This low profitability has always left airlines vulnerable to sudden cost shocks or events leading to reduced demand for services. The major costs faced by airlines are fuel, labour, aircraft depreciation or leasing, overhead and distribution. Importantly, airlines face significant volatility in exchange rates, the price of aviation fuel and as recent world events have illustrated, volatility in passenger demand. This volatility is an ongoing issue for airlines – for instance, a war with Iraq would be likely to have a significant effect on fuel prices, foreign exchange rates and passenger demand for air travel. Commentators note that throughout most of the business cycle in the period 1990-2000, the industry was unable to earn a return in excess of the cost of capital.[11] Indeed, during the 1990s eight European airlines - Sabena, Iberia, Aer Lingus, TAP, Air France, Olympic Airways and Alitalia - all received public funds to maintain their viability. In the United States, Continental sought the protection of Chapter 11 (and has since restructured). However, Continental's successful restructuring contributed to the contraction of US Airways (now in Chapter 11 bankruptcy). Eastern Airlines was bankrupt and eventually closed in 1991. Pan Am sold its European routes to Delta in 1991, shortly after Pan Am entered bankruptcy.

49. Early in 2001, the economic slowdown in the United States left a number of airlines in a vulnerable position. The steep decline in yields due to the shrinkage of corporate sector travel and increased price sensitivity of the corporate and leisure sectors, combined with generally increasing unit costs, meant that only those airlines whose unit costs were low remained profitable.[12]

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10 "The unpalatable truth", November 22 2001, Economist.

11 Stern Stewart (in conjunction with Morgan Stanley Dean Witter) Economic Review of 11 North American airlines - September 2000

12 "Getting it wrong: Yields down, costs up" Aviation Week & Space technology, New York, July 30, 2001

50. The events of 11 September 2001 in the United States (**September 11**) triggered a further substantial and sudden fall in demand for air travel, and the ensuring security precautions and insurance premiums increased airlines' operational costs. These events, combined with the pre-existing market conditions, were the catalyst for structural change in the aviation industry, including:

    (a) the failure of well established airlines, including Swissair, Sabena and to an extent Ansett Australia; and

    (b) the continued, rapid growth of VBAs on short-haul routes at the expense of full service airlines on the same routes, with a flow-on effect to the wider network.

51. The United States Air Transport Stabilzation Board has subsidised United States carriers US$ billions in an effort to resolve the vulnerability of those airlines to collapse. United Airlines hovers near Chapter 11 bankruptcy.

52. Since September 11, United States carriers collectively have been unable to regain the high-yield passengers whose flying habits have changed dramatically. Prior to September 11, high-fare business passengers accounted for around 40% of passengers but two-thirds of revenue, an equation that has been significantly changed, perhaps permanently. September 11 and the resultant security delays have caused a significant portion of high-yield passengers to turn instead to video-conferencing, trains and cars, while the business downturn has led to greater business passenger price sensitivity.

53. In Europe, the problems are similar. Post-September 11, Sabena and Swissair filed for bankruptcy protection, and are now in liquidation. British Airways has experienced record losses and is reportedly considering all available options including major downsizing. The future of Aer Lingus is very much in doubt, Alitalia, SAS and KLM have suffered large losses. The major airlines have structural problems in terms of high and rigid labour costs, inflexibility and declining numbers of high-yield passengers, and they face fierce low-fare competition from an increasingly aggressive, profitable and easily-capitalised group of VBAs.

54. In South-East Asia, Malaysia Airlines has recently also been re-capitalised by the Malaysian government.

Competition From VBAs

55. FSAs, faced with the decline in high yield revenue, now have to prepare for and manage the entry and potential entry of airlines adopting a low cost 'value based' business model.

VBAs utilise their lower cost base to drive low fares and maximise profits. Low fares also stimulate demand for VBA services on routes that fit their business model. These routes are typically short-haul, point to point routes that can be operated by a Boeing 737 or equivalent narrow-body aircraft, such as the Airbus A320.

56. Compared to a full service network operator, the VBA is lean and opportunistic. The classic low cost, no frills VBA models are those of Southwest Airlines (USA), and easyJet and Ryanair (UK/Europe). No two VBAs are the same, although successful VBAs incorporate a majority of the following cost saving measures in their business model:

(a) no 'frills' (no "free" on-board meals or beverages, executive lounges, priority check-in, frequent flyer programmes etc.);

(b) a single aircraft type (many VBAs have a young fleet);

(c) concentration on short-haul, point to point travel, (although new generation aircraft are extending the range serviced by VBAs);

(d) a high proportion of direct ticket sales (which ensures VBAs are not necessarily reliant on, or captive to, third-party distributors and the associated higher distribution costs);

(e) higher aircraft and staff utilisation, achieved via a range of the following:

(i) single class of seats, which increases seats per plane;

(ii) no heated food, which means the aircraft does not require a galley, allowing more seats, fewer cabin staff, and weight and cost reduction;

(iii) faster turnaround time, by virtue of a combination of all or some of:

- no interlining or codesharing – aircraft do not have to wait for connecting inbound services;
- utilising un-congested, secondary airports, which reduces the risk of delays and taxi time;
- not carrying freight (which takes time to unload);
- not offering on-board catering facilities, which take time to load; and

- not having a seating allocation, which encourages a faster check-in;

(f) a positive corporate culture;

(g) the opportunistic use of secondary airports, which generally have lower landing and other charges, and will give priority to the VBA operations; and

(h) a high level of outsourcing of maintenance and other operations.

57. In relation to VBAs' low cost structures, it was reported in 1988 that total domestic operating costs in cents per available seat mile for FSAs, in the United States, adjusted for distance, ranged from 9.8 cents for Delta to 11.3 cents for American Airlines. At the same time, costs for the VBAs, Southwest, Frontier and JetBlue were 7.3, 9.2 and 6.9 cents respectively.[13]

58. The effect of VBA presence on fares is significant. The US DOT reported that, in 1997, short-haul routes with a VBA presence had a nominal average fare of US$84, while those without a direct or associated VBA presence, had a nominal average fare of US$175.[14] The price difference described by the DOT is between routes with and without a direct "or associated" VBA presence. The US DOT found that there is economic evidence that price reductions also occur on neighbouring routes to those on which the VBA enters directly.

59. While the success of VBAs derives in part because their low fares have attracted new customers into the market, it often comes at the particular expense of weaker FSAs. In smaller markets, where the amount of high-yield traffic has proved insufficient to sustain more than one full service network carrier, the VBAs have displaced the second-line majors, which are frequently forced from the market by their high, and significantly entrenched, costs and a shrinking revenue base as they price to compete with the VBA. In Australia, Virgin Blue effectively replaced Ansett, while in Canada, WestJet replaced Canadian Airlines. In the United States, the successful expansion of Southwest contributed significantly to the decline, and ultimate Chapter 11, of US Airways.

60. While it has been accepted that VBAs tend to target customers that are relatively more price sensitive, many successful VBAs, such as Virgin Blue, are also targeting business customers, thereby further eroding the traditional profitability arising from the customer base of the major carriers. Brett Godfrey, CEO of Virgin Blue stated in November 2000:

> "We are very much focussed now on the business market as well. We're focussed on all markets and we're pricing accordingly"[15]

and in mid 2002:

> "There are a hell of a lot of people getting off aircraft at 7am in Sydney, and they're all wearing suits."[16]

61. easyJet notes that on some routes/services corporate traffic comprises more than 50% of the customers carried.

62. For a more detailed examination of VBAs and of these impacts on the Relevant Markets see the NECG Report.

Australasian Aviation Environment

63. The Australasian market mirrors the global aviation environment. Within this market, the Applicants have independently reached the view that steps need to be taken to address the problems associated with the environment. In order to maintain a level of sustainable profitability while maintaining their existing networks, the airlines must focus on radically reducing costs and achieving other efficiencies. Each has concluded that objective cannot be achieved absent the Transactions. They must prepare for the arrival of VBA airlines operating in their domestic markets, and on their trans-Tasman and other short-haul international routes. That has already occurred in Australia with the commencement of Virgin Blue, contributing to the much-publicised demise of Ansett Australia. Virgin Blue is preparing for its entry into domestic New Zealand and the trans-Tasman. (See paragraph 284 for further discussion on Virgin Blue and Schedule 5 for comments made by Virgin Blue.)

64. In response to the threat of VBA expansion and to the presence of Qantas, Air New Zealand has already commenced restructuring, adopting a "VBA+" model in domestic New Zealand. From Qantas' perspective, while it expects that its operations in New Zealand will continue, and even expand, it is apparent that the current situation is not optimal for Qantas. Qantas' New Zealand operations are very important to its network, and although they make a positive contribution to its network, the New Zealand routes

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13 Centre for Asia Pacific Aviation *Low cost Airlines in the Asia Pacific Region* page 61 Can be found at www.centrefor aviation.com

14 U.S. DOT *Competition in the U.S. Airline Industry: The Need for a Policy to Prevent Unfair Practices* (2001), page 3

15 ninemsn, Business Sunday Interview: Brett Godfrey, CEO, Virgin Blue, 26 November, 2000, http://finance.ninemsn.com.au/businesssunday/Interviews/stories/story_1317.asp.

16 Airline Business, June 2002

are currently losing money on a stand alone basis. The high risk of failure in many markets (international and domestic) and the uncertainty of strategic outcomes means that neither Air New Zealand nor Qantas can predict their likelihood of success with any degree of certainty. Indeed, NECG has predicted that in the absence of the Transactions, following a period of attrition, one of the airlines is likely to withdraw from a number of routes on which it currently operates.

65. Entry or expansion of a VBA in the New Zealand domestic or trans-Tasman routes could see Air New Zealand "squeezed" between the larger and profitable network carrier and the lower cost VBA in the same way as Ansett was squeezed in Australia. The prospect of Air New Zealand failing altogether cannot be discounted.

Regulatory Environment

66. Air services between Australia and New Zealand are among the most liberalised in the world.

67. Air services between the two countries were formalised on 8 August 2002, with the signing of an "open skies" air services agreement. This treaty formalises the Single Aviation Market arrangements signed by the countries in November 2000. The new treaty allows airlines of both countries to operate services beyond the other country, with flexibility over the routes adopted and the number of flights flown.

68. The "open skies agreement" encompasses the Single Aviation Market Arrangements signed in 1996, and replaces the 1961 agreement with Australia, which was New Zealand's oldest bilateral air services agreement. The effect of the Single Aviation Market is to create one Australasian market for the provision of passenger and freight air services.

69. No restrictions apply to an Australasian majority-owned and controlled airline in the Australasian markets. However, restrictions still apply to international airlines that do not meet the ownership and control pre-requisite – although even these restrictions are relatively liberal by world standards.

70. In order to minimise the inefficiencies and distortions of airline regulation, and obtain the maximum efficiencies from an alliance, the Applicants are seeking to integrate their operations to the extent provided through the structure of the Transactions. These Transactions further Australia and New Zealand's needs in terms of continuing to provide a regional network – and to expand that network – and are consistent with the New

Zealand and Australian Governments' policy objectives as reflected in the creation of the Single Aviation Market within and between Australia and New Zealand.

Implications for Australasia of Changing Market Conditions

71. Almost without exception, the world's largest and most successful international FSAs have implemented hub and spoke strategies from geographically advantageous locations central to high density markets. A hub and spoke strategy delivers a number of competitive advantages, chief among them being the ability to lower unit costs and increase yields by consolidating inbound traffic (arriving via the "spokes") at the "hub" thereby justifying the use of larger, more cost-effective aircraft to carry traffic to the next hub, where smaller, outbound aircraft deliver traffic to its ultimate destination. Examples of this strategy include Singapore Airlines (from Singapore), American Airlines (from Dallas) and Delta (from Atlanta).

72. Australia and New Zealand are positioned at the end of any network and their geographic locations are such that they do not form a natural central hub from which to materially expand beyond Australasia.

73. In addition, the smaller and more isolated population bases of Australia and New Zealand do not generate sufficient traffic density across enough routes to justify investment by an existing, international FSA in an expansive network across Australasia.

74. However, the Australasian geography does lend itself to the VBA business model. As discussed in the NECG Report, the typical VBA business model is based on flying point to point, on high density, short haul routes. A number of the Australasian domestic and local short-haul international routes are ideal for VBA entry and expansion.

Rationale

Introduction

75. FSAs operating in today's air transport markets face a dual challenge. They must continue to maximise revenue by offering customers increasing levels of network breadth. They must achieve this by building connectivity, starting new non-stop services, code-sharing, and interlining while also offering network depth through multiple frequencies in the highest demand city pairs. They also must maintain competition based on onboard product innovation, e.g. comfort, entertainment etc.

76. Just as FSAs are seeking to expand and secure their presence, FSAs face a threat that was, until recently, substantially overlooked, namely the emergence of aggressive, highly successful, airlines operating on a VBA business model. The VBA model offers low fares, generally courtesy of a very low cost base, driven by operating a rapid turn around point to point service, avoiding most low demand city pairs, adopting a single class offering, and utilising, a "greenfield" cost base. The model generally operates on short-haul routes, i.e. up to 5 hours, utilising narrow-body aircraft that are widely available.

77. The success of VBA entry internationally, and of Virgin Blue in Australia, provides cogent evidence that VBAs are able to establish themselves quickly and effectively. Experience also shows that the competitive constraints of VBAs are significant and extend beyond the reach of the specific routes serviced by VBAs. In addition, competition between VBAs and FSAs is much more intense than competition among FSAs, principally due to the VBAs much lower cost base and simplified fare structure. In contrast when FSAs lower prices to match rival FSA prices there is an inevitable shift in demand into the lower fare, reducing both companies' profitability. Attempt to gain business from any discounting remains viable only for so long as the discount is unmatched. The success of discounting as a means of gaining business is minimal as the response to match fares is typically swift.

78. Australia and New Zealand are "end of route" destinations. In addition, from a commercial perspective the Australasian market does not have a large enough base to support two sustainable FSAs with independent global networks. This is because of the relatively low number of destinations served non-stop, and because many of the Australasian city pairs which are currently supported by FSAs are too "thin" profitably to support more than one FSA network structure.

79. Nevertheless, the Australasian short-haul routes are ideally suited for VBA entry due to the fact that:

(a) there are a limited number of city pairs which comprise a high percentage of overall traffic. This permits a VBA to replicate very quickly that key part of the full service network; and

(b) consumers, both leisure customers and many business customers, give preference to price and frequency. This limits the effectiveness of FSA product differentiation including loyalty programmes, lounges, etc.

80. Australasia is among the most de-regulated aviation markets in the world, which compounds the limitations described above. In Australasian markets there are no material regulatory barriers to entry. There is an Open Skies arrangement between Australia and New Zealand and numerous Fifth Freedom operators provide services on the trans-Tasman with only marginal costs of providing these services.

81. A number of these Fifth Freedom operators are key global network competitors for Air New Zealand and Qantas. These airlines, however, mostly operate with natural geographic hub advantages and distorted market conditions and incentives that enable them to focus on expanding their international networks, insulated from market forces that would otherwise apply. Many such airlines – including Singapore Airlines, Thai Airways or Malaysian Airlines, already have a strong (and growing) presence in Australasia.

82. The Single Aviation Market created by the Australian and New Zealand Governments together with the relative closeness of the countries, has ensured that for the foreseeable future, Australian and New Zealand carriers are bound to perceive their home market to be Australasia, not national. Indeed, for Qantas, New Zealand is closer to Sydney than is Perth. It was the driver for Air New Zealand entering domestic Australia, eventually through the acquisition of Ansett Australia, and for Qantas entering the New Zealand main trunk routes. Virgin Blue clearly views the market place in the same way. Having commenced operations in Australia, Virgin Blue immediately announced its intention to enter the trans-Tasman and the New Zealand main trunk routes.

83. Qantas has determined that in order to achieve a sustainable base in the domestic New Zealand segment of the Australasian market, it must enlarge its current fleet of aircraft that are dedicated to this segment. This requirement is driven by the need to have sufficient frequency of flights to be attractive to customers, particularly high value business passengers. Given the particular importance of domestic New Zealand to Air New Zealand's operations, Air New Zealand would be forced to engage in a debilitating and expensive period of unsustainable competition.

84. The options for Air New Zealand are limited. Air New Zealand does not have the size or strength to wrestle with Qantas for the position of FSA of choice for Australasia. In addition, market conditions are conducive to VBA entry and growth, and Virgin Blue's presence in Australia means it already occupies an estimated 70% of the available Australasian VBA space.[17]

Air New Zealand's Specific Rationale

85. From Air New Zealand's perspective, the Transactions are a unique opportunity to remove the threat to its medium to long term viability and to remove the likelihood of material contraction of its international networks (which could otherwise only be maintained through continuing and extensive shareholder support). It is also the means to maintain a New Zealand owned and controlled flag carrier having the necessary incentives and capability to encourage tourism growth in New Zealand as well as providing increasing support for New Zealand's export industries. It provides an opportunity for Air New Zealand to regain feed from Australia which is important to its domestic New Zealand, trans-Tasman, and international networks.

86. Air New Zealand's ability to invest in necessary fleet upgrades, improved IT, etc. would be severely prejudiced without the Transactions – currently it is expected to achieve only around a 3% return on investment on its international operations. This is less than its cost of capital and therefore it is unsustainable.

Qantas' Specific Rationale

87. Qantas also sees itself vulnerable to pressure exerted on its markets by other international airlines, and by the VBA impact that it is already experiencing in the Australasian market. Despite Qantas' strong performance relative to industry peers at the moment, there is a risk of being marginalised by failing to recognise the extreme pressures on the global aviation industry, and also by failing to participate in global industry developments and compete effectively beyond the immediate region. For Qantas, the Transactions represent a unique opportunity to establish a significant airline grouping within Australasia and an important step towards securing Qantas' long term position as an Australasian based global network carrier.

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[17] In revenue terms, the Australian market is approximately 70% of the Australian, trans-Tasman and New Zealand markets combined

The Joint Rationale

88. From the perspective of both airlines, the Transactions provides a one-off window of opportunity to combine two strongly branded locally based international airlines into a sustainable regional airline group. If they do not achieve that combination now, it is unlikely that the opportunity will remain for the future. Damage from the ongoing battle to develop sustainable networks will substantially erode the benefits of an alliance available to New Zealand and Australia in the future. Air New Zealand's current negotiation strengths also will dissipate as it comes under renewed financial pressures.

89. For the Australian and New Zealand economies the Transactions are about maintaining dedicated flag carriers with strong international networks which are sustainable in the global markets and dedicated to advancing each country's important tourism and export industries. The Transactions will allow the airline industry to play a key role in developing and enhancing those industries.

COUNTERFACTUAL

Introduction

90. The Commission's approach to counterfactuals is well-established, and has been described by the Commission as follows:

> "… the Commission is required to assess the likely competitive effects of the arrangement, and any public benefits likely to result from the arrangement. This requires the Commission to determine a "benchmark" against which to measure the likely competitive effects and public benefits … this benchmark is the likely situation without the arrangement. That is, the Commission makes a "with" and "without" (the arrangement) comparison, rather than a "before" and "after" comparison.
>
> To assess the without, or "counterfactual", requires the Commission to ask itself what would be the likely situation if the arrangement did not exist, which is not necessarily the situation which might be preferred by the Commission or by others with an interest in the industry. … senior counsel … submitted that, in determining the counterfactual, the Commission must make a "pragmatic and commercial assessment of what is likely to occur in the absence of the proposed arrangements". The Commission accepts that submission."[18]

91. The Commission's Guidelines to the Analysis of Public Benefits and Detriments (the **Guidelines**) (subsequently withdrawn, but not yet replaced)[19] reinforce the fact that the assessment is "pragmatic and commercial".[20] This approach is supported by the Commission's reference in its recent Electricity Governance Board Decision, *Decision 473,* to the Occasional Paper 7, *The Evaluation of Public Benefits and Detriments under the Commerce Act 1986* (1998).

92. The Guidelines also referred to the status quo counterfactual and noted:

> *"However,* the markets in question are likely in the future to continue to adjust and change in a dynamic fashion both with and without *the acquisition, as will the parties themselves.* Such likely changes *, based upon industry knowledge and the submissions of industry participants,* have to be factored into the Commission's assessment*."*[21] (emphasis added)

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[18] Commerce Commission Decision No 277 of 30 January 1996 *Electricity Corporation of New Zealand Limited; Contact Energy Ltd and Electricity Market Company Ltd* and *Electricity Corporation of New Zealand Limited and Contact Energy*, para 82,83

[19] October 1994 (Revised December 1997). The Commission's web site states that the guideline "is being revised in line with the new legislation. Old Copies are no longer the Commission's view and should be kept for historical interest only."

[20] Commission's Guidelines to the Analysis of Public Benefits and Detriments page 10

[21] Commission's Guidelines to the Analysis of Public Benefits and Detriments page 10

93. In the absence of the Transactions, there are a number of potential counterfactuals which fall to be examined. This section outlines those counterfactuals and explains the justification for the counterfactual adopted in the Application and the NECG Report.

A network business

94. The economics of airline networks underpin the analysis of the relevant counterfactual. This is because Air New Zealand and Qantas operate a network service based on interconnectivity across a wide range of routes.

95. Because of the interdependence of the routes, changes in capacity or load factors on one sector necessarily affect the profitability of other sectors in the network. These effects can be illustrated by analysing the impact, for example, of Air New Zealand reducing capacity on, or exiting, the Los Angeles-–London sector:

   (a) Air New Zealand's Auckland-Los Angeles traffic would decrease, as customers requiring a connection to or from London would travel Auckland-London on an airline that provides carriage through to London or from London.[22]

   (b) Other airlines would commit additional capacity on the Los Angeles-London sector to fill the gap left by Air New Zealand.

   (c) Other airlines would commit additional capacity on the Auckland-Los Angeles sector in response to increased residual demand on the Auckland-London route.

   (d) Air New Zealand's share of Auckland-Los Angeles traffic could suffer a *secondary* loss, as those passengers who are now travelling on Air New Zealand, Auckland-Los Angeles, terminating in Los Angeles, have more opportunity to fly with the other airline. Given the similarity in long-haul product offerings, network carriers strenuously avoid creating a situation where a customer diverts to another carrier. This is not only because of foregone revenue for that flight, but also because of the risk that the customer would use the competing airline for future travel on other parts of the network.

   (e) There are flow on effects into domestic New Zealand and other parts of the Air New Zealand international network.

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22 Providing those carriers were price competitive.

Sustainability of more than one FSA network carrier

96. History has illustrated that the Australasian markets will not support more than one locally based full service network carrier. This is even more so since the integration of the Single Aviation Market which now permits Single Aviation Market carriers to consider New Zealand, the Tasman, and Australia as one market. In New Zealand, the financial difficulties of Ansett New Zealand leading to its sale to Tasman Pacific (trading as "Qantas" New Zealand) illustrate the point, as does the subsequent failure of Tasman Pacific, and also the failure of Ansett Australia.

97. Current capacity, costs, load factors and fares in the Australasian markets mean that it is impossible to generate long-term economic rates of return for two locally based network carriers. Tasman routes have traditionally been insufficient to cover the cost of capital and the current limited profitability is not sustainable as more capacity flows onto those routes. Qantas' domestic New Zealand operations incurred a loss in 2001/02 as it went through its start-up phase. Qantas has signalled that, absent the Transactions, it will move to address this position by materially increasing capacity for the reasons discussed below.

The Adopted Counterfactual

98. The Applicants have independently concluded that the only counterfactual to test against the world with the Transactions is a more aggressive level of competition between them resulting in increased capacity being applied to material parts of their Australasian networks.

99. This counterfactual is consistent with Qantas' stated intention to materially increase capacity on domestic New Zealand Main Trunk and trans-Tasman routes, as well as increasing capacity on the Auckland-Los Angeles route. It is also consistent with information and assessments provided by each airline to NECG on a confidential basis.

100. Qantas' New Zealand operations are very important to the Qantas network as a way of achieving the efficiencies that come from interconnecting the routes within, to and from New Zealand into its wider network. They make a positive contribution to its network, although they are currently losing money on a standalone basis. Consistent with the Single Aviation Market, Qantas views New Zealand as part of its home market. For Qantas, abandoning the New Zealand market would be tantamount to abandoning a segment of Australia.

101. Securing a strong home base is essential to place Qantas on a more even footing with its main international competitors and contribute to the sustainability of Qantas as a global competitor. Attracting high yield passengers (who require frequency of service) is an important feature of Qantas' business model and is part of its strategy to secure a strong home base. In order to attract those customers and thereby obtain a sustainable presence throughout Australasia, Qantas must match the frequency offered by Air New Zealand. That will entail an increase in capacity in domestic New Zealand as well as on the trans-Tasman. In respect of domestic New Zealand, Qantas will add three additional Boeing 737 aircraft to its current fleet of five, an increase of some 60% on current capacity.

102. Air New Zealand will respond to capacity increases by Qantas because to do otherwise will be a step towards surrendering control of its important domestic network to its competitor. In order to maximise network profitability, neither airline is unilaterally likely to reduce its commitment to these routes in the short to medium term.

103. A failure by a network carrier such as Air New Zealand to react to Qantas' capacity increases on Air New Zealand's core domestic and trans-Tasman routes would have a detrimental effect on the viability and profitability of Air New Zealand's entire network, including its international routes. Even if it were to retain an approximate even split of capacity with Qantas, NECG's modelling shows that in domestic New Zealand it would reduce the contribution from domestic operations by close to a third. Accordingly, Air New Zealand cannot afford to decrease capacity and would slightly increase its domestic and trans-Tasman capacity by a combined 5% over a three year period. Although Air New Zealand's reaction would increase its costs, reduce load factors and cut profits, it is nevertheless a profit maximising response. In NECG's view, Air New Zealand would remain cash positive, but absent continued underwriting by the New Zealand government, its long term financial position would not be such as to allow major investments to be financed on an economic basis. The contribution Air New Zealand could secure from its domestic and trans-Tasman operations would at best be uncertain.

104. As highlighted above, the Australasian markets cannot support more than one FSA network, and so in the counterfactual scenario, ultimately one airline will be forced to accept a secondary role on the network to the other which, in time, will necessarily lead to the contraction of other elements of its network. The timing of this ultimate contraction depends on the intensity and degree of the capacity increases – it is possible that contraction will occur within the five year period modelled by NECG (although NECG has adopted a conservative position, and has not assumed any contraction in its modelling).

105. In NECG's view, the airline that is ultimately forced to contract is more likely to be Air New Zealand, given the relative financial strength of the two Applicants. If this occurred, Air New Zealand would be forced to cut back international services because its domestic operations would no longer provide sufficient feed and revenue to maintain its international services. As the NECG Report notes, for Air New Zealand's long haul operations to be viable, they must be based on interconnectivity with its domestic network, and be able to draw on a customer base that includes the higher yield segments. A more detailed discussion of this view is set out in the Air New Zealand Confidential Counterfactual attached as Schedule 8. The prospect of Air New Zealand failing altogether cannot be discounted (see NECG Report).

106. Air New Zealand has recently restructured its New Zealand operations as a VBA+, which has been branded "NZ Express". Each VBA establishes itself along a continuum of cost depending upon the extent to which that VBA removes cost normally associated with the operations of a FSA. As detailed below, Air New Zealand retains a number of FSA features not normally associated with a VBA, hence the description "VBA+". However, despite removal by Air New Zealand of significant cost out of its domestic operations, it retains material elements of an FSA on domestic routes. In particular, it retains interlining, connectivity, codesharing, lounges, FFPs, and seamless baggage handling on domestic routes and of course, remains a full FSA on the remainder of its network. NECG estimates that a full VBA's cost base is on average at least 20% lower than that of a FSA. It estimates that NZ Express has reduced its cost base by 7.5% as against a FSA cost base.

107. Despite this restructuring, entry or expansion of a VBA in the New Zealand domestic or trans-Tasman markets could see Air New Zealand "squeezed" between the larger and more profitable network carrier and the lower cost VBA in the same way as Ansett was squeezed in Australia. In addition, the strategy of moving to a VBA+ operation within New Zealand cannot fully address the underlying problems associated with the market structure, namely the small size of domestic New Zealand and New Zealand's isolated geographical location.

Other Airlines

108. As summarised in section 2.3.5 of the NECG Report, economic analysis suggests it is more profitable for a VBA to commence services on the trans-Tasman and in domestic New Zealand if the Transactions proceed, than under the counterfactual. The details of entry under the factual and counterfactual are set out in the NECG Report.

Examination of other scenarios

109. There are a number of other scenarios which might be advanced by others as alternative counterfactuals. For the reasons described below, none of these are plausible. As such they cannot avoid the consequences of the war of attrition for pre-eminence on the New Zealand and the trans-Tasman networks, and the potential for contraction discussed above. Nor do they provide the benefits which flow under the Transactions. The scenarios include:

(a) the status quo, whereby current aircraft, schedules and frequencies are maintained (**the Status Quo**);

(b) Qantas and Air New Zealand cease competing aggressively, with price and output trending toward the duopoly level, which may occur after a period of aggressive competition (**Cosy Duopoly**);

(c) Air New Zealand entering into an alternative alliance (**Alternative Alliance**); and

(d) Air New Zealand receiving stand-alone equity injections (**Equity Injections**).

The Status Quo

110. As can be seen from the above counterfactual discussion, it is not plausible to argue that Qantas will continue to operate on domestic New Zealand Main Trunk routes without increasing capacity. Qantas has made it clear that it does not intend to withdraw and it remains commercially rational for it to remain and expand. It sees itself as currently well-placed ultimately to achieve a successful outcome in respect of the relevant routes. However, it acknowledges that in so doing, it will lose the opportunity for immediate growth and to achieve the major benefits described by NECG as arising under the Transactions.

Cosy Duopoly

111. Certain economic conditions are internationally recognised as being conducive to the existence of a “cosy duopoly”. As NECG observes, liberalised aviation markets do not evidence these characteristics. Fixed costs are high, marginal costs are very low, the product is highly perishable, and sales occur in small units, with prices that are complex and relatively difficult to observe. These are features that make for very strong competition, and indeed, industries that fail to attain profitable equilibria. As described in more depth in the section relating to the Australasian Aviation Environment above, this is clearly the environment in which the Applicants are operating.

112. At a practical level, there is no recent history of a cosy duopoly existing in these markets. Further, for the reasons discussed earlier, including the fact that there is no room for two network FSAs in the Australasian markets, it appears perfectly rational for Qantas to continue to compete aggressively and successfully. In any event, given low barriers to entry/expansion for an Australasian airline, any tacit agreement to raise prices would:

(a) drive down demand to the detriment of the wider Air New Zealand and Qantas networks; and

(b) encourage entry or expansion by a VBA.

Alternative Alliance

113. There are no airlines that have indicated a willingness to enter into a strategic alliance which can resolve the strategic imperatives for Air New Zealand discussed above in respect of the counterfactual.

114. An acceptable medium to long-term strategy must remove or avoid the wasteful and debilitating costs associated with a war of attrition with Qantas and avoid material contraction of Air New Zealand's international network. An alliance with Qantas is the only alliance which enables that strategy to be achieved. Those carriers with which Air New Zealand currently has an association provide interlining and connectivity benefits, but do not avoid the war of attrition and its consequences. The injection of capital by Qantas is advantageous, but is secondary to the objective of achieving a medium-long term sustainable business strategy.

Equity Injection

115. Short of a continuous subsidy of losses by way of regular equity injections, equity merely prolongs the war of attrition; it does not cure the underlying problem. Indeed, faced with a war of attrition, for which there is no winning strategy, it is unlikely that such regular equity injections would be forthcoming. Such an investment would be implausible and irrational unless it derived from a party with some other, non-profit maximising objective. No shareholder commitment to such a subsidy has been received or ought to be expected.

MARKET DEFINITION

Introduction

116. Identification of the relevant markets provides the framework within which to examine the competition law implications of the Transactions.

117. The principal areas of competition between Air New Zealand and Qantas are the provision of domestic passenger and freight air services in New Zealand, and international passenger and air freight services between New Zealand and Australia and between the United States and New Zealand and Australia. Other areas potentially relevant to the assessment of the Transactions include travel distribution services, computerised information and reservation services, engineering and maintenance services, and terminal and ground handling services.

118. The airline industry has previously been examined by:

(a) the Commission in Kiwi Airlines,[23] *Bodas*[24] and *Brierley/Air New Zealand;*[25]

(b) the ACCC (Qantas/British Airways RSJA,[26] and JSA[27] and in respect of Ansett/Air New Zealand/Singapore Airlines Air Alliance (the **Tripartite Alliance**) (1997) [28]); and

(c) the New Zealand Ministry of Transport in respect of the Tripartite Alliance and the alliance between Air New Zealand and United Airlines (2002).

119. From a commercial perspective, the Applicants treat the whole of the Australasian market as the natural base for their local operations. The basis for this view is:

(a) the Open Skies and Single Aviation Market agreements between New Zealand and Australia which remove the legal or regulatory barriers to Australasian owned and controlled airlines providing services along Australian, trans-Tasman and Domestic New Zealand routes, and vice versa;

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23 *Termination Report: Kiwi International Airlines/Air New Zealand* Commerce Commission Memorandum 12 August 1997 (***Kiwi/Air New Zealand***)

24 *Air New Zealand/Ansett Holdings/Bodas Pty*, Commerce Commission Decision No. 278 3 April 1996 (***Bodas***)

25 *Brierley Investments Limited, Qantas Airways Limited, Japan Air Lines Co Ltd, American Airlines Inc and Air New Zealand Limited*, Commerce Commission Decision No. 229A 27 April 1989 (***Brierley Investments/Air New Zealand***).

26 *Joint Services Agreement between Qantas Airways Limited and British Airways Plc* (2000) ATPR (Com) 50-280 (**RJSA**).

27 *Qantas Airways Limited and British Airways Plc* (1995) ATPR (Com) 50-184 (**JSA**)

28 (1998) ATPR (Com) 50-265

(b) the ease of supply side substitution; and

(c) the fact that airlines operating domestically within Australia transfer aircraft to the trans-Tasman routes and on to domestic New Zealand routes, and vice versa.

120. However, the Applicants also acknowledge the definition of a market in the Commerce Act. They also believe that whatever the market definition, the Transactions qualify for authorisation. Therefore, having regard to previous regulatory determinations in New Zealand and Australia, other overseas precedent and the analysis set out in the NECG Report, for the purposes of this Application, the Applicants describe the relevant competition implications of the Transactions on the basis that the following are the relevant markets:

(a) the markets for the provision of passenger air services:

(i) on New Zealand main trunk routes (routes between Auckland, Wellington and Christchurch) (the **New Zealand Main Trunk Market**); and

(ii) on New Zealand provincial routes[29] (the **New Zealand Provincial Market**),

(collectively the **New Zealand Domestic Markets**);

(iii) on routes between New Zealand and Australia (the **trans-Tasman Market**);

(iv) between New Zealand and the Pacific Island and South East Asia holiday destinations - this includes Fiji, Samoa, Kingdom of Tonga, Cook Islands, Tahiti, Vanuatu, Noumea, Norfolk Island, Honolulu (Hawaii Islands), Bali, and destinations within Malaysia and Thailand (the **Asia/Pacific Destinations Market**);

(v) between New Zealand and the United States (**the USA Market**); and

(vi) a number of other fully contested international markets,

(collectively, (i) to (vi) above are referred to as the **Passenger Air Services Markets**);

(b) the markets for the provision of:

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29 Qantas indirectly competes with Air New Zealand on certain provincial routes by way of a codeshare with Origin Pacific.

(i) time critical air freight services between points in New Zealand (the **New Zealand same-day Freight Market**); and

(ii) international air freight services to or from New Zealand (the **International Air Freight Market**),

(collectively the **Freight Markets**); and

(c) associated markets, including the markets for:

(i) the provision of travel distribution services in New Zealand (the **Travel Distribution Services Market**);

(ii) the provision of engineering and maintenance services in New Zealand (the **Engineering Services Market**);

(iii) the provision of Computer Reservation Systems (**CRS**) and Global Distribution Systems in New Zealand (the **CRS Market**); and

(iv) the provision of terminal and ground handling services in New Zealand (the **Terminal Services Market**),

(collectively, the **Associated Markets**),

(collectively, (a) to (c) above are referred to as the **Relevant Markets**).

Approach to Market Definition

121. The Commerce Act defines a market as "a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them".

122. An accepted starting point when identifying the relevant markets is the Australian Trade Practices Tribunal's *Re Queensland* Co-*op Milling Assn Ltd* decision.[30] At page 190 the Tribunal commented:

> "A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them. (If there is no close competition there is of course a monopolistic market). Within the bounds of a market there is substitution - substitution between one product and another, and between one source of supply and another, in response to changing prices. *So a*

[30] (1976) 25 FLR 169.

market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive. Let us suppose that the price of one supplier goes up. Then on the demand side buyers may switch their patronage from this firm's product to another, or from this geographic source of supply to another.

"As well, *on the supply side, sellers can adjust their production plans, substituting one product for another in their output mix, or substituting one geographic source of supply for another*. Whether such substitution is feasible or likely depends ultimately on customer attitudes, technology, distance, and cost and price incentives." (Emphasis added)

123. The "*SSNIP*" test utilised by the Commission,[31] and the ACCC,[32] is a useful tool for defining markets so as to best expose the competitive effects of the conduct at issue. Demand and supply side substitutability is inherent in the *SSNIP* framework. Established Commission comment illustrates the *SSNIP* test:[33]

"For the purpose of competition analysis, a relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, could impose at least a Small yet Significant and Non-transitory Increase in Price, assuming all other terms of sale remain constant (the "*ssnip* test"). For the purpose of determining relevant markets, the Commission will generally consider a *ssnip* to involve a five percent increase in price for a period of one year".

124. The product, geographic and functional dimensions of the Relevant Markets are discussed below.

Passenger Air Services

Product Dimension

125. Supported by Commission precedent, this Application is based on a single product market for passenger air services.[34] For the purposes of market definition, there is no relevant distinction between business and leisure passengers or economy and business/first class passengers.

126. In *Bodas,* the Commission rejected the argument that there are separate customer markets or sub-markets, despite recognising that there may exist distinct customer segments. The Commission stated (at paragraph 125):

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31 Commerce Commission, Practice Note 4, 2001, page 22-24

32 ACCC, Merger Guidelines, June 1999, para 5.46

33 *GE Capital Finance Australasia PTY Limited/Australian Guarantee Corporation (N.Z.) Limited* Commerce Commission Decision No. 461, para 33

34 See, for example, *Kiwi/Air New Zealand, Bodas* and *Brierley/Air New Zealand*

> "The Commission does not believe that the domestic air services markets should be separated into categories for business and VFR *[Visiting Friends and Relatives]* travellers. Rather than each passenger type constituting separate markets, the Commission believes that they are different segments of the same markets".

127. In earlier determinations, the ACCC also generally concluded that there is a single product market for passenger air services, which includes all passenger types and classes of travel. However, in its RJSA determination, the ACCC examined the application "on the basis that a single air transport market for economy and premium class passengers can no longer be assumed".[35] This statement was reaffirmed in the ACCC's IATA PAP determination.[36]

128. The Applicants agree with the Commission's most recently expressed view, and also support the ACCC's earlier view (see for example the Tripartite determination)[37] that "different passenger types (business/leisure) represent different segments of the passenger services market" rather than representing different markets.

129. The classes of travel available to passengers, including business class and economy class, simply reflect "physical" features of the product or service offering. The Applicants submit that it is not differences between the physical features of products that are key to delineating markets. Rather, an informed investigation of the legitimacy of distinctions made on the basis of product features begins with an analysis of the manner in which these features are related to the demand for the products.[38]

130. The labels which are given to types of passengers, including "leisure" and "business", merely reflect a passenger's reason for travel, and not the entirety of, nor the most important of, the demand characteristics of the customer. Accordingly, these labels are not appropriate market delineators.

131. Passengers demonstrate a range of demand characteristics, relating to time sensitivity, flexibility in regard to conditions, complexity of itinerary, and product quality (both in flight and "pre- and post- flight" services). Airlines offer an array of fare types to meet those demand characteristics. Demand characteristics are not uniform among business and leisure travellers. The same customer may exhibit different demand characteristics at different times. Customers who purchase tickets with special fare conditions are usually

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35 Restated JSA (*Joint Services Agreement between Qantas Airways Limited and British Airways Plc* (2000) ATPR (Com) 50-280); page 53,498.

36 IATA PAP Determination C2001/601 13 November 2001; pp 56 to 57. Available at www.accc.gov.au.

37 Air Alliance Determination page 50

less time sensitive and more flexible than customers who purchase unrestricted fare types. The customer, whether or not they are a business or leisure traveller, selects the fare type that is most appropriate to their needs at that time.

132. This approach has economic support. The NECG analysis demonstrates that, even if there are some customers who are not willing to substitute fare types, the cross-section of customers who are willing to substitute is significant enough to prevent a price increase by a hypothetical monopolist. Accordingly, the existence of some passengers who are not willing to substitute between fare types does not support a conclusion that these passenger types are in separate markets, or that there are separate markets for different fare types. At best, it is indicative only of separate segments within the one market.

133. Additional support for the Applicants' approach includes:

(a) the supply side complementarities in servicing the full range of customers, which makes it artificial to regard different passenger types as falling within distinct markets;

(b) the relatively small size of the Domestic New Zealand and trans-Tasman Markets, which necessitates the targeting of a broad range of customers (even VBA airlines target leisure and business passengers under the same fare structures);

(c) the ease at which airlines can substitute to targeting different customer types. In terms of cabin seating, recent Boeing 737s can be configured to allow the replacement of business seats with economy seats overnight;

(d) substitution between customer groups (i.e. revenue management); and

(e) the "chain of substitution" that links all fares such that an attempt to exercise a *SSNIP* over only one segment of that continuum will be defeated by substitution.

134. The relevant market does not include the provision of passenger services using other modes of transport for the reasons set out in of the NECG Report.

135. The economic support for a single passenger market, including a critical loss analysis is set out in Attachment A to Appendix A of the NECG Report.

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[38] See Office of Fair Trading research paper, *Market Definition in UK Competition Policy*, prepared by National Economic Research Associates (NERA), February 1992, page 71

Geographic Dimension

Generally

136. Aviation geographic market boundaries are blurred. Airlines themselves view the geographic extent of the market in terms significantly wider than that permitted by the geographic restriction in the Commerce Act. However, as set out in the NECG Report, there are strong economic arguments for a single market that includes passenger air services provided along New Zealand domestic main trunk routes, Australian domestic main trunk routes and trans-Tasman routes (an Australasian passenger air services market).

137. For the reasons set out above, the Applicants treat the Australasian market as the natural base for their local operations.

138. However, despite the Applicants' view that a broader Australasian market is commercially more relevant, the Applicants consider that the Transactions qualify for authorisation even if narrower markets are adopted.

139. In relation to the geographical extent of passenger air service markets, the Commission in *Bodas* commented:

> "…where a number of narrowly defined markets exhibit similar characteristics, they can be conveniently treated as a single class for the purposes of competition analysis. In this case, supply side substitutability and economies of scale and scope in operating route networks also suggest wider market definitions are appropriate."[39]

140. From a demand side perspective, air services market generally comprise a number of city pair routes. With the exception of holiday destinations and the intermediate leg of long haul services, consumers are generally unlikely to consider air services on one city pair as substitute for the services on another city pair. However, once an airline has committed to supplying services on a particular route, the costs associated with servicing an additional route in that market marginal. Airlines can quickly, and at minimal cost, offer (or increase) services on other city pairs in response to a *SSNIP*, for example, by changing the type of aircraft flown effected routes.

141. From a supply-side perspective, airlines deploy aircraft on a number of different city pairs world-wide. For e.g., for the week beginning 9 December 2002, Air New Zealand is deploying a Boeing 767-300 to the following destinations (in order): Auckland-Singapore-

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[39] *Bodas* para 113

Auckland-Perth-Auckland-Melbourne-Auckland-Rarotonga-Los Angeles- Rarotonga-Auckland-Japan-Auckland-Rarotonga-Auckland-Melbourne-Auckland-Rarotonga-Papeete-Los Angeles-Rarotonga-Auckland.

142. Consistent with Commission, other regulatory bodies and judicial precedent, this Application is based on the following geographic markets for passenger air services:

(a) New Zealand Main Trunk (Auckland, Wellington and Christchurch);

(b) New Zealand Provincial (includes all other domestic routes);

(c) trans-Tasman;

(d) New Zealand – Asia/Pacific Destinations;

(e) New Zealand – USA; and

(f) other international markets.

<u>New Zealand Main Trunk and New Zealand Provincial Markets</u>

143. In *Bodas* the Commission adopted three geographical markets:

(a) main trunk (between Auckland, Wellington and Christchurch);

(b) provincial routes (between provincial airports serving cities such as Dunedin and Hamilton through to smaller communities); and

(c) tourist routes (to and from tourist destinations such as Rotorua and Queenstown).

144. The Applicants consider tourist and provincial routes now comprise one market. As noted in *Bodas* "there have been some changes which make the distinction between these markets less apparent."[40] Further, there is nothing material to be gained by further segmentation of the market.

145. Therefore for the purposes of this Application, the Applicants consider the geographic extent of the New Zealand Domestic Markets are:

(a) New Zealand Main Trunk Market; and

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[40] *Bodas* para 131

(b) New Zealand Provincial Market.

trans-Tasman Market

146. In *Bodas* the Commission adopted a trans-Tasman Market, consistent with the earlier *Brierley/Air New Zealand* decision where the Commission considered the relevant markets to be the trans-Tasman, New Zealand-Japan and New Zealand-United States markets (although it also reviewed the Auckland-Sydney, Auckland-Melbourne and Auckland-Perth city pairs). Having regard to the Single Aviation Market and the Open Skies arrangement and the ease with which suppliers can substitute (or shift supply) to alternative city pairs, the Applicants consider a trans-Tasman Market is the narrowest market which might reasonably be considered. In any event, constrained by available information, the analysis carried out by NECG is based on city pairs for each of the Relevant Markets.

Asia/Pacific Destinations Market

147. The Applicants consider that the market is an Asia/Pacific Destinations Market due largely to the high degree of demand-side substitutability. Consumers can, and do, choose from a variety of sun seeking holiday destinations which have broadly comparable prices. In addition, there is a high level of supply-side substitutability due to the ability of many carriers to increase/shift capacity in the region.

148. An Asia/Pacific Destinations Market definition is supported by the Australian Federal Court's decision (on appeal) in *Taprobane*.[41] In that case, the Federal Court noted that a market definition of the supply of wholesale packages to the Maldives was too narrow because consumers would substitute to alternative destinations:

> "In the end the relevant substitutions are not between airlines, but between destinations. The evidence supports the conclusion that there are island holiday packages available at the retail and wholesale levels which are substitutable for Maldive Island holiday services. The range of possible alternatives is wide as Professor McKern pointed out in his evidence and would include such destinations as Bali, Fiji, Tahiti, New Caledonia, Hawaii, Penang, the Philippines, the Solomon Islands, the Barrier Reef Islands, Guam and Mauritius. It is not at all clear that the product market would not extend to the provision of holiday package tours to the Mediterranean and Caribbean Islands."

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41 *Singapore Airlines Limited v Tarobane Tours W.A. PTY LTD* No. WA G101 of 1990 FED No. 808 Trade Practices (1992) 14 ATPR 41-159 para 57, per French J

149. Substitutability of other destinations was also one of the elements taken into account by the Ministry of Transport when it authorised the Tripartite Alliance [42]

150. As noted above, the availability of travel package holidays at comparable prices supports an Asia/Pacific Destinations Market definition comprising sun seeking holiday destinations within the Pacific Islands and South East Asia. Travel packages typically consolidate airfares, transfers, and accommodation into a package retailed for a single, all inclusive price. Brochure pricing for packages to Pacific Island destinations closely correlate with brochure pricing for travel packages to Honolulu (Hawaii Islands), Denpasar (Bali) and other South East Asian holiday destinations.

151. The following table is an example of a current range of brochure prices for these destinations. Looking at the spread of pricing, South East Asian destinations appear well integrated as substitutes for Pacific Island destinations. This continuation of pricing supports the existence of a chain of substitution between the destinations, particularly because both South East Asian and Pacific destinations appear throughout the price spectrum in the sample.

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[42] Report from the Ministry of Transport to the Minister of Transport *Air New Zealand: Application for Authorisation of Alliance between Air New Zealand, Ansett Australia Limited, Ansett International Limited and Singapore Airlines Limited* 4 December 1997

Price comparison of Asia/Pacific Destination holidays (November 2002)[43]

Destination	Operator	Duration Offered	Adjusted Duration	Season	Price + extra per night	Adjusted Price	Airline
Phuket	Escape Holidays	8 nights	7 nights	Jan-March	$1,729	$1,513	Malaysia Airlines
Phuket	Gullivers	8 nights	7 nights	Jan-March	$2,275	$1,990	Air New Zealand
Phuket	Gullivers	8 nights	7 nights	Jan-March	$2,339	$2,047	Qantas
Bali	Go Holidays	6 nights	7 nights	Jan-March	$1,099 + 22	$1,121	Garuda Indonesia
Bali	Gullivers	7 nights	7 nights	Jan-March	$1,628	$1,628	Qantas
Bali	Escape Holidays	7 nights (1 free)	7 nights	Jan-March	$1,319 + 0	$1,319	Garuda Indonesia
Kuala Lumpur (City)	Gullivers	4 nights	7 nights	Nov-March	$1,546 + 36	$1,654	Qantas
Kuala Lumpur (City)	Go Holidays	4 nights	7 nights	Jan-March	$1,295 + 67	$1,496	Malaysia Airlines
Langkawi	Gullivers	4 nights	7 nights	Jan-March	$1,659 + 43	$1,788	Air New Zealand
Tahiti	Talpacific holidays	6 nights	7 nights	Nov-March	$2415 + 205	$2,620	Air Tahiti Nui
Noumea	Gullivers	7 nights	7 nights	Feb-March	$1,270	$1,270	Aircalin
Samoa	Go Holidays	5 nights	7 nights	Jan-March	$1,299 + 86	$1,471	Polynesian
Fiji	Escape Holidays	7 nights	7 nights	Nov-March	$1,752	$1,752	Air New Zealand
Fiji	Go Holidays	7 nights	7 nights	Jan-March	$1,719	$1,719	Air Pacific
Niue	Talpacific holidays	10 nights	7 nights	Nov-March	$1,269	$888	Polynesian
Vanuatu	Go Holidays	7 nights	7 nights	Nov-March	$1,245	$1,245	Air Vanuatu
Vanuatu	Gullivers	7 nights	7 nights	Nov-March	$1,043	$1,043	Air Vanuatu
Cook Islands	Go Holidays	5 nights	7 nights	Jan-March	$1,759 + 173	$2,105	Air New Zealand

[43] Indicative analysis prepared from brochures available in Auckland CBD, November 2002.

152. A further example of demand side substitutability for various Pacific Islands is illustrated by traffic to Fiji in the period surrounding the coup in 2000. While Air New Zealand revenue in July 2000 on routes through Nadi decreased by $2.914m, revenue on routes through other Pacific Islands increased by $2.155m for the same period. Similar results were also recorded in August 2000.

New Zealand – USA Market

153. The Applicants' New Zealand – USA market definition is supported by the *Brierley/Air New Zealand* decision[44] and the United States of America Department of Transport (**US DOT**) and the New Zealand Ministry of Transport (**MOT**).[45] There have been no changes in this market to warrant the adoption of a different market definition.

Other International Markets

154. The ACCC has generally defined geographic markets on a regional basis. In its RJSA determination, the ACCC defined the relevant markets as: Australia – South East Asia; Australia – Europe; Australia – New Zealand/Oceania; Australia – North Asia; Australia and India/Middle East; and Australia – North/South America. The ACCC took account of the extent of indirect travel, with passengers having the option of travelling directly to a destination or via a number of other countries. The ACCC also noted the common practice of common rating fares to points within a region, for example, a passenger pays the same price for a ticket to virtually any point in Europe with a given airline.[46]

155. For these reasons the Applicants adopt regional markets in terms of other international destinations that may interest the Commission.

Freight

Product Dimension

156. The Applicants agree with the Commission's comment in *Bodas* that, in respect of New Zealand domestic routes, "the provision of deferred and overnight delivery is equally

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[44] *Brierley Investments/Air New Zealand*

[45] *United Airlines Inc, and Air New Zealand* Order to Show Cause – USA Department of Transportation 2 March 2001 Docket OST-1999-6680-7. The Final Order of 3 April 2001 (Docket OST-1999-6680-8) upheld the tentative decision in the Order to Show Cause to grant authorisation for the alliance between Air New Zealand and United Air Lines; and report from the Ministry of Transport to the Minister of Transport: *Air New Zealand application for authorisation of alliance between Air New Zealand Limited and United Airlines Limited* 28 February 2002

[46] The ACCC commented that a regional approach to market definition should not necessarily be assumed in the future, particularly where a high proportion of passengers travelled on direct services.

contested by air and land transport, and is part of a wider domestic freight market."[47] Having regard to the large number of competing transport modes (including train, road and sea) and the large number of constraining participants in the market, the Commission concluded that the "acquisition does not raise any competition issues in that market".[48]

157. In respect of other freight markets, the Applicants accept that lesser constraint is imposed by other transport modes and therefore the correct product market is restricted to air freight services.

Geographic Dimension

158. In *Bodas* the Commission commented that "there is nothing to be gained, in competition analysis terms, by further differentiating freight services with separate trans-Tasman, and other international, markets".[49] The Applicants have adopted the geographic markets identified by the Commission in *Bodas*, although note that indirect routes impose a greater degree of constraint on direct freight services than in respect of direct passenger services.

Competitive Impact

159. The Applicants refer to the Commission's observation in *Bodas* where it commented that:

> "…same day air freight is a by-product of passenger air services, any issues that arise in this instance, as a result of the acquisition, would be reflected in consideration of the main trunk passenger air services market. Therefore, separate consideration of the domestic same day air freight services market is not required."[50]

160. Because the majority of freight in the Relevant Markets is carried in the belly space of aircraft operating scheduled passenger services, the assessment of the various Passenger Air Services Markets will also illuminate the competitive dynamic in the relevant Freight Markets. However, this assessment will significantly overstate the competitive detriment associated with the Transactions because the Freight Markets are characterised by very low barriers to entry and expansion and the presence of a number of dedicated freight services. Having regard to the Commission's view, references to freight in this Application are limited to instances where the competitive dynamic of the

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[47] *Bodas* para 149

[48] *Bodas* para 149

[49] *Bodas* para 152

[50] *Bodas* para 150

equivalent passenger and freight markets differ, e.g., where there are dedicated freighter services in addition to the belly space of passenger services. Further information in respect of freight is available if the Commission requires it.

Travel Distribution Services

161. This is the market for the retailing of passenger air travel both to and from New Zealand, and within New Zealand. The geographical extent of the market is national.

162. In broad terms, airline tickets are sold by:

(a) airlines directly to the public, via the internet, telephone, to businesses direct, via airline owned tour package wholesalers and airline owned retail travel centres;

(b) airlines to ”consolidators” who purchase tickets (frequently constructing multi-hop itineraries) and on-sell to travel distributors, who then on-sell in their own right to the public;

(c) airlines to ”wholesalers” who purchase tickets and package with other products, e.g. accommodation who then on-sell to travel distributors, who then sell in their own right to the public; and

(d) airlines to the public via travel agents, interline airline partners and internet travel portals.

163. As the Commission commented in *Bodas*, travel agencies act as agents for suppliers of travel services, in terms of the sale of transportation, accommodation and activities to tourists and other travellers. Providers of travel services promote their services both directly, and through intermediaries, or travel wholesalers. Travel wholesalers aggregate the various services available from several service providers and on-supply to retail travel agencies.

164. The Travel Distribution Services Market has changed markedly since the *Bodas* decision due the wide spread use of the internet and telephone call centres. The internet has been adopted by airlines selling directly to the public and airlines have now become much more active and competitive participants in the market for the retailing of airline tickets. NZ Express reports that around 29% (on average) of its bookings are made through the internet. Similarly, the ACCC recently reported that in Australian around half of all domestic air ticket sales are through the airlines, either through call centres or through the internet. Already in New Zealand, the role of travel agents in respect of domestic New Zealand is changing, with an increasing focus on “value added” services,

e.g. House of Travel's "Searchflight" service, which searches across airlines' websites and constructs the cheapest itinerary. Travel agents are moving to provide more cost effective services (e.g. travel.co.nz, itchyfeet.co.nz, and travelonline.co.nz).

165. In *Bodas* the Commission commented that "there is nothing material to be gained by separating functional levels of wholesale and retail distribution into separate markets". The ACCC has adopted a similar approach, determining that the relevant functional market includes all stages in the distribution chain.[51] This view was confirmed in the ACCC's recent IATA Passenger Agency Programme Determination.[52] The Applicants agree with this approach.

Computer Reservation System Market

166. There are two types of computerised information and reservation systems that are relevant:

(a) Computer Reservation Systems (**CRS**s) are used by airlines for booking, pricing and ticketing functions, inventory management, and departure control functions. Some airlines host other airlines on their CRS.

(b) Global Distribution Systems (**GDS**s) are used by travel agents, including many "e-agents", and encompass booking, pricing and ticketing functions, where ticketing occurs on neutral (not airline specific) ticket stock. Products booked are predominantly air travel, but may also include hotels, cars, and tours.

167. Air New Zealand and Qantas operate their own internal CRSs – Air New Zealand uses "Carina" and Qantas uses "Amadeus". However, with the exception of Polynesian Airlines which is "hosted" on Amadeus by Qantas and Royal Tongan, Air Rarotonga and Chatham Air which are "hosted" by Air New Zealand on Carina, neither party makes its CRS available to other carriers.

168. Neither Air New Zealand nor Qantas have an equity interest in a GDS.

169. No material aggregation occurs in respect of the market.

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[51] *Restated JSA* pages 53,498-53,499.

[52] C2001/601 13 November 2002 page 67. Available from www.accc.gov.au

Engineering and Maintenance Services

170. There is a market in New Zealand for the provision of aircraft engineering and maintenance services.

171. Operators of airline services must ensure that their aircraft comply with the maintenance and safety requirements of manufacturers, such as Boeing and Airbus, and the relevant regulatory authorities. The market is national.

Terminal/Ground Handling Services

172. The provision of passenger air and freight services requires the acquisition of additional services provided at terminals and by airport ground-staff such as:

   (a) counters, lounges, and terminal areas;

   (b) gates and airbridges;

   (c) departure and arrival slots (which are allocated to airlines by airports);

   (d) baggage handling services;

   (e) catering services; and

   (f) aircraft cleaning and servicing.

173. Consistent with the Commission's determination in *Bodas,* the Applicants consider these services cannot be differentiated and comprise a market for the provision of terminal/ground handling services.

BARRIERS TO ENTRY/EXPANSION

Introduction

174. An assessment of the nature and extent of any barriers to entry or expansion is important to any determination of the competitive impact of the Transactions. Case law, the Commission's Business Acquisitions Practice Note and the ACCC's Merger Guidelines clearly state that when barriers to entry or expansion are such that entry and expansion is likely in response to an attempt to increase price or decrease quality or standards of service, then there can be no market power and therefore there is unlikely to be a substantial lessening of competition.

175. The Courts have confirmed that market power requires the presence of barriers to entry and expansion and have recognised that low barriers to entry or expansion will constrain an incumbent with a high market share:

> "Whatever the size of the merged entity's market share, it is elementary that its market power will not be insufficiently [sic: sufficiently] constrained unless there are barriers to entry or expansion which protect it from effective rivalrous reaction to the exercise of its market power."[53]

and

> "What level of market power a firm has, as a result of its market share, will depend substantially on the level of barriers to entry and expansion which apply to the market. If the barriers are low, a high market share is unlikely to result in an insufficiently constrained level of market power".

176. Barriers to entry or expansion have been identified by the Court of Appeal as:

> "[a]nything…[that] amounts to a significant cost or limitation which a person has to face to enter a market or expand in the market and maintain that entry or expansion in the long run, being a cost or limitation that an established incumbent does not face. The height of the barrier is a function of the degree of the differential. A barrier to entry or expansion reflects the extent to which an established firm can, in the long run, raise price above marginal cost (supra-competitive pricing) without inducing potential competitors to enter or expand in the market". [54]

177. The Commission generally examines broader entry (or expansion) conditions and then considers whether these conditions restrict entry or expansion to a sufficient extent to be considered barriers.[51] The Application proceeds on the basis that although there may be

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[53] *The Southern Cross Medical Care Society v Commerce Commission* CA89/01 21 December 2001, Court of Appeal, Auckland, Richardson P and Tipping J, para 86

[54] Para 68

conditions that must be satisfied in order to enter or expand into the Relevant Markets, these conditions do not necessarily constitute barriers.

178. For the purposes of the Application, a distinction is made between potential barriers to new entry (by a person currently not providing passenger air services in Australasia) and potential barriers to expansion (by an airline already operating in Australasia). Consistent with precedent, either or both of low barriers to entry and low barriers to expansion will result in incumbents being sufficiently constrained either by the threat of entry or the threat of expansion. In any event, it is the Applicants' view that while it is important to consider conditions relating to entry or expansion, in this instance there is a real practical likelihood of expansion, which would defeat any attempted exercise of market power arising from the Transactions.

Summary

179. The nature and extent of potential barriers to entry and expansion in the Relevant Markets has been considered by various competition regulatory bodies.

180. In relation to the trans-Tasman Market, the Commission has concluded on various occasions that barriers to entry or expansion are low. In *Bodas* the Commission commented "[t]he regulatory and other barriers to entry are low". In *Kiwi Airlines* the Commission acknowledged that barriers in the trans-Tasman market, in relation to more 'provincial routes', were low.[55] The Commission then commented that barriers to entry on trans-Tasman routes generally, and more specifically in respect of individual city pairs, were relatively low and suggested some potential constraint from new entrants existed.[56]

181. In the past, the Commission has considered barriers to entry or expansion into domestic New Zealand routes to be higher than those on trans-Tasman routes. The Commission's key concern in *Bodas* was that entrants would be forced to incur sunk costs (losses) during the period in which the incumbent airline(s) mounted a response. However, the significant cost advantage enjoyed by VBAs means that the incumbent response discussed in *Bodas* is no longer plausible because the incumbent knows that simply matching fares will not drive the VBA from the market, due again to the cost advantage enjoyed by the VBA. This is supported by the sustainable entry of Virgin Blue in Australia two years ago (from a capital base of A$10m (plus a parent loan of A$15m)), and its intended expansion into the trans-Tasman and domestic New Zealand markets.

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[55] *Kiwi International Airlines/Air New Zealand*, para 15.5. "Provincial Routes" refers to routes originating or terminating outside of New Zealand's three main centres, such as Hamilton.

[56] *Kiwi/Air New Zealand* para 16

182. Origin Pacific entered domestic New Zealand routes and subsequently expanded successfully. Kiwi Airlines entered the trans-Tasman market, as have a host of international airlines exercising Fifth Freedom rights.

183. The history of entry and expansion activity suggests that traditional perceived barriers to entry and expansion into the Relevant Markets have not protected incumbents from the threat or reality of entry or expansion. Incumbents are constrained and will continue to be constrained from exercising market power in the Relevant Markets because entry or expansion is likely if they increase price or decrease quality.

New Zealand Main Trunk and Provincial Markets

184. The Applicants consider that the conditions of entry and expansion on the New Zealand Main Trunk and Provincial routes do not amount to material barriers to entry for a VBA or barriers to expansion for an incumbent airlines.

185. The Commission examined the following conditions of entry or expansion into the New Zealand Main Trunk Market in the *Bodas* decision:[57]

- Capital requirements;
- Sunk costs;
- Regulatory requirements;
- Scale and scope of entry;
- Access to terminals;
- Access to slots;
- Access to travel distribution services;
- Access to feeder services;
- Access to computer information/reservation services;
- Access to catering services;
- Availability of pilots;
- Availability of aircraft; and
- Incumbent response.

186. This section assesses each of these conditions and concludes that none of them constitute a material barrier to entry or to expansion.

57 *Bodas* para 226

Capital Requirements

187. In *Bodas*, the Commission stated it considered that estimates of start-up capital of NZ$30 million for entry in the New Zealand Main Trunk Market were conservative, and in the absence of access to further financial backing, might not be sufficient to sustain an entrant. The Commission was of the view that a VBA was likely to invest in some infrastructure, “such as limited engineering facilities”, and was likely to build in a considerable amount of funding to withstand operating losses during its initial entry period.

188. Air New Zealand and Qantas note that at the time of the *Bodas* decision, Origin Pacific was not active on domestic New Zealand routes as a separate entity. In the past six years, Origin Pacific has expanded significantly by taking a material niche position and consolidating growth at each stage. The success of Origin Pacific suggests that significant capital in terms of sustaining initial operating losses may not be required and further demonstrates that entry strategies significantly impact the cost and success of entry.

189. Origin Pacific adopted a cautious approach to entering the New Zealand provincial and main trunk routes, focussing on key routes before expanding. This consolidation of position on key routes prior to further expansion reduced initial operating costs and contrasted to the losses sustained by Ansett New Zealand which were, at least in part, attributable to its decision to service a significant proportion of provincial routes upon entry. Leasing of aircraft is another entry strategy which reduces initial capital costs.

190. The Applicants consider the expansion by incumbent Australasian air services providers such as Virgin Blue and Origin Pacific requires less capital than the type of entry considered by the Commission in *Bodas*. As discussed below, the capital required to overcome sunk costs (see paras 191 to 194 and 230 to 232) is likely to be less than envisaged by the Commission in *Bodas*. For these reasons the Applicants are of the firm view that capital requirements are not of an extent to constitute a barrier to expansion.

Sunk Costs

191. The Commission has accepted that “sunk costs, in the forms of start-up sunk costs, market-specific assets, product differentiation, and investment … to overcome behaviour of incumbent firms” exist in the aviation industry.[58] Start-up sunk costs include “computerised information and reservation systems, terminal facilities, engineering

facilities, advertising costs, painting aircraft, hiring and training pilots and flight attendants, setting up operations manuals and schedules and test flights".[59]

192. By concentrating on the three main trunk routes, an entrant could access 54% of New Zealand domestic passengers, while at the same time mitigating the level of start-up costs.

193. The Applicants are of the firm view that sunk costs are not a material barrier to entry for a VBA nor a barrier to expansion for an incumbent airline.

194. Sunk costs are appreciably less for an incumbent Australasian air services provider as they already have brand recognition, operating manuals prepared, existing computerised information and reservation systems and potentially have underutilised aircraft that may be diverted to the new routes. There is only a marginal cost associated with the infrastructure needs associated with adding additional aircraft. There are no barriers to acquiring new/additional aircraft.

195. In terms of a VBA entrant, the successful entry of such airlines world-wide indicates that safety records, national flag carrier status, advertising and frequent flyer programmes and brand loyalty do not constitute a barrier.

196. Data on air passenger traffic indicates that passenger participation in frequent flyer programmes is not so widespread that it will represent a high barrier to entry. For example, Air New Zealand's removal of frequent flyer points accrual from its lowest booking class has had only a negligible impact – price is the most important attribute. Further, the VBA business model typically encompasses a high degree of outsourcing, which reduces the level of sunk costs.

197. There is a general global trend among businesses to take a greater degree of control over their employees' air travel in order to lower costs.[60] This trend has reduced the importance of brand loyalty as a barrier to entry.

Regulatory Requirements

198. There are three main legal and regulatory conditions that may constitute barriers to entry or expansion: international freedom rights; foreign ownership restrictions; and the

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58 *Bodas* para 244

59 *Bodas* para 244

60 See for example, "Cutting costs but still flying". Reuters Business Briefing, 20 March 2002

requirement to secure an air operator's certificate. However, these legal and regulatory conditions do not pose any significant barrier to entry or expansion.

199. Foreign ownership restrictions do not apply to the entry or expansion of any operator in the domestic New Zealand routes. The most likely new entrants are existing New Zealand or Australian carriers or carriers to New Zealand and as such they will not be impeded by the foreign ownership restrictions.

200. For domestic New Zealand routes, the requirement to secure an air operator's certificate may be a condition but does not constitute a barrier to entry. In *Bodas* the Commission noted that "any airline able to satisfy the regulatory requirements of the CAA as to the safety and competency of a planned service would be permitted to operate domestically."[61] Most of the CAA requirements relate to safety and operational matters. According to the Commission, these requirements "are achievable by a new entrant, although the lead-in time and cost involved would depend to a certain degree on the manner in which the entrant obtained engineering services."[62]

Scale and Scope of Entry

201. The scale and scope of an incumbent's network may give that incumbent an advantage along with cost savings enjoyed from running high levels of traffic over a particular route. However, they also face the cost of operating a network and are vulnerable to cherry picking. An incumbent in the Domestic New Zealand Markets is unlikely to enjoy the substantial economies that exist in other markets such as those in the United States and in Europe, for two reasons:

(a) an entrant can access the majority of passenger traffic with a small route structure. In the United States price wars with VBAs took place on routes that represent a small percentage of the FSA's network (even the biggest route for a United States carrier would still represent less than 10% of revenue), whereas in New Zealand, the largest 3 routes represent 54% of total traffic; and

(b) the network structure in New Zealand is more linear than those of United States and Europe. Therefore any potential barrier to entry in terms of an incumbent having and defending a "fortress hub" does not exist in New Zealand.

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61 *Bodas* para 250

62 *Bodas* para 251

202. Furthermore, as the Commission acknowledged, a VBA can compete effectively on a smaller scale and scope than incumbents do.[63] The Commission noted that a VBA is not likely to match an incumbent's frequency or capacity, rather a VBA is likely to, at least initially, operate at low frequency with few aircraft. Consistent with experience overseas, a VBA will initially seek to expand the market with a more price sensitive customer base, consolidate its position and then expand its frequency to attract a larger proportion of business passengers.

203. In relation to the New Zealand Main Trunk Market, a new entrant can access all passenger traffic in that market by operating on only three routes, which removes the need to create a service with a large scale or scope.

Access to facilities (terminal and ground handling services and landing slots)

204. The availability of landing slots is not an impediment to entry or expansion in the New Zealand Domestic Markets. As noted by the Commission in *Bodas*, generally in New Zealand there are no difficulties in accessing slots. The Commission did highlight that some smaller airlines that operate non-jet aircraft did suffer from a lower priority in Auckland and Wellington airports during peak times or bad weather conditions. However, a new entrant or expanding incumbent operating jet aircraft would not be affected during such circumstances.

205. Access to terminal and ground handling services, does not constitute a barrier to entry or expansion. Although there are some constraints at Auckland Airport in terms of access to gates and terminal facilities it is the Applicants' view that the entrant airline and the Auckland Airport would be able to resolve these constraints. Further, these constraints would be lessened under the Factual, given the wider spread of services contemplated.

Access to travel distribution services

206. The Commission concluded in *Bodas* that access to travel distribution services may be "problematic" for an FSA entrant but recognised that access would be less of a problem for an established airline. The Commission commented that a VBA could choose to bypass travel distribution services and establish its own direct booking service.[64]

207. The travel distribution services market has changed considerably since the *Bodas* decision, when "most domestic air travel was sold through retail travel agents" (page 50

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[63] *Bodas* para 259 and 266

[64] *Bodas* para 296

paragraph 284). The launch of NZ Express has resulted in a substantial increase in the number of flights booked directly with Air New Zealand. It is expected that a VBA entrant would heavily promote direct booking, which would be consistent with Virgin Blue in Australia, and easyJet and Ryanair in Europe.

208. Because entry is likely to be by a VBA, and if not, by an established FSA, the Commission's observations in *Bodas* support the Applicants' view that access to travel distribution services is not a barrier to entry or expansion.

Access to feeder services

209. Accessing feeder services is a condition to be considered when determining barriers to entry or expansion for New Zealand domestic routes. Feeder services may be an international carrier feeding domestic New Zealand carriers or a provincial airline feeding a New Zealand main trunk operator. Access to feeder services may be an advantage because it increases the number of potential passengers. This advantage is offset by the availability of:

(a) Origin Pacific to provide feeder traffic to and from provincial routes to an entrant;

(b) foreign carriers and any trans-Tasman entrant to provide feeder traffic to Origin Pacific or any other domestic New Zealand entrant; and

(c) opportunity for a domestic entrant to form alliances with existing international services provided by independent carriers to provide feeder traffic.

210. The Commission's conclusion in *Bodas* was that access to feeder services "might be a problem for an entrant on the provincial or tourist routes, although it is unlikely to be a problem for either a full service entrant or a value based entrant to the main trunk routes."[65] In any event, a VBA entrant in the New Zealand domestic markets, by its very low cost characteristics, will still operate point to point services, and will not generally seek connectivity with other airlines.

211. Prior to *Bodas*, *Brierley/Air New Zealand*, the Commission rejected Ansett New Zealand's submission that a loss of feed from Qantas' international flights would threaten its viability on the domestic market. The Commission concluded that loss of feeder traffic would not threaten Ansett New Zealand's viability because international feed accounted

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65 *Bodas* para 305

for a relatively small amount of domestic traffic and because there were other airlines flying into New Zealand.

212. In respect of the New Zealand Provincial Market, there are no restrictions on any international carrier providing international feed to Origin Pacific. Origin Pacific has even commented that it would consider opportunities with other airlines.[66]

Access to Computerised Information/Reservation Services

213. Access to CRSs and GDSs does not constitute a barrier to entry or expansion.

214. While Air New Zealand and Qantas previously held equity stakes in GDS this is no longer the case.[67] There are a number of GDS providers from which airlines can purchase services, including Sabre, Galileo, Worldspan, Amadeus, Infini, and Topaz.

215. With respect to CRSs, Air New Zealand operates its own CRS, whereas Qantas works off Amadeus. However, there are independent CRS providers from which an entering or expanding airline could obtain services if airlines were unable to reach a hosting agreement with Air New Zealand, including EDS/Sabre, Unisys, Equant (SITA), and Amadeus.

216. The Commission in *Bodas* has also recognised that access to computerised information reservation systems would not give rise to competition concerns, especially in relation to a VBA because a "value based entrant could have its own CRS without needing to have access to a GDS".[68] Further factors supporting the Applicants' view include:

(a) (as noted in *Bodas*), the costs for an entering airline in setting up its own CRS/GDS are not high, there being no significant barriers to entry in that market;

(b) (as noted in *Bodas*) with respect to a CRS/GDS, a VBA would be likely to use the Navitair Open Skies System, a software suite designed for VBAs, currently utilised by Ryanair, easyJet and Virgin Blue; and

(c) for VBAs concentrating on point to point traffic, the use of the internet is rapidly becoming an effective substitute for GDSs.

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[66] The Nelson Mail "*Air deal not seen as threat*" 26 November 2002

[67] GDS distribute their services through National Marketing Companies (NMC) in each geographic territory. Previously, Air New Zealand and Qantas had equity stakes in two NMCs through the travel distribution company TIAS. Specifically, TIAS used to own two NMCs, namely SCDS and Sabre which distributed Cendant/Galileo and Sabre GDS, respectively. In 2001, TIAS sold its shares in the two NMCs to their respective GDS' owners

[68] *Bodas* para 308

Access to Catering Services

217. The Commission in *Bodas* concluded there was no difficulty obtaining catering for flights. Access to catering services has not been restricted since *Bodas*. In any event, VBAs typically only require minimal access to catering services.

Availability of Pilots

218. The availability of pilots, which was not raised as a potential issue in the *Bodas* decision, has not deteriorated since that decision. In fact, the demise of Ansett in Australia and Tasman Pacific (Qantas New Zealand) and the general international economic downturn has given rise to a substantially greater pool of available pilots. Therefore the Applicants are of the clear view that availability of pilots is not a barrier to entry or expansion.

Availability of Aircraft and Finance

219. As illustrated, there is a wide range of aircraft servicing the Relevant Markets. The availability of aircraft and finance is not a barrier to entry or expansion.

220. There is an active operating lease market for aircraft, accounting for approximately one third of new aircraft activity and enabling airlines to expand their fleet without significant capital outlay. The availability of aircraft to lease has increased since September 11 and the subsequent recession in the aviation industry. Airlines are also able to purchase aircraft on an active second hand aircraft market.

221. In terms of financing mechanisms, although airlines tend to have special financing requirements, this is to some extent mitigated by the security value of modern aircraft as perceived by the financial markets. The range of financing options available to airlines, particularly start up airlines, includes:

(a) Traditional Bank Funding - generally committed medium term finance, in the form of either direct loans (secured against aircraft) or as debt providers in leverage lease transactions.

(b) Export Credit - because a large number of aircraft purchases represent exports from the US or Europe, government sponsored export credit programmes are widely used and often give airlines both an alternate source of credit and attractive terms. Overall, (subject to credit) any new entrant is likely to be able to readily obtain finance.

(c) Leasing Market - usually relates to aircraft, but it can also be used to finance engines and other assets (such as spare parts) has emerged as a major source of capital for the airline sector.

Incumbent Response

222. The Commission has previously considered the possibility that incumbents might adopt strategies, such as selective price reductions and capacity increases, so as to increase initial start up costs for entrants in terms of initial losses. To the extent such a strategy increases the sunk cost and hence the risk premium paid to secure funding, a barrier is arguably created.

223. The traditional model for incumbent response was to undercut the fares offered by a competing FSA using the benefits of incumbent economies of scope and scale. Such a response is no longer logically available to incumbent FSAs faced by a VBA entrant which, utilising a "greenfield" low-cost base, is always able to undercut the FSA pricing usually without detriment to its business model or profitability.

224. However, it would be difficult for incumbents to apply selective strategies given that VBA entry into the New Zealand Main Trunk Market will be based on price.

225. Indeed, the mere threat of entry into the New Zealand Main Trunk Market is sufficient to constrain the incumbents. The much-reduced level of pricing of NZ Express Class in the New Zealand Domestic Markets is as much a recognition that the market is conducive to VBA-type service as it is a response to the existing and threatened competition from Qantas.

226. Finally, the Applicants note that to the extent an entrant also operates trans-Tasman services, it is likely that entrant would already have a presence at all main trunk cities.

trans-Tasman Market

227. The Commission determined that barriers to entry and expansion were low in the trans-Tasman market in *Bodas* and in *Kiwi Airlines.* The MOT concluded in 2002 that the Commission's conclusion remained valid, and further that "[t]he Tasman is recognised to be a prime target for start-up and charter service activity".[69] The ACCC has also examined barriers to entry and expansion on trans-Tasman routes in its authorisation of the Tripartite. Consistent with the precedent from these regulatory bodies, the Applicants

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[69] *Paras 26, 27*

consider that barriers to entry, and in particular barriers to expansion, are low in the trans-Tasman market.

Capital Requirements

228. As discussed from paragraph 187, capital requirements are not a barrier to entry or expansion in the New Zealand Domestic Markets. The capital required to enter or expand into the trans-Tasman Market is no more burdensome than that in the New Zealand Domestic Markets, especially in light of the ability of Fifth Freedom carriers such as Malaysian Airways, Thai Airlines and Garuda to utilise otherwise idle aircraft but only needing to cover marginal costs.

229. The Commission has commented with regard to Kiwi Airlines, that "Kiwi's start up clearly shows that a new "Kiwi-clone" airline could be started by some other party".[70] In a footnote to that quote, the Commission states that "based on the methodologies in the June 1996 issue of the Aircraft Economics magazine, a rough calculation implies start up capital of $NZ 4-5 million would be required".

Sunk Costs

230. Similar to the New Zealand domestic market, the sunk costs incurred upon entry into the trans-Tasman Market are likely to be moderated by the entrant, initially at least, servicing only the key main three cities in New Zealand and Australia. By servicing each of Auckland/Wellington/Christchurch and Brisbane/Sydney/Melbourne an entrant could access 86.9% of all trans-Tasman passengers.

231. Further, the MOU (1996) and the Single Aviation Market (2002) and the MOU (2000), now make it possible for an Australasian airline to operate with the benefit of "cabotage" i.e. uplifting and discharging passengers within either domestic New Zealand or Australia as part of an international route such as Auckland-Sydney-Wellington-Auckland.

232. For these reasons and the various factors discussed in relation to the domestic market (such as brand loyalty, start-up costs, acquisition of aircraft and other up-front costs) sunk costs do not constitute a barrier to entry or expansion by an Australasian VBA into the trans-Tasman market.

Legal and Regulatory Conditions

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[70] *Kiwi/Air New Zealand* para 15.5

233. Legal and regulatory conditions are not real impediments to new entrants intending to expand into the trans-Tasman market. In *Bodas*, the Commission concluded that "[t]he regulatory barrier to entry for another airline from either country is low, and there is no regulatory factor limiting expansion." The Commission also noted that regulatory barriers in the trans-Tasman market were low in the *Bodas* decision.[71] The ACCC has quoted similar statements from the Commission without disapproval.[72]

234. The position since *Bodas* has only improved.

235. As stated above in paragraph 198, the three main legal and regulatory conditions of entry and expansion are international freedom rights, foreign ownership restrictions and the requirement to secure an air operator's certificate.

236. International freedom rights may restrict entry on international routes. However, In respect of trans-Tasman routes, a number of carriers, (e.g. Malaysian Airways, Garuda, Thai Airlines, Polynesian, Aerolineas Argentinas, Lan Chile, British Airways, Lufthansa, Singapore, and United Airlines) have Fifth Freedom rights and therefore are able to (and many do) service trans-Tasman routes.

237. Further, obtaining an operating certificate is not a barrier to trans-Tasman entry. Given the substantial existing participants in the New Zealand and Australian markets, it is apparent that obtaining an operator's certificate is not a significant cost, especially for an airline that already provides services on other routes.

Access to Facilities

238. Obtaining access to terminal and ground services and landing slots is not an impediment to entry or expansion in the trans-Tasman market.

239. Access to terminal and ground handling services, does not constitute a barrier to entry or expansion. Although there are some constraints at Auckland Airport in terms of access to gates and terminal facilities it is the Applicants' view that the entrant airline and the Auckland Airport would be able to resolve these constraints. Further these constraints would be lessened under the Factual, given the wider spread and services contemplated.

240. Since the demise of Ansett, access to slots in Australia is not an impediment.

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[71] *Bodas* page 80

[72] Air Alliance page 55,399

Access to Engineering Services

241. The Applicants are vertically integrated in the provision of engineering maintenance services in their respective home countries. As noted in the NECG Report there would be grounds for competitive concerns if airlines, as a result of the Transactions, were not able to access services at comparable prices to those attained by members of the proposed alliance.

242. Qantas' engineering and maintenance services in Australia do not constrain Air New Zealand's operations in New Zealand because Qantas has no third party capacity. Nevertheless, engineering services are available world-wide and acquirers of those services currently have the ability to (and do) move their aircraft and engines to be serviced by suppliers in other locations. It is worthy of note that the competitiveness of world supply of engineering services (an acquirer constraint) has seen Qantas servicing Air New Zealand aircraft in Australia and Air New Zealand doing the same for Qantas in New Zealand, notwithstanding being direct competitors in the up-stream market. Air New Zealand also provides engineering services to Origin Pacific, Virgin Blue, and, in the past, Qantas New Zealand (Tasman Pacific). Indeed, 45% of Air New Zealand Engineering Services' (ANZES) revenue is derived from external customers.

243. Because ANZES has consistently delivered value to Air New Zealand, it is highly unlikely that it would deny services to an entrant.

Incumbent Response

244. As discussed above in paragraph 222, the Commission traditionally considers whether incumbent response might increase the cost of entering or expanding into a market. However, for the reasons set out above, the Applicants consider that incumbent response is not a credible or logical tactic where the new entrant is a VBA with a significantly lower cost base than the incumbent.

245. The incumbent would have to match the likely entry level fares of a VBA entrant, and this would result in an incumbent FSA or VBA+ incurring losses. Put simply, a VBA entrant's lower cost base would enable it to withstand any attempt by the incumbent to enter into a debilitating price war in response to entry.

246. For that reason the discussion in relation to the New Zealand Domestic Markets is also relevant to the trans-Tasman market. The Applicants are of the firm view that incumbent response is not a barrier to entry by a VBA or expansion by an incumbent airline.

Other Conditions

247. In respect of the following conditions, the Applicants adopt the same arguments as have been made in respect of the New Zealand Domestic Markets:

- scale and scope of entry;
- access to travel distribution services;
- access to feeder services;
- access to computerised information/reservation system;
- access to catering services;
- availability of pilots; and
- availability of aircraft.

248. In the discussion of barriers to entry and expansion, the Applicants concluded that none of these conditions amounted to barriers to entry or expansion on the New Zealand Domestic Markets. For the same reasons, the Applicants consider they will not amount to barriers to entry or expansion on the trans-Tasman Market.

New Zealand – Asia/Pacific Destinations Market

249. The Applicants consider that there are low barriers to entry or expansion on the New Zealand- Asia/Pacific Destinations Market.

250. New Zealand has concluded bilateral arrangements with a number of countries in this region, including Fiji, Cook Islands, Samoa, Tonga, Thailand, Malaysia, and Singapore. The regulatory and legal conditions of entry do not constitute a material barrier to entry or expansion in respect of the Asia/Pacific Destinations routes.

251. The New Zealand – Fiji sector is the only ex-New Zealand sector serviced by both Air New Zealand and Air Pacific.[73] In respect of that route, Korean Air competes utilising Fifth Freedom rights (although is limited to 100 Fifth Freedom passengers per flight).

[73] Air New Zealand and Air Pacific also operate on the Fiji-Los Angeles sector.

252. Many of the Asia/Pacific Destination routes are particularly conducive to entry or expansion by a VBA airline as they primarily service price sensitive leisure passengers, flight times for many routes are short, particularly to the Pacific Islands, and an airline could service these markets using a point-to-point schedule. As discussed in paragraph 190, many entry or expansion conditions are appreciably less for a VBA than an FSA. The capital requirement and sunk costs that a VBA would need to overcome are unlikely to constitute barriers to entry or expansion.

253. For these reasons the Applicants consider that barriers to entry or expansion on the New Zealand – Asia/Pacific Destinations Market are low and the incumbents will continue to be constrained by the threat of potential entry or expansion by FSAs or by VBAs.

New Zealand – USA Market

254. The Commission has considered there were no regulatory barriers to entry on the New Zealand – USA market because of the very liberal bilateral agreement between New Zealand and the USA.[74] This condition prevails today. The low barriers to entry were acknowledged by the United States Department of Transportation when it granted antitrust immunity to Air New Zealand and United Airlines:

> "The U.S.-New Zealand market is governed by an open-skies agreement that eliminates barriers to new entry, expansion and competition created by government regulation in the U.S.-New Zealand market. The agreement provides for unrestricted competitive opportunities for all U.S. and New Zealand airlines, including the flexibility to operate their own direct services, or joint services with another airline."

And further:

> "This is precisely the type of market envisioned and promoted by the U.S.-New Zealand open-skies accord. Despite the large market share held by United's foreign partner in its homeland market, we see no barriers to entry by other airlines in this market. Because of the open-skies accord, any U.S. carrier may serve New Zealand from any point in the United States. Furthermore, the record of this case does not show any significant operational barriers to entry in the U.S.-New Zealand market (*i.e.*, access to slots or airport facilities) or marketing barriers that would prevent entry."[75]

255. The same view was expressed by the Ministry of Transport in its 2002 decision granting antitrust immunity to the Alliance Expansion Agreement between Air New Zealand and United Airlines. The Commission in *Air New Zealand/Brierley* expressed a similar view,

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[74] *Brierley/Air New Zealand*

where it commented that there were no regulatory barriers to entry in the New Zealand/United States market because of the very liberal bilateral agreement between New Zealand and the USA.

256. Sunk costs and capital requirements are also unlikely to pose a barrier to entry because of the likely nature of any new entrants, i.e. large established airlines. These airlines should have adequate access to capital to overcome sunk costs. Potential entrants include Delta, American Airlines, Northwest and Continental. Each has a base at Los Angeles and aircraft to operate direct services to New Zealand.

257. In terms of capital requirements, scale and scope economies and incumbent response, these are not likely to pose a barrier to entry given the likelihood that new entrants in this market will be large established international airlines.

Freight Markets

258. The Applicants are of the firm view there are no material barriers to entry or expansion in relation to freight services.

259. To the extent freight is carried in the belly-space of scheduled passenger aircraft, the earlier discussion of barriers to entry is relevant. In addition to passenger aircraft there are freight carriers operating dedicated freighter aircraft e.g. Lufthansa Cargo, DHL, etc. The conditions of entry or expansion for dedicated freight providers are even less material than they are for passenger air services. For example, a new entrant in the Freight Market would not incur the same advertising and marketing expenses. For further discussion see the NECG Report.

CONDITIONS

260. The Applicants believe that if authorisation is granted subject to conditions, this will assist the Commission's consideration of this Application. The Applicants will discuss details of proposed conditions with the Commission as soon as possible. The conditions proffered will be designed to achieve the following objectives:

(a) to facilitate and protect new entry on trans-Tasman and domestic New Zealand routes, including (if necessary) access to terminals, ground services and engineering facilities;

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[75] *United Airlines Inc, and Air New Zealand* Order to Show Cause – USA Department of Transportation 2 March 2001 Docket OST-1999-6680-7 page 8

(b) to ensure that the Applicants do not take unreasonable actions relating to capacity or pricing on routes they will be the sole operators; and

(c) to ensure the delivery of certain of the public benefits identified in the Application.

261. The conditions proffered will take into account the remedies commonly accepted by overseas regulators.

MARKET CHARACTERISTICS

Introduction

262. The Applicants acknowledge that the Transactions will give rise to some lessening of competition in a number of markets where the Applicants are the primary providers of passenger air and air freight services. These markets include:

    (a) New Zealand Main Trunk Market;

    (b) trans-Tasman Market; and

    (c) New Zealand – USA Market.

263. In assessing the extent to which competition will be lessened in any market as a result of the Transactions, it is necessary to consider the net competitive impact of the Transactions under the factual and the counterfactual. Relevant factors include:

    (a) the constraint imposed by existing (and continuing) competition;

    (b) the constraint imposed by near entrants, such as Virgin Blue, and potential competition;

    (c) the existence and height of any barriers to entry and expansion; and

    (d) the constraint imposed by the ability of acquirers and suppliers to exercise countervailing power.

264. In the Relevant Markets, any lessening of competition is ameliorated by low to moderate barriers to entry and low barriers to expansion, existing competitors and the existence of near entrant Virgin Blue.

265. Prior to examining the competitive impact of the Transactions on each of the Relevant Markets, it is useful to provide some base operational information relevant to the analysis.

Base Market Information

266. Attached as Schedules 3(g) and 6 respectively are:

    (a) a description of the aircraft types operated in each market, including their typical capacity and;

(b) route maps for each market showing the sectors served by each participant.

267. In respect of the New Zealand Main Trunk Market and the trans-Tasman Market there are two key features relevant to the analysis:

(a) Concentration of Passengers/Freight

Traffic in the New Zealand Domestic Markets and the trans-Tasman Market is concentrated on a small number of routes. In particular, the New Zealand Main Trunk Market (Auckland-Wellington, Auckland-Christchurch, and Wellington-Christchurch) accounts for 54% of all domestic New Zealand air passenger traffic. Likewise, in the trans-Tasman market, 86.9% of all trans-Tasman air passengers travel on routes between Auckland/Wellington/Christchurch and Brisbane/Sydney/Melbourne, with 54.8% of all trans-Tasman passenger traffic carried between those three Australian cities and Auckland alone.[76]

(b) Short-haul/Long-haul markets

As acknowledged earlier, in the key short-haul routes (travel not exceeding five hours) the Transactions will have a greater impact than in respect of long-haul routes. In the latter, barriers to entry and expansion tend to be lower (e.g. New Zealand-USA) and there is material constraint imposed by existing major international airlines and the potential for new entry on those routes, e.g. Singapore Airlines, Thai International Airlines and Malaysian Airlines, Garuda in respect of the New Zealand-South East Asia market; and other American airlines, in respect of the New Zealand-USA Market.

By comparison, the short-haul routes exhibit a greater degree of concentration at present, and constraint in the future (i.e. over and above that already imposed by the threat of entry) will likely be greater from new entry as opposed to expansion by existing participants.

Assessment of Constraints in the Relevant Markets

New Zealand Main Trunk Market

New Zealand Main Trunk – Summary

268. In summary, the extent of any competitive detriment in this market is minimised by:

(a) the low barriers to entry and expansion by an airline with an existing presence in Australasia, and the low to moderate barriers to new entry;

(b) the likely entry and expansion of a VBA, such as Virgin Blue, which likelihood is supported by market conditions, NECG's analysis as to the profitability of entry under the factual, and by Virgin Blue's initial reaction to the Transactions; and

(c) the expansion of Origin Pacific.

New Zealand Main Trunk – Background

269. Air New Zealand has been a participant in the New Zealand Domestic Markets from its inception in 1940 (renamed Air New Zealand in 1979). Air New Zealand was the sole provider of passenger air and air cargo services in this market until the entry of Ansett New Zealand (facilitated by deregulation), a wholly owned subsidiary of Ansett Holdings Limited Australia, in July 1987. Ansett New Zealand contemporaneously entered both New Zealand Domestic Markets (both main trunk and provincial). It established dedicated infrastructure, which included engineering and maintenance services, terminal and ground handling services, computerised information and reservation services and cargo handling facilities.

270. Ansett New Zealand continued to compete domestically until March 2000, when having accumulated losses of over $200 million it was sold to Tasman Pacific Airlines of NZ Limited, a wholly owned subsidiary of Zazu Limited, a company owned by a consortium of New Zealand and Australian businessmen. Tasman Pacific traded as Qantas New Zealand under a franchise arrangement with Qantas. Qantas had no equity or other financial relationship with Qantas New Zealand. Tasman Pacific competed in the New Zealand Domestic Markets until it was placed in receivership in April 2001. In September 2001, Qantas entered the New Zealand Main Trunk Market utilising four Boeing 737 aircraft. In November 2002 it increased capacity by 25% when it added an additional Boeing 737 aircraft.

271. Freedom Air began operations in 1995 and was 're-launched' in 1999 as a VBA operating out of secondary airports in the trans-Tasman Market. In 2001 Freedom Air expanded on to New Zealand Main Trunk routes, in addition to its trans-Tasman services, to fill the void left by Tasman Pacific's exit. Given the high degree of flexibility inherent in the Freedom Air VBA model (particularly a high degree of outsourcing) it was able to commence main trunk operations within 7 days of a decision to enter. However,

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[76] Australian Department of Transportation, YE July 2002.

with the recent restructuring of Air New Zealand domestically as a VBA+, Freedom Air now operates solely on trans-Tasman routes.

New Zealand Main Trunk – Existing competition

272. Existing participants in this market comprise Air New Zealand, Qantas, and as an expanding participant, Origin Pacific. The market shares (on the basis of capacity) of the major participants are outlined below. [77]

One way Domestic Trunk capacity shares week 9 December 02						
Weekly OW seats						
From	To	**NZ**	**QF**	**Origin**		**JAO Shares**
AKL	CHC	12,894	6,264	50	19,208	99.74%
AKL	WLG	14,552	7,540	0	22,092	100.00%
CHC	WLG	9,810	0	1,999	11,809	83.07%
		37,256	13,804	2,049	53,109	96.14%

<u>Origin Pacific</u>

273. Origin Pacific provides passenger air, charter and freight services in the New Zealand Provincial Market, but more recently has expanded its services by entering the New Zealand Main Trunk Market using larger turbo-prop aircraft.

274. Origin Pacific's entry into both New Zealand Domestic Markets has occurred since the *Bodas* decision in 1996. Contrary to the view expressed by the Commission in *Bodas* that an entry strategy would have to be wide ranging and encompass both markets, Origin Pacific has achieved a successful entry in the New Zealand Provincial Market by means of limited niche entry with steady growth. It appears to be adopting the same strategy in respect of the New Zealand Main Trunk Market. Origin Pacific provides internet and call centre booking services as well as bookings through travel agents.

275. As Origin Pacific operates in the New Zealand Main Trunk Market and the New Zealand Provincial Market, after the financial difficulties of Ansett New Zealand (which led to its sale to Tasman Pacific, which subsequently went into receivership), Qantas has been codesharing on routes with Origin Pacific since August 2001. Qantas also operates two

[77] Market shares throughout this Application are calculated on the basis of capacity. A typical week in a given month is used (chosen to avoid schedules which may contain ad-hoc operations like Christmas specials, All Black services etc.). As 99.9% of all flights into/ex NZ are return services, the one-way schedules as detailed in Air New Zealand's Carina reservation system are used. All airlines' services are initially captured and the reduced to account for: (a) code-share operations, leaving only the operating carriers' schedules; and (b) multi-stop services (e.g. Auckland-Sydney if the service is Auckland-Melbourne-Sydney, in which case only the Auckland-Melbourne service is counted). These schedules are than grouped by city pair and region of operation. This process enables the determination of the level of one-way weekly trips, by aircraft type and city pair. Capacities are than calculated by multiplying the above trips by the saleable capacity of the aircraft as advised by the airlines to the Air New Zealand airport slot co-ordinator.

provincial routes (QF designated) using Origin Pacific ATRs. The codesharing arrangement is not exclusive, and is terminable by either party at three months' notice. The current arrangement in respect of the ATRs is due to expire in March 2003.

276. While the codesharing arrangement provides Origin Pacific with some additional support for its operations through Qantas feeder traffic and Qantas' marketing of Origin Pacific flights, it does not comprise a core part of Origin Pacific's business. Recently, and following announcement of the Transactions, Mr Robert Inglis, Origin Pacific's Managing Director, was reported as saying that the arrangement with Qantas was incremental, and not its core business.[78] Mr Inglis has drawn attention to the short duration of the arrangements, and observed:

> "The arrangement we have had since the failure of Qantas New Zealand has always been a short-life arrangement… We have accepted we just keep our own brand and our own product, and have never taken the view that another carrier was our future…."[79]

277. Mr Inglis was also reported as saying that he had always maintained the arrangement was set up not to exclude Origin from working with any other carrier. If opportunities came up with other airlines, Origin would look at them as long as they brought mutual benefits.

278. Similarly, Mr Inglis was recently reported as saying that Origin would survive if it lost its codeshare agreement with Qantas and would not need to downsize, and that the agreement with Qantas accounted for only a relatively small percentage of Origin's total capacity.[80]

279. On 8 August 2002 Origin Pacific announced an expansion to its scheduled services.[81] Origin now operates over 100 flights each weekday, servicing 14 destinations. As set out below, it currently services Auckland, Tauranga, Hamilton, Rotorua, New Plymouth, Napier, Palmerston North, Wellington, Nelson, Blenheim, Christchurch, Queenstown, Dunedin and Invercargill.

280. Given the ready availability of appropriate jet aircraft and turbo-prop in the international market (see Schedule 3(g)), there is no reason, given the right financial incentives, why Origin Pacific cannot continue its steady expansion and become a full geographic

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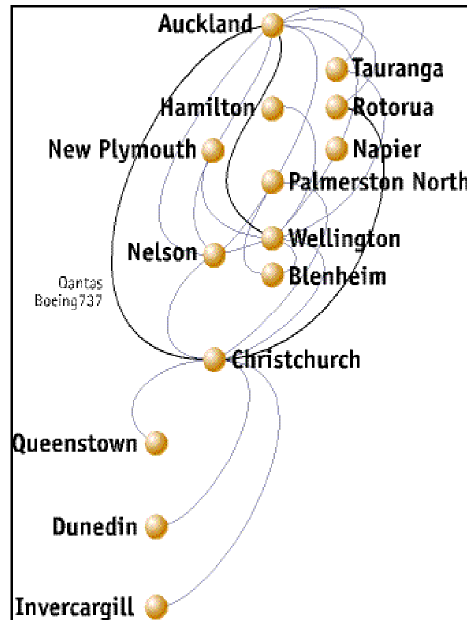
[78] The Nelson Mail, 26 November 2002, "Air Deal not seen as threat"

[79] The Nelson Mail, 26 November 2002, "Air Deal not seen as threat"

[80] The Dominion Post, 28 November 2002, "Origin can't rival alliance" says boss

[81] Origin Pacific Press Release 8 August 2002

competitor in the New Zealand Main Trunk Market. Origin Pacific can expand as slowly or as quickly as it desires and can minimise sunk costs. It has an established brand.



281. Origin Pacific is the classic niche operator discussed by the Court of Appeal in *Southern Cross*. In *Southern Cross,* the Court of Appeal emphasised that a small player in a market (or small players in a market) can constrain a firm with a large market share provided barriers to expansion are low.

> "Whatever the size of the merged entity's market share, it is elementary that its market power will not be insufficiently constrained unless there are barriers to entry or expansion which protect it from effective rivalrous reaction to the exercise of its market power."[82]

282. Origin Pacific has already commenced operations on the Wellington-Christchurch route. The Applicants' main advantage over Origin Pacific is the Applicants' ability to access economies of scale. However, in *Southern Cross* the Court of Appeal stated:

> "It is not, however, sufficient to point simply to economies of scale to establish a barrier to entry or expansion. In the absence of a natural monopoly, or significant sunk costs, or other like advantages, the incumbent is unlikely to be insufficiently constrained."[83]

[82] Para 86

New Zealand Main Trunk – Potential Competition

283. Barriers to entry and expansion in this market are considered to be low to moderate for an existing airline, and moderate for de novo entry (see discussion commencing at paragraph 184). Any Australian or New Zealand or other existing or potential airline can enter as of right. There are no ownership concerns – New Zealand is one of the few countries in the world where a foreign-owned airline can fly domestically. For that reason, potential entry and potential expansion will provide an important constraining influence on the Applicants, each of which will remain substantially constrained in this market by the ability for new entry or expansion to occur without significant delay. In the Applicants' view, such entry and expansion can occur well within the two-year period adopted by the Commission at paragraph 7.5 of its Practice Note 4. As the Freedom Air domestic start-up illustrated, for an incumbent Australasian VBA, entry or expansion can occur in a very short space of time.

Virgin Blue

284. Currently, Virgin Blue is consolidating its position in Australia as the number two supplier of domestic passenger air services. Virgin Blue has become an Australian resident airline with unfettered rights of entry into the New Zealand Domestic Markets and the trans-Tasman Market. It would qualify as a Single Aviation Market airline. It has strong shareholder and financial support for its business operations and expansion plans.

285. A number of factors have contributed to Virgin Blue's success.

   (a) Virgin Blue has strong financial backing, both in Sir Richard Branson and his extensive network of Virgin group companies, and in the $260 million investment recently made by Patrick Corporation, one of Australia's leading transport companies;

   (b) Virgin Blue's low VBA cost structure through maintaining low employee costs, operating a single type of aircraft and basing its operations in Brisbane (rather than Sydney);

   (c) Virgin Blue's operators, which focus on cherry-picking high density city pair routes to ensure high load factors; and

[83] Para 91

(d) Virgin Blue's success in launching its brand, which is now well recognised in the Asia-Pacific region. (Virgin Blue's marketing achievements are in line with those of the Virgin group, which is among the 12 most globally recognised brands.)[84]

286. While Virgin Blue has been inconsistent in its statements regarding entry on the trans-Tasman, there is no doubt that Virgin Blue's intention is to expand internationally. Virgin Blue's conduct confirms its planned expansion – and suggests that its expansion will be on a considerable scale. Sir Richard Branson has announced that Virgin Blue is intending to float in 2003, which will provide Virgin Blue with additional capital to fund its proposed acquisition of new aircraft, which will increase its fleet by over 40% in the next few years.[85] In addition, Virgin Blue has been seeking bids from various airports in the region, including in particular, a number of airports in New Zealand.

287. Recent comments aside, Virgin Blue has consistently expressed its intention to enter the New Zealand Main Trunk Market and the trans-Tasman Market (see Schedule 5). The recent entry and significant growth achieved by Virgin Blue in Australia illustrates its ability to compete with major incumbent airlines and to survive a price battle. The Ansett Australia disappearance provides startling evidence of that assertion.

288. NECG’s economic modelling has confirmed that it is profitable for a VBA such as Virgin Blue to enter domestic New Zealand routes under the Factual. This modelling supports the Applicants’ views that by year 2 of the Alliance a VBA would have entered Domestic New Zealand Main Trunk routes, operating 4 Boeing 737s. Virgin Blue faces no barrier to entry or expansion into the New Zealand Main Trunk Market.

289. Virgin Blue’s entry complies with the Commission’s LET test:

(a) *likely* – Virgin Blue has access to sufficient capital, it has access to aircraft and facilities, and it has repeatedly stated its intention of entering the New Zealand Main Trunk Market in combination with an entry into the trans-Tasman Market, and has lodged tender documents with several New Zealand airports;

(b) of sufficient *extent* – Virgin Blue’s current size, skill and track record in Australia, its access to capital and its structure as a full VBA demonstrate that its entry will be at a strongly competitive level; and

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[84] According to Interbrand's Brand of the Year Survey 2001 (released in March 2002).

[85] From 28 aircraft to 40: Jane Boyle "New Jets but No Virgin Float" *Australian Financial Review*, 12 November 2002

(c) *timely* – Virgin Blue has expressed the intention of entering the market within 12 months (certainly, given the financial incentive discussed by NECG in its Report, it will enter within 2 years).

290. In the Applicants' view, entry by Virgin Blue into the New Zealand Main Trunk Market in compliance with the Commission's LET test is more probable than not given the financial incentive to do so. This view is supported by Air New Zealand's investigations prior to NZ Express, which confirmed that the New Zealand domestic market would be best served by a low cost carrier.

New Zealand Provincial Market

New Zealand Provincial Market - Existing competition

291. In this market, the Transactions will not result in any market aggregation. Except for codeshares on Origin Pacific, Qantas does not operate in this market. [86] Therefore, there will be no material impact in the market and Origin Pacific and Air New Zealand will continue to compete in the same manner as presently. This is supported by the statements made on behalf of Origin Pacific, set out above.

292. Origin Pacific operates in the Provincial Market utilising ATR 72, Aerospace Jetstream 31, 32 and 41 aircraft, Dash 8, Fairchild Metroliners, and for charter services a Cessna 421 Golden Eagle 7-seater.

293. Other existing participants in the New Zealand Provincial Market include Air Adventures/Air Chathams, Air Fiordland, Air Kaitaia, Mountain Air, Southern Air, Aspiring Air, Air Kapiti/Wairarapa Alpine and Air Coromandel.

294. Because of the ability for Origin Pacific to expand, the Applicants make only make summary comments in respect of the New Zealand Provincial Market. Further information is available if the Commission requires.

New Zealand Provincial Market - Ease of expansion

295. Air New Zealand (directly or via group companies) has been a participant in this market since its inception. Competition in this market is provided by Origin Pacific which commenced operations post the Commission's *Bodas* decision. As noted above, in that

[86] Qantas currently codeshares with Origin Pacific ("Origin") on the following routes, namely Christchurch-Dunedin, Christchurch-Invercargill, Christchurch-Nelson Christchurch-Rotorua , Christchurch-Wellington , Christchurch-Queenstown, Wellington -Nelson , Wellington -Hamilton , Auckland-Nelson , Auckland-Palmerston North , and Auckland-Rotorua routes, pursuant to an agreement dated 25 June 2001 ("OP Codeshare Agreement").

Decision the Commission concluded that entry, sufficient to act as a constraint on a merged Air New Zealand and Ansett New Zealand, would need to involve simultaneous entry to multiple routes in the New Zealand Provincial Market. The Commission also concluded that such entry would of necessity include services on the New Zealand Main Trunk routes. However, since *Bodas*, Origin Pacific has slowly entered the New Zealand Provincial Market and has gradually expanded to service 14 different centres in New Zealand. As discussed earlier, it has recently entered Wellington-Christchurch, one of the main trunk routes. Origin Pacific is currently operating turbo prop aircraft and although benefiting to some extent from feeder traffic from Qantas, it has consolidated a sustainable position in the New Zealand Provincial Market, which it has steadily expanded since its entry in 1998.

296. In addition, Origin Pacific has recently introduced its 64 seat ATR72 aircraft on Nelson to Auckland and its 29 seat Jetstream 41 aircraft on its Nelson-Wellington services. A further enhancement of the current schedule has recently been implemented on Origin's Palmerston North-Auckland, Nelson-Christchurch and Napier to Wellington services. Origin Pacific has also announced services to Invercargill pursuant to a codeshare arrangement with Qantas.

297. As of 30 September 2002, Origin also increased its Auckland-Rotorua, Auckland-Palmerston North, and Auckland-New Plymouth services. Origin also announced the use of its ATR72 aircraft on its Auckland-Nelson service at peak times and direct off-peak services utilising the 29 seat Jetstream 41 aircraft.

298. Despite the Commission's finding in *Bodas* with regard to entry barriers in this market, Origin Pacific has made a steady but sustainable step-by-step entry. It did not have to enter on a broad network in order to achieve that sustainable entry.

trans-Tasman Market

trans-Tasman Market – Summary

299. In summary, the extent of likely competitive detriment in this market is minimised by:

(a) the presence of significant Fifth Freedom carriers;

(b) the constraint imposed by potential competition, consistent with the previous view of the Commission and the ACCC that barriers to entry in this market are low; and

(c) the stated intention of, and business case for, Virgin Blue to enter sooner rather than later.

trans-Tasman Market – Existing Competitors

300. Existing participants in this market comprise Air New Zealand, Freedom Air (a wholly-owned subsidiary of Air New Zealand), Qantas and a number of Fifth Freedom carriers. As noted earlier, 86.9% of all trans-Tasman traffic travel occurs between Auckland/Wellington/Christchurch and Brisbane/Sydney/Melbourne, enabling entry at a significant level to occur without the need for an entrant to encompass all routes.

301. The Market shares of the major participants are outlined below.[87]

One way Tasman cacpacity shares week 9 December 02

Weekly OW seats													**JAO**
From	To	**NZ**	**QF**	**SJ**	**TG**	**AR**	**LA**	**GA**	**MH**	**PH**	**WR**	**OB NZ**	**Shares**
AKL	SYD	6,030	7,834		2,835	450	807			308	172	**18,436**	**75.2%**
AKL	MEL	3,224	3,304									**6,528**	**100.0%**
AKL	BNE	1,468	2,758	568	855			879	2,010			**8,538**	**56.1%**
AKL	PER	920										**920**	**100.0%**
AKL	CNS	460										**460**	**100.0%**
CHC	SYD	2,198	4,356									**6,554**	**100.0%**
CHC	BNE	228	626	994								**1,848**	**100.0%**
CHC	MEL	798	974									**1,772**	**100.0%**
WLG	SYD	1,482	1,890									**3,372**	**100.0%**
WLG	BNE		462	852								**1,314**	**100.0%**
WLG	MEL	798	656									**1,454**	**100.0%**
ZQN	SYD	114										**114**	**100.0%**
Other	Freedom			4,936								**4,936**	**100.0%**
Tasman	**Seats**	**17,720**	**22,860**	**7,350**	**3,690**	**450**	**807**	**879**	**2,010**	**308**	**172**	**56,246**	**85.2%**

<u>Fifth Freedom Carriers</u>

302. Once the Transactions are implemented, *existing* competition will derive from the expanding Fifth Freedom Carriers, which now account for approximately 15% of the capacity on the trans-Tasman Market.

303. Fifth Freedom trans-Tasman rights are generally exercised by those airlines that operate from another country into Australia (or New Zealand) and that have aircraft on the ground in Australia (or New Zealand) for an extended period due to the need to meet timetabling schedules, often related to Northern Hemisphere arrivals. Such airlines frequently utilise the idle aircraft to fly from Australia to New Zealand (or vice versa) on a scheduled basis. Fifth Freedom carriers also expand their trans-Tasman services when there is incentive to do so by connecting through Australia (or New Zealand) rather than flying direct to their home country. Fifth Freedom services are usually provided at low fares recognising

[87] Note that Qantas uses spare Air Pacific and Polynesian Airlines aircraft time for trans-Tasman operations from time to time.

the Fifth Freedom carrier's ability to take advantage of marginal pricing – there is a real commercial incentive for those airlines to maintain these services.

304. The constraint imposed on the Applicants by Fifth Freedom carriers is significant. Existing Fifth Freedom Carriers flying regular scheduled services include:

(a) Thai International Airlines;

(b) Malaysian Airlines;

(c) Garuda Airlines;

(d) Lan Chile;

(e) Aerolineas Argentinas;

(f) Polynesian; and

(g) Royal Tongan.

305. The constraint imposed by Fifth Freedom carriers was recognised by the ACCC in its submission to the Australian Productivity Commission where it commented:

> "Examination of routes where fifth freedom carriers have operated would suggest that consumers are likely to benefit from their operations. For example, fifth freedom carriers on the Australia - UK route such as Singapore Airlines and Cathay Pacific have provided a credible competitive force to Qantas and British Airways. Even on the Australia - New Zealand route, fifth freedom carriers have provided strong competition (e.g. Continental Airlines in the 1980s). In these cases the fifth freedom carriers have provided a countervailing force to the third/fourth freedom carriers and been a significant determinant in setting prices."[88]

306. This constraint is evident on the Auckland-Sydney route where the Fifth Freedom carriers account for approximately 25% of total capacity, and on the Auckland-Brisbane route where they account for approximately 44% of total capacity. A proportion of this capacity is through-traffic (i.e. passengers with a final destination in the airline's home port).

[88] "Submission to the Industry Commission Inquiry into International Air Services", 20 April 1998, page 5

307. The ACCC's comment that carriers operating pursuant to Fifth Freedom rights provided "strong competition" preceded the most recent expansion of services, which is outlined below.

308. Thai expanded its trans-Tasman services in July 2002, when it added 3 MD11 (approximately 285 seats per aircraft) Auckland-Brisbane services per week to its existing daily Auckland-Sydney Boeing 747-400 services. This measure increased its weekly capacity from 2803 to 3690 one-way seats.

309. Malaysian Airlines, in July 2002, opted to substitute its direct Auckland-Kuala Lumpur Boeing 747-400 service for a 5 per week Auckland-Brisbane-Kuala Lumpur service. This measure increased its weekly trans-Tasman capacity from 0 to 2010 one-way seats.

310. Garuda has recently expanded its Auckland-Brisbane service. Prior to April 2002, Garuda operated twice weekly Auckland-Brisbane-Denpasar Airbus A330 services and one direct Auckland-Denpasar service per week. In response to a perceived opportunity, Garuda elected, from April 2002, to route all Auckland-Denpasar services via Brisbane. This measure has increased its weekly capacity from 572 to 879 seats.

311. United Airlines operated Fifth Freedom services on the trans-Tasman until April 2002. The Applicants understand that United Airlines ceased its Auckland-Melbourne service because:

(a) improved schedules on the route by alliance partner Air New Zealand allowed it to connect more efficiently to Air New Zealand's Auckland-Melbourne sector;

(b) ceasing the Auckland-Melbourne service allowed it to operate the more efficient, but smaller, Boeing 777 on the Auckland-Los Angeles route (its Boeing 747-400 aircraft became relatively more expensive to operate when it signed a new pilot contract in 2000).

312. In summary, trans-Tasman capacity as at 9 December 2002 is 19% higher than December 2001 capacity (47,284 to 56,246 one way seats). Having regard to the importance of the trans-Tasman routes to its overall network, the Air New Zealand Group (including Freedom) has been forced to increase capacity to retain its existing share of this enlarged market. Qantas has increased its seats on the trans-Tasman over the same period by approximately 17.5% (19446 to 22860 one way seats).

trans-Tasman Market – Potential competition

313. There are other international airlines, notably Singapore Airlines and United Airlines, that have aircraft available enabling them to use their Fifth Freedom rights to transport passengers and freight in the trans-Tasman Market on a marginal cost basis. Other airlines based in countries with the requisite passenger rights include Air China, Air France, Lufthansa, Cathay Pacific, Air Macau, Mandarin Airlines, British Airways, and United States-based carriers, e.g. Continental, Delta and American Airlines. Further, the majority of airlines servicing New Zealand from Asian points direct have Fifth Freedom rights, and could elect to route services through Australian points in a similar fashion to Malaysian Airlines, in response to the necessary incentive.

Virgin Blue

314. The low barriers to entry and expansion in the trans-Tasman Market are discussed at paragraph 227. In *Bodas*, the Commission found that the regulatory barrier to entry for another airline from either Australia or New Zealand was low and that there was no regulatory factor limiting expansion.[89]

315. Virgin Blue has continually stated its intention of entering the trans-Tasman Market. As recently as November 2002 Virgin Blue issued Tender Documents to at least 3 airports in New Zealand seeking their views on Virgin Blue entry, querying what incentives Virgin Blue might receive to commence services.

316. Virgin Blue's intentions to enter the trans-Tasman have been unequivocally stated by various members of the Virgin Blue team, including the CEO of Virgin Blue, Brett Godfrey,[90] Virgin Blue's commercial head, David Huttner,[91] Chris Corrigan,[92] and Richard Branson himself.[93]

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[89] *Bodas* para 380

[90] The Dominion – 3 June 2002. On 3 June 2002, Brett Godfrey, CEO of Virgin Blue, reiterated that "Virgin Blue aims to be flying across the Tasman into New Zealand within 12 months and possibly operating within New Zealand"

The Australian – 17 June 2002. On 17 June 2002, Brett Godfrey explained that the airline "was going through the regulatory ropes" to enable it to launch trans-Tasman services "in the not too distant future."

[91] INL Newspapers – 13 March 2002, per David Huttner: "we hope to fly to New Zealand by the end of the year".

The New Zealand Herald – 13 May 2002. On 13 May 2002, Virgin Blue's commercial head, David Huttner, was quoted as saying that he hoped to call on the Government while in New Zealand next week. "I think we will come down very soon to kickstart the process again and see where we left off … The application process became dormant," Mr Huttner said. A spokeswoman for Transport Minister Mark Gosche said he planned to meet Virgin Blue representatives on Monday, but that was a routine meeting. "The no-frills carrier – owned by British entrepreneur Sir Richard Branson – said in April it wanted to expand to New Zealand and hoped to offer international and domestic services, flying Boeing 737s, by the end of this year"

[92] Mark Todd, "Qantas puts squeeze on Clark and Air NZ", Sydney Morning Herald, 30 July 2002

Xtramsn website – 18 March 2002, Chris Corrigan noted that Virgin Blue's priority is to expand in Australia prior to entering the New Zealand domestic market while "definitely [*wanting*] Virgin Blue to fly in New Zealand at some point.

[93] The Age – 16 April 2002. Sir Richard Branson also repeated that his plan was to expand internationally over the next two years, with Hong Kong, Indonesia and New Zealand as possible routes.

317. Virgin Blue's plans for further expansion across the Tasman have been strengthened by Patrick Corporation's recent acquisition of 50% equity in Virgin Blue. The Virgin Blue media release noted that this agreement would allow Virgin Blue, as an Australian owned airline, "to operate international routes in the future should it wish to do so."[94]

318. Given the rate and scope of Virgin Blue's entry and growth in the Australian domestic market, Virgin Blue's conduct and NECG's modelling of the profitability of entry by Virgin Blue on the trans-Tasman, it is apparent that it would be both rational and profitable for Virgin Blue to continue its expansion in Australasia. It can also be assumed that its entry into the trans-Tasman market will be at a significant level, certainly including the four principal routes which carry the majority of trans-Tasman traffic. Indeed, Brett Godfrey has stated (as recently as 6 weeks ago) that:

> "Virgin Blue plans to fly to New Zealand next year and have a fleet of eight planes operating international flights by the end of 2004."[95]

319. This can be compared to the approximately 10 aircraft currently operated by Qantas on the trans-Tasman and the 12 operated by Air NZ.

320. The threat of entry by Virgin Blue and/or expansion by Fifth Freedom carriers is sufficient to constrain Qantas and Air NZ, even without the significant level of competition from existing competitors. In addition, the ability of a new entrant, including Virgin Blue, to enter the trans-Tasman will be enhanced by Qantas and Air NZ who are willing to facilitate and protect new entry on trans-Tasman routes.

321. For the same reasons as are described in respect of the New Zealand Domestic Market, and for the reasons set out in the NECG Report, Virgin Blue's potential entry into the trans-Tasman Market complies, in all respects, with the Commission's LET test. The Applicants assume that Virgin Blue will enter this market as a VBA under the Factual, utilising the same, or similar, aircraft that it utilises on Australian main trunk and regional routes, i.e. Boeing 737s.

The New Zealand Herald – 13 May 2002. On 13 May 2002, Sir Richard Branson said Virgin Blue would "establish an international operation within 12 months and look at listing within two years". He said "New Zealand would be one of Virgin Blue's first international destinations.

Also on 13 May, the South China Morning Post reported that Sir Richard Branson's Virgin Blue, "would almost certainly begin trans-Tasman flights within a year". The newspaper quoted Virgin boss Richard Branson as saying "services on the route could begin in a year

[94] Virgin Blue media release, "Virgin Blue and Patrick forge new aviation partnership", 12 March 2002.

[95] Jane Boyle, "Virgin Blue plans Tasman flights for next year" *Australian Financial Review* 21 October 2002.

322. Given the nature and extent of Virgin Blue's entry into the Australian domestic market, it can be assumed that its entry into the trans-Tasman market will be at a significant level, and will be likely to include the four principal routes discussed earlier.

323. The threat of Virgin Blue entering this market already places a significant constraint upon the existing participants.

Asia/Pacific Destinations Market

Asia/Pacific Islands – Destinations Summary

324. Aggregation occurs in this market by virtue of Qantas' 46.32% shareholding in Air Pacific, (in which Air New Zealand also holds a 1.97% stake). The only ex-New Zealand sector that Air New Zealand and Air Pacific overlap is Auckland – Nadi, on which they compete directly with Korean Air.[96]

325. The Transactions do not result in aggregation on any other Asia/Pacific Destination route.

326. The Applicants do not consider that there would be any competitive detriments in the Asia/Pacific Destinations Market given the following market features:

(a) the number of competing airlines offering travel to a range of competing destinations in the market such as Hawaii, Vanuatu, Tonga, Bali, and Thailand;

(b) the low barriers to entry and expansion by existing airlines;

(c) the countervailing power imposed by travel wholesalers and consolidators;

(d) the high degree of price-sensitivity of passengers;

(e) the importance of Fijian tourism to the Fijian Government (majority shareholder in Air Pacific) which limits the extent to which Qantas' relationship with Air Pacific could result in supra-competitive pricing on Air Pacific routes to and from Fiji; and

(f) the constraint imposed by the range of alternative holiday destinations which do not immediately fall within this market, such as the Barrier Reef Islands, Brisbane (Gold Coast and Sunshine Coasts) together with a range of other holiday options.

[96] Air New Zealand and Air Pacific also compete on the Nadi-Los Angeles sector.

Asia/Pacific Island Destination - Existing competitors

327. The Applicants will be constrained by competition from the existing carriers in this market. As discussed in the market definition section, prices on the various Asia/Pacific Destinations sectors are constrained by the price of other sectors.[97]

328. Any attempt by the Applicants to increase price, or decrease service, on any service in this market will result in either substitution by these price sensitive passengers to other Asia/Pacific Island destinations, or the foregoing of such travel altogether, at a level sufficient to render the price increase unprofitable. As set out in the market definition section, the likelihood of switching to alternative holiday destinations was accepted by the Australian Federal Court in *Taprobane*.

The constraint imposed by Fifth Freedom carriers on this route is evidenced by Korean Air. Korean Air offers twice weekly services from Auckland to Nadi utilising a Boeing 777-200 as part of its Auckland-Seoul service, although currently, South Korea's bilateral with Fiji limits it to carrying 100 Fifth Freedom passengers. Korean Air is one of the world's top 20 airlines operating a fleet of 100 passenger aircraft, including 28 Boeing 747s, 10 777s and 16 A330s,[98] all of which are suitable for Auckland-Nadi-Seoul services. It operates almost 400 passenger flights per day to 77 cities in 29 countries on five continents.[99] Korean Air commenced its Auckland-Nadi service in September 1995, ceased in April 1998 and recommenced in August 2000.

Asia/Pacific Destinations Market - Potential competition

329. Barriers to entry and expansion in this market are considered to be low to moderate. For that reason, constraint from potential entry or from potential expansion in this market will provide a major constraining influence on the Applicants.

330. None of the existing competitors face material barriers in expanding their current services. In respect of Fiji, the Fijian Government in the past has expressed the view that strengthening its air services agreements with other countries is important in terms of increased tourism[100] and therefore the potential for airlines with Fifth Freedom rights to enter currently imposes, and will continue to impose, constraint upon the Applicants.

Asia/Pacific Destinations Market - Acquirer and supplier constraints

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[97] Qantas codeshares with Polynesian to Samoa, Tonga and Tahiti and with Air Tahiti to Papeete, however Qantas and the operating carrier retain absolute pricing discretion on these services. These arrangements will continue post-Transactions. Qantas also codeshares with on Pacific routes with Air Pacific, Polynesian Airlines,, Air Caledonie International and Air Vanuatu.

[98] www.koreanair.com/AboutKe/akmmedialit007.html

331. A significant proportion of traffic to Asia/Pacific destinations is carried pursuant to travel packages assembled by travel wholesalers. These packages typically include airfares, transfers, accommodation and in some cases additional activities (e.g., tours). Wholesalers typically determine which airline to use for the packages it is assembling. Many wholesalers are vertically integrated with downstream retail outlets, which enhances their bargaining power.

332. In these circumstances, the Applicants consider there is no material effect on competition in this market as a result of the Transactions. Further information can be made available if the Commission requires.

New Zealand – USA Market

Summary

333. The competitive effect in this market as a result of the Transactions is likely to be minimal for the following reasons:

(a) there are low barriers to entry and expansion for all New Zealand and American carriers;

(b) the counterfactual is a situation where Air New Zealand and United co-ordinate capacity and pricing in this market pursuant to their antitrust immunity, in which case there is little difference between the factual and the counterfactual insofar as constraint will continue to be imposed by a single FSA.

New Zealand-USA Market – Existing Competitors

334. Currently, there are three major carriers on this route: Air New Zealand, Qantas and United Airlines. The market shares of each competitor is provided below.

One way Non stop USA capacity shares - week 9 Dec 02						
Weekly one way trips						**JAO**
		NZ	**QF**	**UA**	**OB NZ**	**Shares**
AKL	LAX	5488	2758	2044	10290	80.1%

Antitrust immunity

335. Air New Zealand and United Airlines currently have authorisation from the Minister of Transport pursuant to section 88 of the Civil Aviation Act (which operates as a statutory

99 http://www.koreanair.com.au/AboutKe/ak_mediakit001.html.

authorisation for the purposes of section 43 of the Commerce Act). This section provides for the fixing and application of tariffs and capacity in respect of international carriage by air. The USDOT has granted equivalent antitrust immunity. On that basis, there is currently no incentive for United Airlines and Air New Zealand to compete.

336. Air New Zealand accepts it will be necessary to give notice terminating the United Alliance agreements immediately on the Transactions becoming unconditional. Pending termination, a condition in the Strategic Alliance Agreement specifically prohibits the Applicants from co-ordinating pricing or capacity on the New Zealand-USA (direct and indirect services), Sydney-Los Angeles and Los Angeles-London sectors during the period that "Air NZ and United Airlines are required pursuant to the United Airlines Agreements and permitted under the required regulatory approvals relating thereto to co-ordinate pricing and capacity in respect of Sectors between NZ and the United States". In the event of United filing for Chapter 11 protection, the Applicants believe that it will continue to have the capacity to operate on all relevant routes.

New Zealand-USA Market – Potential Competition

337. Further constraint is imposed by potential entry or expansion by competing airlines, aided by the low barriers to entry and expansion in this market.

338. American Airlines, Northwest, Continental and Delta are free to resume or initiate Australia/New Zealand services should a profitable opportunity arise due to attempts by incumbents to raise prices or restrict output on the relevant routes. All of these carriers participate in alliances with a number of foreign partners and have actively been working to extend the geographic scope of their systems and their global on-line networks. Further, their current fleet configurations are more suited to direct North American-New Zealand services than in the past. The New Zealand-United States Open Skies agreement ensures these carriers and all other United States airlines have the ability to extend their global networks into New Zealand without limitation on capacity whenever they wish.

339. **[**

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340. **[**

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[100] http://www.fiji.gov.fj/press/2001_10/2001_10_17-02.shtml.

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New Zealand - UK/Europe Market

Summary

341. Air New Zealand operates services to London via Los Angeles. Qantas does not provide any one-stop services in this market. Its New Zealand-UK/Europe services are primarily through Asia, and require an additional stop-over in Australia through the “Kangaroo route” to the west or require a connection with another carrier (such as British Airways) in the United States mainland. There are a large number of other carriers offering ex-New Zealand services to London. These carriers include:

(a) United Airlines;

(b) Malaysian Airlines;

(c) Singapore Airlines;

(d) Thai International;

(e) Cathay Pacific;

(f) Garuda;

(g) Korean Airlines;

(h) China Airlines; and

(i) EVA.

342. Given the large number of competing carriers, the Applicants believe the Transactions will have only a minimal effect on competition in this market and accordingly make no further comment. Further information is available if the Commission requires.

Travel Distribution Services Market

343. This market is relevant to the extent that Air New Zealand and Qantas sell tickets directly to customers . There are in excess of 600 competing suppliers in this market. In *Bodas*

the Commission concluded the travel distribution services market was "relatively competitive" (para 415) because:

(a) barriers to entry for both wholesalers and agents "appear low" - only "sufficient knowledge, skills, contacts, standing, accreditation with airlines and provision of a bond" were required to enter the market (para 410);

(b) the market was characterised by an abundance of travel agents (para 408); and

(c) a high proportion of travel agents' business was international travel related and Air New Zealand would have to compete with other international carriers in this segment. (paras 414 to 415)

344. These remain key features of the market for travel distribution services. There remains a high level of competition in this market, although there is a trend towards increased competition to supply passengers "value-added" services, rather than simple ticketing, e.g. House of Travel's "Searchflight", which searches across all airlines' offerings to search out the cheapest fare.

345. Having regard to the high level of competition in this market, no further comment is made. Further information is available of the Commission requests.

CONCLUSIONS ON COMPETITIVE DETRIMENTS

Introduction

346. The Applicants have assessed potential detriments that could arise in the four areas the Commission has identified as relevant to a consideration of detriment:

(a) loss of allocative efficiency;

(b) loss of productive efficiency;

(c) loss of product quality; and

(d) loss of dynamic efficiency.

347. In summary, the Applicants consider:

(a) the dead weight loss of allocative efficiency is likely to be small compared with the public benefits flowing from transaction discussed in Part III below; and

(b) there will be no material adverse impact on productive efficiency, loss of service quality or innovation incentives in the Relevant Markets.

Allocative Efficiency

Trans-Tasman and Main Domestic New Zealand

348. Loss of allocative efficiency arises if prices rise to a non-competitive level. To test and quantify the possible implications for prices and outputs, NECG have developed the models set out in section 4.1 of the NECG Report. These models are based on approaches that are very widely used in, and well accepted by, the economic literature and in practice in analysing mergers and strategic alliances. Essentially, they determine outcomes as a result of a process in which rival firms set the quantities they will offer, with markets establishing prices that clear these quantities.

349. It is important to note that these models, at least in the specifications NECG have adopted, tend to understate the impacts of rivalry between FSAs and VBAs on price outcomes compared with two FSAs competing with each other. This can be seen from the analysis discussed in sections 2.1.3 and 4.2.1 of the NECG Report of the impact of Virgin Blue's entry on prices in the Australian market. Actual price reductions exceeded those predicted by NECG's models by 2% to 13%. In essence this reflects the fact that the type of model NECG has adopted produces a more conservative result than is likely

to occur in fact, in that it assumes a less intense or "tough" form of competition (between two FSAs) than is likely to occur between a VBA and an FSA. The results NECG set out therefore are likely to over-state any competitive detriments which might arise.

350. The Applicants acknowledge that the counterfactual, in which the Applicants continue to fight for supremacy in the Relevant Markets, would involve lower prices than under the Transactions in the short to medium term (although in the medium to longer term this level of competition will be ultimately unsustainable). However, those impacts are likely to be small. This is because the Transactions will have two, inter-related, effects on market structure: while it will eliminate competition between the parties, it will also accelerate VBA expansion onto affected routes.

351. The results of NECG's modelling are presented in section 4.2 of the NECG Report. NECG's results are presented as the difference between the future with the Transactions and the future without the Transactions. Hence, although VBA entry would reduce price in the world with the Transactions compared to today's situation, this is not necessarily the case if the future without the Transactions also includes VBA entry. The impact on price and output will depend on the difference between the level of VBA entry in these two future states of the world.

352.

353. By year 3 of the Transactions, NECG's modelling suggests that, compared with the counterfactual in which the Applicants continue a destructive price war in these markets, there could be maximum average price changes of 4.7% on the main Tasman routes and 4.3% on the main domestic New Zealand routes.

354. Associated with these price changes, output is estimated to decrease 5.9% on the main Tasman routes and on the main domestic New Zealand routes output is estimated to decline by 3.6%.

355. In each case it is important to note that the changes are compared with the counterfactual. The results compared with the today are substantially different. On the trans-Tasman the model predicts the weighted average price increase comparing the factual and today's prices is very small, at only 1.7%. On the main domestic New Zealand routes it is only 3.1%. More significantly, the factual is estimated to result in 17.3% higher passenger volumes than current volumes on Tasman routes, and 17.6% higher passenger volumes on domestic New Zealand routes.

Provincial New Zealand routes

356. The Applicants note that the Transactions will have some impact on provincial city-pair routes within New Zealand. At present there are two carriers offering scheduled services to multiple destinations within New Zealand. These are Air New Zealand and Origin Pacific. In addition, Qantas codeshares on these routes. Ten of the locations are served only by Air New Zealand.

357. Origin Pacific, has been adding new nodes to its service network, with Invercargill, Blenheim and Rotorua services commencing on 30 September 2002. Origin Pacific has positioned itself towards the budget end of the market, and offers some direct region-region services that are not available on other airlines. Origin Pacific currently has a feeder arrangement with Qantas. This resulted in it receiving 174,198 passengers in the 12-month period to July 2002. Of these, 28% were connecting to or from a Qantas flight, with the remaining 72% being direct local sales independent of any other flight.

358. The Transactions will have two types of impact on these routes. The first is that the Transactions can be expected to have some adverse price consequences. However, for the four most significant routes, this effect is already captured in the competitive model constructed by NECG.

359. Secondly, the working relationship between Qantas and Origin Pacific will no longer be an exclusive one within New Zealand. It is therefore unlikely to continue in the longer term in its current form. This may have an effect on Origin Pacific's traffic flows to the extent that they depend on traffic feed from Qantas.

360. However, as noted earlier, Mr Inglis, Origin Pacific's Managing Director, was reported recently stating both that the arrangement with Qantas was incremental, and not core to Origin Pacific's business, and that Origin Pacific would not need to downsize if it lost its codeshare with Qantas.

361. In these circumstances, while the Transactions will result in some detriment in the New Zealand Provincial Market, there affects have been assessed and incorporated in NECG's cournot modelling on the four main provincial routes. The Applicants do not consider that the competitive detriments will be significant on the other provincial routes (of which ten are served only by Air New Zealand).

Asia/Pacific Destinations, NZ-USA and other international markets

362. NECG's modelling predicts moderate price increases in these markets compared with the counterfactual. These results are summarised in section 4.2 of the NECG Report.

Other markets

363. The Applicants do not consider there are any material competitive detriments in any other markets. In airfreight, entry barriers are low. Although the bulk of airfreight in the markets affected by the transaction is currently transported in scheduled passenger services, specialised freight carriers could readily expand and deflect any sustained price increase. In other markets identified in the Application and in the NECG Report, the applicants do not consider there would be any competitive detriments.

Welfare impact

364. NECG have converted the modelled price and output impacts to a measure of the welfare impacts of the Transactions by calculating the deadweight loss associated with the price increases and a portion of the transfers between producers to consumers. This is identified in section 4.2.3 of NECG's report. The deadweight losses allocated to New Zealand and Australia are based on the proportion of New Zealand and Australian passengers carried on each of the major routes. Three years after the Transactions are implemented, the estimated deadweight loss associated with the above price and output changes is estimated to be $25.9 million in New Zealand.

365. As discussed above, the Applicants propose that the authorisation be granted on the basis that it is granted subject to conditions. These conditions would be equivalent in their effect to the undertakings offered by the Applicants to the ACCC. They will be aimed both at facilitating entry and at providing assurances about the range and prices of services to consumers.

366. The conditions to be proposed will reduce economic costs (deadweight losses plus international transfers) of the Transactions to Australia and New Zealand combined.

367. In addition to the deadweight loss, NECG have identified the relevant proportion of transfers between consumers and producers. This proportion would arise if New Zealand residents face a price increase, but the profits resulting from that price increase were transferred to a foreign producer (including Australian firms). Similarly, if an Australian resident were to face a price increase, but the resulting profits were transferred to a foreign producer (including a New Zealand firm) this would be a detriment to Australia for the purpose of the Applicants' application for authorisation from the ACCC. Consistent approaches must be applied to transfers to producers. For example, if there were a price increase which impacted on a non-New Zealand resident, but the resulting profits were transferred to New Zealand producers, the transfer would be included as a gain to New Zealand.

368. This approach is consistent with the intention and purpose of the authorisation process and has been the approach consistently applied by the Commerce Commission in previous applications.

369. The relevant net transfers for year 3 of the Transactions without taking into account any conditions are estimated to be -$15.6 million for New Zealand.

370. Therefore, in year 3, the total detriments associated with the Transactions compared with a future without the Transactions are estimated to be $10.2 million for New Zealand.

371. For the full five years, with VBA entry, and without reliance on any conditions, the total detriments associated with the Transactions (on a city-pair basis) compared with a world without the Transactions are estimated to be, in present value terms, $129.9 million for New Zealand.

No loss of productive efficiency

372. The Applicants do not consider that the Transactions will have an adverse effect on productive efficiency. Net integration costs will not be material. The Applicants do not consider there is any risk that cost efficiencies gained through the Transactions, but not passed on to consumers, will be dissipated by subsequent managerial slackness (so called "x-inefficiency"). The Applicants consider x-inefficiency is unlikely to have any measurable effect on the overall efficiency gains of the Transactions:

(a) x-inefficiency, to the degree that it even occurs, is not a measure of economic inefficiency, but rather exaggerates it. X-inefficiency transfers (that is, redistributes) income from the firm to input suppliers. Only resources spent to obtain (and possibly to prevent) the transfers are potential sources of economic waste. Further, the only relevant waste is that which occurs in the factual, but not the counterfactual. But since governance of contracts with input suppliers is important in both cases, the change in the costs of governance between the factual and counterfactual is likely to be small. Moreover, the dynamic efficiency effects of failing to engage in governance suggests governance costs may not be wasteful at all.

(b) x-inefficiency is simply unlikely to occur for a range of reasons, the most compelling of which are that it is not profit-maximising. That is, the same motive that would lead the Applicants to set price as high as possible (and indeed higher than under the counterfactual) would also lead the Applicants to seek to prevent x-inefficiency; the Strategic Alliance Agreement penalises inefficiency by requiring a subsidy

margin to be paid by a party if it operates on a route in a manner that does not produce the highest available margin.

(c) if x-inefficiency were to occur, and the previous point suggests it would not, then it is likely to erode considerably less than 0.5% of cost efficiencies gained by the Transactions. This figure is based on US productive efficiency gains due to airline deregulation, and exceeds any likely loss of cost efficiencies between the factual and counterfactual because the factual does not involve the range of regulatory constraints that generated the 0.5% figure.

No loss of service quality

373. The Applicants do not consider that there will be any loss of quality in the provision of services. 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. The fact that a VBA service might be of different quality than that provided by a full service airline is not directly relevant in and of itself, since VBA fares are also substantially lower. The Applicants consider that there will be sufficient competitive discipline among service providers operating in each end of the service quality space that consumers will benefit from this expansion in the range of their choices. The Applicants do not consider that there will be any likely reduction in quality – if anything there will be an expansion in the range of choices available to consumers and therefore an increase in quality.

No loss of dynamic efficiency

374. The public benefits and competitive detriments associated with the Transactions are assessed by the Applicants for a relatively short-term horizon of three to five years. The Applicants anticipate that the Transactions will increase the likelihood of innovation, mostly notably in the form of entry by one or more VBAs.

375. In the longer term, the Applicants consider that there will be no loss of innovation incentives and therefore no loss of dynamic efficiency.

376. The Commerce Commission was concerned about innovation in its *Bodas* determination. This issue is considered in detail in section 4.6 of the NECG Report. NECG conclude that there are good reasons to believe quality-enhancing innovation will be at least as high under the factual as the counterfactual. Under the counterfactual, harsh price competition will reduce each carrier's broad capacity to invest, reducing access to funds, availability of scarce managerial time, and the attractiveness of any investment (because

of the difficulty of making a return on it). In contrast, the Applicants will have greater incentives to invest because the gains of investment are more readily achieved by the investor.

PART III: PUBLIC BENEFITS

Introduction

377. The Transactions will result in very substantial public benefits. The primary sources of benefits from the Transactions are:

(a) cost efficiencies;

(b) scheduling efficiencies;

(c) tourism benefits;

(d) engineering and maintenance benefits;

(e) freight benefits;

(f) capital related efficiencies;

(g) increased global competitiveness; and

(h) preservation of national flag carrier.

378. The benefits are substantial and demonstrable and considerably outweigh the competition detriment that may result from the Transactions. NECG has conducted a detailed analysis of these benefits and have quantified those that are capable of empirical assessment. The share of the quantifiable benefits attributable to New Zealand over the five years of the Transactions exceeds $1.5 billion.

Summary of total annual public benefits, $ million

Year	Cost Savings	Scheduling	New Direct	Tourism	E & M	Freight
1	-$5	11	13	81	39	1
2	$105	10	12	148	37	0
3	$183	9	12	148	35	3
4	$177	9	11	138	33	3
5	$167	8	10	130	31	3
5 yr Total	$627	47	58	645	174	11

379. However, some significant benefits from the Transactions are unquantifiable. Consequently, NECG's modelling results set out in the table understates the benefits flowing from the Transaction. The benefits that are not included in the table which cannot be readily quantified are:

(a) benefit of enhanced connectivity;

(b) capital related efficiencies;

(c) benefit of increased global competitiveness; and

(d) benefit preservation of national flag carrier.

380. The Applicants note that NECG has prepared its modelling on a *worst case scenario*. That is, NECG has adopted a conservative approach to its modelling of benefits. Their reported results are the minimum benefits which will flow from the Transactions. In its *Bodas* decision, the Commission considered that the benefits of the type listed above were properly described as public benefits for assessment and balancing of benefits and detriments in the airline industry.[101]

[101] *Bodas,* paras 511, 513, 526, 530, 531, 540, 546.

381. The structure of the Transactions is wholly different from those previously considered by the Commission, which will see greater rationalisation benefits accruing to New Zealand than was possible in *Bodas*.

382. The benefits set out flow from, and are dependent on, the Transactions. These benefits are net gains to society and not redistributions of wealth per se, or transfers between areas of the economy having a nil net impact on welfare.

Cost efficiencies

383. Strategic Alliances between competitors often result in benefits through cost rationalisation, efficiencies or synergies. The Transactions will permit substantial cost savings from:

(a) economies of scale; and

(b) more cost efficient aircraft selection.

Economies of scale

384. These will fall into two categories: costs that are duplicated across both carriers; and costs which, while not being duplicated, nevertheless present significant economies of scale. These will include, IT systems maintenance; lounge maintenance and some frontline functions, such as baggage handling and check-in services.

385. The Applicants acknowledge, however, that there are likely to be additional costs in the harmonisation of systems, particularly in the case of IT systems, where integration is likely to be costly. The Applicants expect to recoup the cost of integration over the three to five year period through the creation of a sustainable lower cost structure. While the Applicants consider that there are likely to be net economies of scale over the three to five year period, no value is claimed for them because quantification of them is difficult. In this respect, the Applicants consider that the approach taken is conservative.

Improved aircraft selection

386. The Applicants have agreed that both brands will continue to fly as part of the Transactions. The Applicants expect substantial cost savings as a result of economies resulting from improved aircraft selection.

387. There is a variation in cost advantages between the Applicants when assessed across different aircraft. By selecting the higher margin provider of particular aircraft types

where this is possible, genuine synergies are available from the Transactions. NECG have constructed a “bottom-up” cost model to study various aspects of the Transactions. They have used this cost model to estimate the savings resulting from improved aircraft selection (NECG Report, section 5.1.3). NECG’s modelling demonstrates that considerable cost savings will be achieved as compared to the counterfactual by reallocating aircraft across sectors and from aircraft rationalisation. The net cost savings resulting from the Transactions by year 3 are $363 million split between New Zealand and Australia.

Scheduling efficiencies

388. The Transactions will result in a significant change in the scheduling of flights, particularly on routes served by both parties. These changes will generate several classes of public benefits to New Zealand:

    (a) improved flight frequencies;

    (b) enhanced connectivity; and

    (c) additional direct services.

Improved flight scheduling

389. Where Qantas and Air NZ have been in competition with each other on a route, each has a strong incentive to schedule flights at roughly the same times as its rival. Firstly, the airlines will seek to operate their flights at those times when there is the greatest level of high yield traffic, in order to maximise their load factors and revenue. Secondly, each airline will seek to draw business away from the other. The result is that there is considerable alignment and overlap between the schedules of Qantas and Air NZ.

390. Under the Transactions, the incentive to "mirror" one another's schedules no longer exists. The objective for a unified operator is to arrange the schedules such that optimum frequency is provided to consumers, minimising "spilt" traffic that cannot be served because of schedule gaps. In addition, consumers receive a greater choice of flight times – and benefits will accrue to consumers who are presently unable to fly at a convenient time.

391. The combined management of Qantas and Air NZ is likely, on some routes, to replace two overlapping flights with one flight with greater capacity, and to offer an additional flight at a new time.

392. The improved scheduling under the Transactions provides substantial benefits to the New Zealand public in two main ways. The consolidation of overlapping flights into one flight with greater capacity will free up the use of an aircraft and additional landing slots at peak times. This will release a valuable resource and facilitate entry or expansion by other airlines. There is a public benefit in better and more efficient use of existing resources.

393. NECG have constructed a model which maps the two airlines' schedules and estimates the magnitude of the benefits likely to flow as a result of proposed schedule changes. The result is a total benefit to the New Zealand public of $10.6m per annum. As NECG note in their report, the measure provided is a conservative valuation due to the fact that saving time (or having an increased flexibility of choice) at one point in any given process (be it an airline schedule or otherwise) provides positive flow-on benefits with respect to the timing of the following steps in the process.

Enhanced connectivity

394. A second general type of scheduling efficiency arises from enhanced connectivity between the schedules operated by the two airlines. However, as NECG note in section 5.2.2 of their report quantification of the benefits associated with enhanced connectivity is difficult. While the Applicants are confident there will be a significant benefit to the New Zealand public from enhanced connectivity, NECG have advised that there is no reliable way of evaluating these benefits, even though it is apparent that they exist. Accordingly, this benefit has not been quantified. Again, this is an indication of the manner in which the quantified benefits claimed are conservative in the sense of understating public benefits from the Transactions.

Additional direct services

395. The third type of scheduling efficiency arises from the supply of additional direct services. There are a number of routes where a direct flight would be unprofitable for either airline on a stand-alone basis, and hence is not served by a direct flight. Under the Transactions, the effect of consolidating demand will enable the Transactions to provide a greater number of direct services.

396. The benefits arising from new direct services fall into three categories:

(a) passengers who currently travel indirectly can complete their journeys more quickly;

(b) the existence of a direct service is itself likely to stimulate demand on that city-pair so that the number of travellers increases; and

(c) because traffic is taken off the indirect flights, these have additional capacity which the airline will have an incentive to fill, leading to lower prices in the short term.

397. These effects illustrate the public benefit of obtaining a greater network. The Applicants initially expect to introduce four new direct services following implementation of the Transactions:

(a) Auckland-Adelaide;

(b) Auckland-Canberra;

(c) Auckland-Hobart; and

(d) Wellington-Canberra.

398. NECG have prepared a model which estimates the benefits from the direct flights. The total estimated benefit by year 3 is $26m per annum, split evenly between New Zealand and Australia on the grounds that all new direct routes are Trans-Tasman, and traffic across the Tasman is approximately evenly balanced between New Zealanders and Australians.

Tourism benefits

399. The Transactions will have a significant positive impact on tourism in three principal ways:

(a) Qantas Holidays, which is a significant division of Qantas Airways Limited with $1.1 billion of revenue in 2002, will have an increased incentive under the Transactions to market New Zealand in its products. This would generate additional tourists for New Zealand and, because of dual destination travel, also for Australia;

(b) the Transactions will improve the effectiveness of promotion by national tourism bodies and the parties; and

(c) new fares, network and loyalty programme integration (more direct routes, additional travel time options) is likely to stimulate tourism.

400. Benefits deriving from each of these factors have been quantified by NECG.

Qantas Holidays

401. Qantas Holiday's will have an increased incentive to market Air New Zealand as a carrier and New Zealand as a destination. Absent the Transactions, Qantas Holidays has a far lesser incentive to market Air New Zealand as a carrier, preferring to market only those destinations in New Zealand which it secures from Australia. By changing this incentive, the Transaction will result in a significant benefit for New Zealand and the Australasian region.

402. Qantas Holidays has assessed that, under the Transactions, it will increase tourist penetration from the regions where its "global footprint" is strong for travel to New Zealand. These regions include:

 (a) Australia;

 (b) the Americas;

 (c) Asia;

 (d) Europe; and

 (e) Africa and the Middle East.

403. The are approximately 2.3m inbound holiday passengers to Australia per year. Qantas Holidays has a market share of approximately 7.5% of the inbound tourist market. Qantas Holidays believes it will achieve a similar market share into New Zealand under the Transactions. As set out in the NECG Report Qantas Holidays has calculated that that alone would result in Qantas Holidays generating 73,000 overseas visitors per year under the Transactions. While a proportion of these tourists would be likely to have visited New Zealand in any event, Qantas Holidays estimates that the proportion that would have travelled to New Zealand in the absence of any Qantas Holidays initiatives to be about 32%. This results in a net gain from Qantas Holidays initiatives under the Transactions of 50,000 tourists per annum to New Zealand.

404. Tourism Futures International has reviewed these calculations and considers them to be reasonable.

Improved promotion effectiveness and levels

405. The Transactions will result in significant improvement in the effectiveness of existing promotion activities. The Transactions will also result in additional promotional expenditure.

Promotion effectiveness

406. The Transactions will enable the Applicants to co-operate in the advertising, primarily in the area of retail sales promotion and home markets. Qantas currently advertises fares in New Zealand and Australia, and Air New Zealand likewise promotes business to Australia within the New Zealand market. Co-operative advertising will lead to more effective promotion (and hence market stimulation) as well as rationalisation of expenditure. This will free up existing expenditure for promotion in other areas.

407. This will also be true in offshore markets such as Asia where the Applicants will be able to operate a streamlined combined "Australia/New Zealand" itinerary by triangulating with a combination of QF/NZ flights. This will unlock strong marketing opportunities. Currently Qantas invests in co-operative advertising with the Australian Tourist Destination focused exclusively on Australia destination travel, as does Air New Zealand with Tourism NZ. A triangulating routes network will improve the opportunities for the joint promotion of a "third market": the dual AUS/NZ market.

408. The Transactions will also provide opportunities for savings through joint media purchasing, although such savings may be limited.

409. It is estimated that these two factors will increase net tourist arrivals in New Zealand by 13,300 per annum.

Promotion Levels

410. The Applicants consider the Alliance will have a positive impact on promotion levels and therefore on tourist numbers. However, NECG have not been able to model these impacts. In this respect the estimated overall positive impact on tourist numbers is regarded as conservative.

Tourism impacts from new flights and new fares

411. Under the current market structure there are limitations on the extent to which tourists travelling to New Zealand and Australia can optimise their travel arrangements. That is because Qantas does not have the requisite bilateral rights to fly directly between New

Zealand and North Asia. For that reason, tourists from that region who are travelling on Qantas and visiting both Australia and New Zealand need to cross the Tasman twice. That will not be necessary under the Transactions because Air New Zealand's rights can be used to form a more efficient triangular journey.

412. The benefits delivered by the Transactions come from two sources: the absolute increase in tourism directly resulting from the decreased travel time and complexity, as well as the enhanced access to flights via improved scheduling; and the increase in utility for those tourists who would have made the trip anyway, but who do not now have to bear the time costs of inefficient international flight routings. In the short run, only the first of these is relevant to the public benefits accruing to New Zealand and Australia. Over the longer-term, however, it is likely that there would be benefits resulting from greater tourist satisfaction, leading to greater tourist numbers. Accordingly, the initial impacts are likely to under-estimate the long-term benefits.

413. At the same time, as discussed earlier, the NECG modelling estimates some price and capacity increases. The model estimates a net reduction of 10,000 tourists resulting from new flights and fares by the third year of the Transactions.

Total net tourist impact

414. The total impact on tourism from the above effects are an additional 53,000 tourists for New Zealand per annum.

Benefits associated with additional tourists

415. The benefits of the additional tourists have been evaluated by NECG using two alternative approaches: a general equilibrium analysis and evaluation based on expenditure per tourist. NECG conclude that the impact of this increase in tourist numbers will translate into a gain by year 3 of $148m per annum to New Zealand.

416. NECG have also assessed that the employment impact associated with the additional tourists indicate that in excess of 2,500 new jobs would be created by year 3.

Engineering and Maintenance

417. Without the Transactions, Qantas is likely to seek out the most cost effective heavy maintenance arrangements available in the region. It is unlikely that this process would no longer see large parcels of heavy maintenance work being awarded by Qantas to Air New Zealand. The Applicants believe that in the absence of the Transactions, external

work directed to Air New Zealand are likely to be as low as 10% of Qantas' external work requirements.

418. This is significantly less than the share of Qantas' sub-contracted heavy maintenance work undertaken by Air New Zealand in 2002/03 (at 78%). Qantas has indicated a likelihood to Air New Zealand that Air New Zealand's share will reduce substantially in 2003/04 in the absence of the Transactions. The reason for the predicted decrease is that third parties such as Singapore Technologies can provide a similar quantity of work at the same or similar price.

419. Under the Transactions, Qantas agrees that Air New Zealand will be its preferred supplier for sub-contracted heavy maintenance work. That is likely to result in Air New Zealand maintaining a share in the order of 80%, resulting in additional revenue of $39m to New Zealand compared to $6m without the Transactions. This is not only an annual benefit in monetary terms of $39m but also represents the retention and/or creation of nearly 200 skilled engineering jobs.

420. The future with the Transactions is also likely to provide a substantial platform for investment in the development of additional Air New Zealand engineering and maintenance facilities and the creation of new employment. This benefit has not been quantified, but the Applicants believe it is likely to be substantial. In this respect, the quantification of the benefit can be seen as conservative.

Improved freight operations

421. Under the Transactions, there are likely to be improvements in freight access to major markets for New Zealand suppliers. Under the Transactions a number of routes will be supplemented by "back of the clock" flying using Boeing 767 aircraft currently overnighting in Melbourne. The additional Melbourne services will enhance links from NZ to the Qantas' time sensitive Australia network. There will also be options to expand freight services into Asia through the use of freighters that currently position empty to Asia, although this may require the negotiation of additional rights. The introduction of Qantas Boeing 744 ER aircraft on the USA to New Zealand and Australia routes will enhance availability capacity.

422. Excluding additional narrow body aircraft, there is 5.3% additional freight capacity in the future with the Transactions compared with the future without the Transactions by year 3. The majority of this is on the Tasman and Asian routes.

423. The Transactions will also involve:

(a) improved scheduling, which will delivery efficiency benefits, particularly for the delivery of perishable freight;

(b) the realisation of cost savings from the use of common facilities and systems; and

(c) the ability of the two airlines to operate joint freighter services.

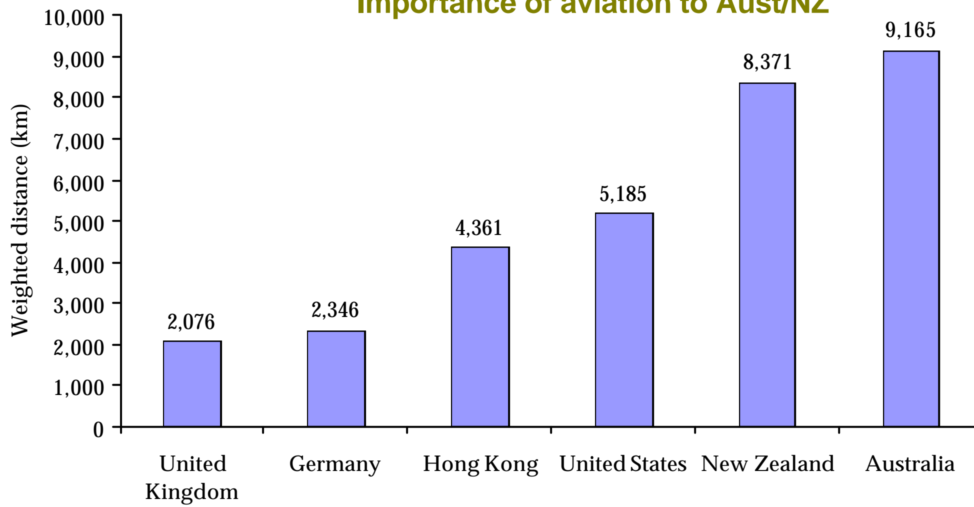
424. The additional 5.3% of capacity will result in a benefit of $4.6m per annum as a result of the Transactions for both countries ($3.3m for New Zealand).

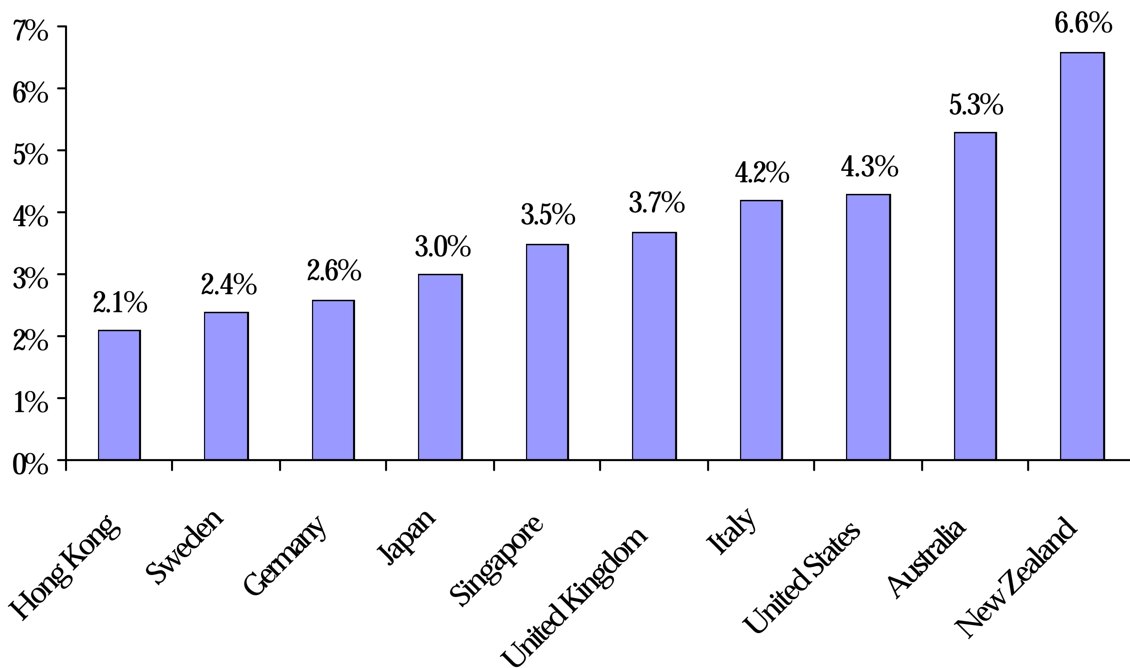
Capital related efficiencies

425. The Transactions is likely to eliminate the need for further New Zealand Government funding. There are two public benefits associated with this outcome. The first will be the demand from the new shareholder strengthening the incentives for management and Board to perform well. Secondly, to the extent that Government capital has a higher opportunity cost than private capital, there will be a lower resource cost associated with financing Air New Zealand. There is also a third type of capital related efficiency. This arises from the current taxation environment facing Australian investors in New Zealand firms. The benefits of improved governance and the dead weight cost of taxation are not capable of quantification with any degree of precision. They nevertheless exist and should be taken into account in considering the Transactions as a whole.

Global competitiveness

426. The Applicants consider that it is important for this region to maintain significant international airline operations. Many of the benefits outlined above, particularly those associated with additional and network reach extensions, would not be available at all in the event that the viability of airlines domiciled in Australasia were substantially eroded. The graphs below speak for themselves:


Weighted average distance to 10 major trading partners, 2001
Importance of aviation to Aust/NZ
Weighted distance (km)
10,000
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
2,076
2,346
4,361
5,185
8,371
9,165
United Kingdom
Germany
Hong Kong
United States
New Zealand
Australia


Estimated 2002 Travel & Tourism Industry as % GDP
7%
6%
5%
4%
3%
2%
1%
0%
2.1%
2.4%
2.6%
3.0%
3.5%
3.7%
4.2%
4.3%
5.3%
6.6%
Hong Kong
Sweden
Germany
Japan
Singapore
United Kingdom
Italy
United States
Australia
New Zealand

427. Though it is not possible to quantify the public benefits to New Zealand associated with having a more robust and viable international airline located in Australasia, the Applicants nevertheless believe that benefits do exist and are significant.

Preservation of national flag carrier

428. While the Applicants do not envisage that either of the carriers will go out of business within a three to five year period, the Transactions will reduce the risk of loss of the national New Zealand flag carrier. This issue is discussed in confidential Appendix F to the NECG Report. While these benefits are difficult to quantify, the New Zealand Government's capital injection into Air New Zealand of $885m indicates the substantial value the New Zealand Government placed on maintaining a viable national flag carrier at the time the capital injection was made.

SUMMARY

429. The Transactions will generate substantial and demonstrable benefits to New Zealand, including air passengers, importers, exporters, the tourism industry and the airline industry. NECG have estimated that the quantifiable benefits to New Zealand will be over $1.5billion in years one to five of the Transactions.

430. Not all the benefits identified above are capable of being rigorously quantified. The Applicants have therefore not sought to quantify and therefore place numerical weight on all the sources of benefits that are relevant to the Transactions. This relates, in particular, to benefits such as:

(a) capital related efficiencies;

(b) the greater sustainability of a national flag carrier for New Zealand;

(c) the increased ability of the Applicants to compete and operate globally.

431. As a result, the quantified estimates of the total public benefits to New Zealand deriving from the transaction are conservative. This is particularly so as the analysis above has not sought to quantify the social costs that would arise if Air New Zealand were forced as a result of a period of sustained competition to scale back the scope of its operations.

PART IV: BALANCING

432. The framework adopted for the assessment of benefits and detriments in the foregoing analysis is consistent with that set out in the Commission's Occasional Paper on the Public Benefits and Detriments.[102] That approach adopts a welfare framework to assess the effect on net public benefits of changes in allocative, productive, and dynamic efficiency.

433. The following are statements of principle deriving from recent Commission and Court decisions:

(a) While the detriments may only be found in the market or markets in which there is a lessening of competition, benefits may arise both in those and in any other markets.

(b) Where the likely benefits outweigh the detriments the Commission must be satisfied that the proposed transaction will result, in such a benefit to the public that it should be permitted, and must thus grant an authorisation. The standard of proof is the civil standard, i.e. on the balance of probabilities.

(c) 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. However, the courts have made it clear that they would not wish to rule out any argument coming within the widest possible conception of public benefit.[103] In contrast, changes to the distribution of income where one group gains while another simultaneously loses, are generally not included because a change in efficiency is not involved.

(d) Future benefits "likely" to result are to be considered. "Likely" effects need not be "more probable than not", but they must be "more than a mere possibility".

(e) The benefits and detriments likely to flow from the proposed transaction in the future have to be assessed against a counterfactual of what might otherwise happen in the future in the absence of the proposed transaction. The Commission

[102] Commerce Commission (1998) *The Evaluation of Public Benefits and Detriments under the Commerce Act 1986*, Occasional Paper 7. While this paper is undergoing revision due to recent legislative changes, the Commission noted in its recent Decision 473, in relation to the Electricity Governance Board, para 393, footnote 81, that that revision is unlikely to affect the analysis in that case.

[103] See *Re Queensland Co-operative Milling* [1976] 8 ALR 479

has recently noted (again) in *Decision 410 (Ruapehu Alpine Lifts,* 14 November 2000) supra:

> "A comparison has to be made between two hypothetical future situations, one with a proposed transaction and one without. The differences between these two scenarios can then be attributed to the impact of the proposed [transaction] in question. In framing a suitable counterfactual, the Commission bases its view on a pragmatic and commercial assessment of what is likely to occur in the absence of the proposed acquisition."

434. As the Commission has recently noted in *Decision 410* and *473*, the Commission will seek to attempt to quantify benefits and detriments where and to the extent that it is feasible, rather than relying on purely intuitive judgement. The Commission's approach to the quantification of detriments and public benefits draws on the comments of Richardson J in *Telecom v the Commerce Commission*[104] and of the High Court in the decision in *Ravensdown Corporation Limited v Commerce Commission* (unreported, High Court Wellington, AP 168/96, 9 December 1996, Panckurst J. and Prof. RG Lattimour). Nevertheless, the Commission recognises that not all gains and losses can readily be measured in dollar terms, and that those of an intangible nature, which are not readily measured in monetary terms, must also be included in the assessment. Most recently, in *Decision 473*, the Commission noted that the quantitative framework provides a more objective framework for establishing the weights given to various claims of benefits and detriments.[105]

435. Benefits and detriments accrue over time. No fixed timeframe arises from the cases or the Commission's decisions in relation to the assessment of these benefits and detriments. In *Decision 410* (supra) the Commission noted that it "customarily" uses a 3 to 5 year horizon over which to forecast possible detriments (paragraph 368) and adopted a 5 year horizon for convenience.

436. The Applicants consider that the proposed Alliance will result in benefits to the New Zealand public which will overwhelmingly outweigh any lessening of competition that may result from the Transactions.

437. The Applicants' assessment of the net benefits associated with the Transactions are set out below for years one to five after the Transactions commences:

Balancing of Benefits and Detriments

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[104] [1992] 3 NZLR 429, 447

[105] *Decision 473*, para 395

Years	$ million
1	67
2	285
3	380
4	361
5	340
5 year Total	1,433

438. These results are calculated without reference to any conditions. Even on the highly unlikely scenario involving no VBA entry in years 1 to 5 of the Transactions there remains a substantial net benefit to New Zealand of $1,249 million. Hence, authorisation should not be regarded as dependent on the likelihood of VBA entry.

439. The Applicants submit that the Transactions meets the requirements for authorisation under the Commerce Act 1986 and should be authorised. The Transactions will create substantial public benefits including:

(a) consumer benefits, particularly through expansion of services, improved availability of services and improved quality of services;

(b) cost savings and more efficient use of resources;

(c) increased functional co-operativeness of New Zealand's national airline;

(d) tourism benefits; and

(e) achievement of New Zealand Government objective of maintaining a national flag carrier.

440. The Applicants are confident these benefits will flow from the Transactions. The Applicants submit that there is a very low risk of any national anti-co-operative detriment being carried by the Transactions.

PART V: CONFIDENTIALITY

441. Confidentiality is not claimed for the fact of the Transactions.

442. Air New Zealand and Qantas seek confidentiality for all information contained in bolded square brackets (i.e. **[ ]).** Confidential information is deleted in the "Public Copy" of this Application. Confidentiality is also sought for those parts of the NECG Report contained in bolded square brackets (i.e. **[ ]**). Confidential information is deleted in the "Public Copy" of the NECG Report.

443. Confidentiality is sought for all confidential information in the application and in the NECG Report for a period of three years, or until Air New Zealand and Qantas advise the Commission it may disclose this information.

444. The information that has been deleted is commercially sensitive and valuable information that is confidential to Air New Zealand and Qantas. Disclosure of that information could result in material financial loss and prejudice to the competitive position of the Applicants. In this respect, Air New Zealand and Qantas rely on section 9(2)(b) of the Official Information Act 1982. The foregoing applies equally in respect of all additional information (expressed to be confidential) that Air New Zealand or Qantas may provide in relation to the Transactions.