# Cost savings

# Overview

**NECG estimates NZ$383m in cost savings over 5 years from the Alliance**

- Cost savings claimed are similar to those claimed in any other merger

- Commission's calculations are incorrect on account of the following:
  - Starting value for NECG cost savings is in AUD and a discounted value
  - View as to relevant counterfactual
  - Assumption that cost savings are driven by passengers

- Hence, we maintain the view that NECG estimation of cost savings is the most accurate estimate of likely cost savings from the Alliance

# Nature of cost savings

**The Alliance permits substantial cost savings associated with avoiding at least some of the duplication of capacity that already now occurs, and is likely to worsen under the Counterfactual**

- Removal of duplicate flights ('wing-tip' flying)

**e.g. Flight schedule for Qantas and Air NZ for AKL-MEL, 20 June 2002**

| *Carrier* | *Depart* |
|---|---|
| Qantas | 06:00 |
| Air NZ | 06:45 |
| Air NZ | 15:00 |
| Qantas | 16:15 |

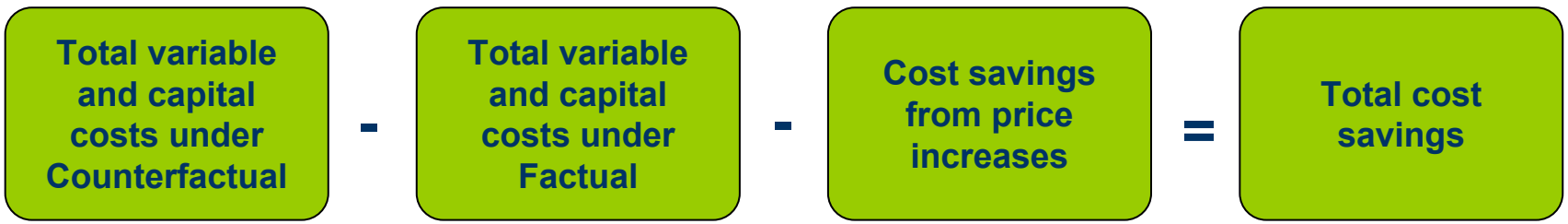
# Nature of cost savings

**Cost savings being claimed are conventional**

- When two widget firms merge, efficiencies secured can take the form of consolidating production facilities and using those to process a higher scale of output
- By exactly the same token, when two airlines form an alliance, the efficiencies they secure can take the form of making better use of aircraft
- These are the savings NECG models
- They are no different in substance from those that could attach to the more conventional case of the widget suppliers

# NECG approach

**Cost savings are calculated as the difference between the operational and capital costs associated with the Factual versus those associated with Counterfactual (less cost savings resulting from price increases)**

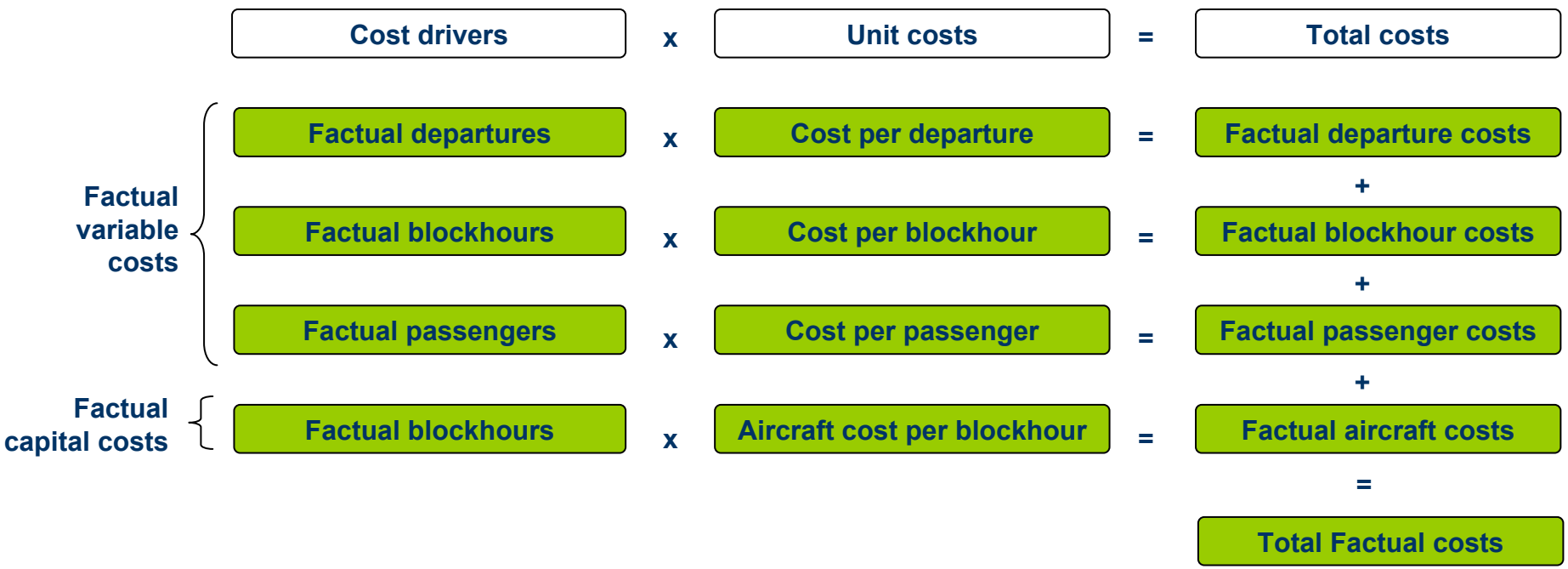



- Cost savings allocated between Australia and NZ based on commercial agreement
- Alliance is likely to yield other savings (e.g. in marketing costs, lounges and IT), which have not been quantified, thereby making estimates conservative

# NECG approach to estimating cost savings

**Costs associated with Factual/ Counterfactual calculated by multiplying unit costs by cost drivers**

- Example (using Factual)



# Commission approach to estimation

**Commission states: "Whatever cost savings are available will be a function of the change in traffic between the factual and counterfactual scenarios and the cost of supplying capacity to carry that traffic."**

- Commission's approach is to take NECG cost savings and to scale these down by two ratios

**Commission example (Year 3)**

| NECG estimate of cost savings | x | NECG Change in passengers / NZCC change in passengers | x | NECG load factor / Base case load factor | = | NZCC estimate of cost savings |
|---|---|---|---|---|---|---|
| $74.625m | x | 0.51 | x | 0.92 | = | $35.696m |

# Commission approach to estimation

**Commission uses the incorrect starting value for cost savings**

- $74.625m figure used by Commission is incorrect:
  - First, it is denominated in AUD
  - Second, it is the discounted value rather than the year 3 value
- The appropriate starting figure is in fact $96.4m
- Correcting solely for this, the Commission's estimate increases from $35.7m to $45.2m

# Incorrect assumptions

**The Commission's calculation is also based on incorrect assumptions**

- As demonstrated previously, the Commission's Counterfactual is implausible

- Commission's method of revising down NECG cost savings estimates assumes that passengers drive cost savings:
  - On Domestic and Tasman routes, only around 25 per cent of costs are passenger related
  - Most costs are related to departures and blockhours (e.g. fuel, airport charges)

| | Domestic | Tasman |
|---|---|---|
| Fuel | 18% | 18% |
| Airport charges | 15% | 9% |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