20 AUGUST 2003

PRESENTATION BY THE APPLICANTS (cont)

CHAIR: Good morning ladies and gentlemen, can I ask everyone to sit down please, and we will convene this session.

I'd like to welcome everyone to the third day of the Commerce Commission's Conference being held in relation to the application by Air New Zealand and Qantas Airways who are seeking authorisation to enter into a Strategic Alliance Agreement and related agreements and the application by Qantas Airways seeking authorisation to subscribe for up to 22.5% of the voting equity in Air New Zealand.

Before we start today I just want to update everyone on the timetable, and once again thank people for their flexibility. It is important to the Commission to have the opportunity to test the evidence that each party believes is important to their case, so I will do everything I can to accommodate ensuring that that happens.

To that end the Applicants have helped us adjust the timetable today so that we can hopefully bring us closer back on to track. I'll just briefly set out what the intended order is for today. From 8 to 9.30 we will complete the section on tourism. It's proposed at 9.30 to 11 to have the session on aviation industry conditions, consumer benefit from direct flights on-line connections with Professor Willig. At 11 to 11.15 introduction to economic arguments with NECG. After that going until approximately 3 o'clock in the afternoon we'll have a session on allocative efficiency with NECG with Professor Willig. From 3 to 3.45 productive and dynamic efficiency with NECG. 3.45 to 4.45 cost savings with NECG and 4.45 to 5.45, balancing NECG.

Now, I've changed the last time because I have another commitment, so I'll take that liberty to end it at 5.45 today. So, are there any questions from anyone on that revised timeline? No comments.

If not, I will ask the Applicants to again introduce the speakers on the issue of tourism and then we will proceed with questions that anyone may have, questions from the Commission staff and experts for Mr Thompson. So, if you wouldn't mind introducing one more time the people at the table, please.

Madam Chair, Roger Partridge from Bell Gully, on my right I have Mr Thompson from Air New Zealand and Mr Warbrick, Air New Zealand's Chief Financial Officer.

MR PETERSON: Madam Chair, Andrew Peterson, Minter Ellison for Qantas; on my right I have Simon Bernardi the Chief Operating Officer from Qantas Holidays, and on his right Arthur Hoffman, the GM Strategy and IT, also from Qantas Holidays.

CHAIR: For parties who were not here yesterday, we had the presentation from Mr Thompson and I will now see if there are further questions from Commissioners, staff and the Commission's external experts.

MR PJM TAYLOR: Good morning Mr Thompson. I wonder if you could take us through briefly how you convert the generality, if you like, of the promotional programme that you spoke of yesterday, through to the specifics of the numbers that you have as estimates, and just for ease I reference you to the table after -- at paragraph 1167 of your submission in response to the Draft Determination, and the numbers are, for example, Australia 13,500 and UK 5,600. So how do we get from the promotional programme to those numbers?

MR THOMPSON: Commissioner Taylor, those numbers are actually going to be detailed and discussed a little bit further in Mr Bernardi's presentation this morning. If it's possible we could refer to then, that would be covered.

MR PJM TAYLOR: Sure, and if it's not clear we'll come back to it. Thank you.

PROF GILLEN: I have a couple of questions. One is, you said yesterday that you and Qantas compete for tourist passengers, and I look at page 19 of your presentation and I see two korus and a gazzilian other Qantas offices, and I'm trying to understand the notion of competition given, it seems, the overwhelming presence of Qantas in those particular markets.

MR THOMPSON: This is post the alliance or pre the alliance?

PROF GILLEN: My understanding is that this is the current state of affairs, the distribution networks currently. So, when you say that you compete for tourist passengers, what's the notion of competition here, because it seems that Qantas has an overwhelming presence in a number of different markets where you do, where you don't. So, where does the competition come from?

MR THOMPSON: Okay, if you go back to a further page, we talked about how the two companies would work together and the roles of each brand on page 14, we talked there about the Air New Zealand Holidays brand being the primary brand as far as New Zealand is concerned, Qantas Holidays brand being the primary brand as far as Australia is concerned, and with both brands being used to promote dual destination.

PROF GILLEN: All right. The second question is, you said that 50% of the market really is Australians coming to New Zealand, and I was wondering if there's any evidence that airlines like Virgin Blue would capture some of that market, it would be in their interest to do something like that?

MR THOMPSON: I think it's inevitable that Virgin Blue would pick up some of the market. However, certainly Air New Zealand and Air New Zealand Holidays would be endeavouring to grow the market through significant promotion and hopefully we'd be the main benefactor of that promotional activity, but because they're putting on new capacity, it is inevitable that they will pick up some customers.

PROF GILLEN: And I guess my final question is that, if Qantas is, in the absence of the alliance, is going to expand capacity in the Tasman and domestic New Zealand market, what incentive would they have to share passengers with you in the sense that Qantas Holidays would be promoting joint destination between Australia and New Zealand, and yet it would seem to me that given their expansion of capacity, that they would want to keep those passengers on-line on Qantas aircraft rather than sharing them with Air New Zealand?

MR THOMPSON: With the alliance on the assumption that the alliance goes through approved, we would be having code share on both carriers, NZ and also QF, and so, all services would be open for Air New Zealand Holidays or indeed Qantas Holidays to be sold on.

PROF GILLEN: I understand that, but if you think of -- in the absence of the alliance, and if Qantas does expand capacity, it seems to me that they have a strong incentive to grow the tourism market and keep those people on-line because it is going to fill their capacity. So, if they joined the alliance they're in fact sharing those tourists with Air New Zealand. So, it seems that there's conflicting incentives here. I mean, is that a fair assessment?

MR THOMPSON: Absent the alliance -- I think the question should probably be directed to Qantas, I can't certainly speak on their behalf -- but absent the alliance, all I'd question is whether the commitment to promoting New Zealand as against other destinations in their network would be as great as what it would be with the alliance.

PROF GILLEN: Thank you.

DR PICKFORD: Can I just ask one question about Blue Pacific tourists; you mentioned them yesterday and said what benefits they brought in terms of stimulating tourism demand in Japan. Could you tell us a bit more about how the way they operate and why in fact you haven't replicated their operations in other parts of the world where we draw tourists?

MR THOMPSON: Certainly. Japan is certainly a different market from most other destinations we fly to; there's some pretty special requirements, especially around language, very regulated, and how they do business in Japan.

Some time ago we felt that we were very significantly reliant on about two operators in Japan to provide us with most of the business coming to New Zealand. We also at that time owned a company called Mt Cook -- we still own Mt Cook Airlines of course -- but Mt Cook back in those days also had a significant fleet of coaches, they owned quite a bit of plant in New Zealand, and we felt that given that the majority of their market or a good share of their market was actually coming out of Japan, that we should set up some form of operation in Japan which was supported by the in-bound operation that Mt Cook also owned here in New Zealand. So, it was a natural fit to put an operation into Japan.

I emphasise, as I did yesterday, that it does operate on very old technology, it's not the sort of technology that could be replicated around the rest of the world. So, it was one of -- one not only trying to grow the market ex-Japan to New Zealand, but also to very much support the infrastructure that we had investment in here in the New Zealand marketplace, which since, as you will probably be aware, we have sold on; the coaches, the tour operation here in New Zealand.

DR PICKFORD: But would you not find other similar fits around the world, in countries where we draw large numbers of tourists?

MR THOMPSON: I think the key point here, particularly with the way IT systems operate these days, it is to come up with a global system rather than having several systems with several inventory buckets to draw from, and also moving towards systems these days that are internet capable, we really do need one system to cover the globe and to provide us with the opportunity to market and sell land packages in conjunction with air over the internet, and that is -- that's something that Qantas Holidays is able to offer us very quickly on a global basis, and I emphasise, with the infrastructure in place in key markets; we simply don't have that capability today, and for us to replicate that we virtually would not be able to justify the expenditure, whereas they already have that in place.

MS WHITESIDE: I just have one question; it's based on page 16, the dual destination opportunity. First of all, clearly when you're saying that 50% of the US market to New Zealand also visits Australia; you are saying in the same trip?

MR THOMPSON: Yes.

MS WHITESIDE: What data is this based on?

MR THOMPSON: This is based on tourism trends which we track. This is total market, it's not the Air New Zealand market, this is total market information obtained from arrivals into New Zealand and also arrivals into Australia and then it's actually been pulled together in this particular case by the NECG people.

MS WHITESIDE: Over what period of time is this?

MR THOMPSON: I'd have to come back to you on that particular period of time, unfortunately I haven't got that note in front of me, but it was certainly information that we had as up-to-date as possible; it possibly may be year ended April, May around that particular period of time.

MS WHITESIDE: And whether we could have access to that data?

MR THOMPSON: Okay.

MS WHITESIDE: Thank you.

MR STEPHEN: I'd just like to clarify a comment you made in response to -- it was page 22 of your slides yesterday, where you say there's a commitment to spend an additional A$5.4 million on the promotion of New Zealand, and I think in response to a question from Commissioner Curtin there was a discussion about the extent to which all of the $5.4 million would go, as it were, in relation to the bottom line, in other words, the amount that the $5.4 million would represent in terms of, if I can put it, direct sales and marketing.

The reason I ask that is, when I looked at one of the conditions you offered, or the Applicants offered, which is number 32 in relation to tourism, it seems to split out the $5.4 million -- do you have the...?

MR THOMPSON: 32, is that a paragraph in the submission?

MR STEPHEN: It's paragraph 32 of the conditions.

MR THOMPSON: If I could just obtain that and come back to you. I'm getting it now. [**Pause taken while referring to documents**].

MR STEPHEN: My question is, you will see that there is a final sentence which says, which includes Australian $1.7 million on direct sales and marketing, and when I read that some while ago I assumed that that meant that that was the amount that went on direct sales and marketing and the rest was ascribed to perhaps set-up costs or transitional matters associated with implementation of the alliance arrangements, and I'd just like your clarification.

MR THOMPSON: Certainly, I think we should take from this, and I'll give you some assurances, that the monies that are being suggested here is not to set up infrastructural costs to set up Air New Zealand Holidays, it is monies that is being put into a budget to certainly produce material; it's not just all straight advertising that's going to be above the line in the marketplace. It would include materials such as direct marketing activity, the production of collateral to support Air New Zealand Holidays, but it's not -- I think what you might be alluding to is that it doesn't include infrastructural costs such as offices or staffing costs; it is in market activity.

MR STEPHEN: I mean, you follow my point, there's a cap of 3.5 million, and perhaps I can put it to you. If 1.75 million is on direct sales and marketing, which sounds an awful lot like you've described, where is the 3.6 odd?

MR THOMPSON: I'll just defer to Mr Bernardi to answer that specifically.

MR BERNARDI: Thanks Norm. Sorry, I should speak to that because that's contained within the Qantas Holidays sales and marketing plan.

The direct sales and marketing expenditure is $1.7 million. There are other costs, staff related costs, communications, computer costs, market research, technology and B to B systems and putting things on B to B systems that do make up the rest of that. So, that supports the 5.4.

MR CASEY: Mr Thompson, a great deal of the benefits, it seems, projected from the tourism increases are social benefits and a great deal of constraints faced by your company seem to be amenable anyway to Government action; I mean, particularly around the negotiation of bilateral air rights between New Zealand and the United Kingdom -- you said there are constraints there that are inhibiting growth in tourism. For example, would Tourism New Zealand also have the resources to engage in much of the promotion that you anticipate will boost tourism? I wonder why you can't make the case to Government to actually help you achieve the tourism targets that you hope to achieve via Qantas.

MR THOMPSON: I can assure you that Air New Zealand has certainly been working with the respective Government authorities as far as our bilateral with the UK is concerned, and there is a very strong willingness by the New Zealand Government to support our application to get greater access to the UK market. The problem that we are facing is, not at this end of the market, etc unfortunately at the other end of the market, and that's where the challenge lies.

The UK authorities are very much focused on their bilateral between the UK and the United States at the moment, and that is their priority; it is their second priority, it is their third priority and they aren't interested necessarily in talking to New Zealand at the he moment until such time as they sort out their bilateral between the USA and the UK.

That is the frustration that we've been dealing with now for probably in excess of 12 months. So, trying to get that sorted out is of immense frustration to us and in the meantime we see a very very strong market which is not reaching its full potential because of our inability to be able to market or increase our market in the UK, because, as I said, yesterday, we're operating very high load factors out of the UK at the moment.

MR CASEY: And in terms of Tourism New Zealand allocating resources to promotion?

MR THOMPSON: Tourism New Zealand do an excellent job in the UK market, as indeed they do in other markets as well. They are very much a partner with us in the UK market, and again as I emphasise, in other markets as well, we do work very very well together, and in more recent times Tourism New Zealand in the UK market has had to work with another carrier simply because of the constraints that we have.

MR CASEY: Thank you.

CHAIR: Thank you for that, Mr Thompson. I believe next we will have a presentation from Mr Bernardi of Qantas Holidays, and I would ask you, Mr Bernardi to please summarise your key points in your submission. Thank you.

MR BERNARDI: Good morning Madam Chair, Commissioners, thank you for having me. I will summarise the key points; don't be put off by the size of the pack.

Really what I'm here today to talk about is to talk to the Qantas Holidays business plan which you've seen, which is promoting, or it says that we will be providing an additional incremental over and above 50,000 tourists to New Zealand per annum. I'll go through how we got to that during the presentation and also -- sorry, how we got to the number, but also how we intend to do it.

What I would like to do is firstly talk about the Air New Zealand Holidays brand, which we see as being integral to us achieving the same. The brand is very powerful, particularly in global markets, because it says "New Zealand". Under this agreement Qantas Holidays would licence the brand off Air New Zealand and would build that brand globally through our network of offices.

So when I refer to Qantas Holidays, I'm really talking about the promotion, if you like, through the Air New Zealand Holidays brand, which is the instrument that we will be using internationally. It combines the marketing effort of Air New Zealand, the New Zealand tourism authority, to really give us a greater voice in overseas markets towards selling New Zealand. And, as I said, earlier, it really does say "New Zealand".

I don't want to take too small a base, but just to tell you what package wholesalers do in overseas markets; I've just put an example of a brochure in this case that we use from Australia promoting America. We really do add value to destinations, we don't just promote the point to point concept of an airfare and off you get, etc building value to that destination.

In doing that we need to work very closely with the tourism commissions as we do throughout the world. It's interesting to note that if you look at Qantas' Honolulu services, for example, there's much more benefit derived out of the Qantas Holidays value story than there is out of the airline flying there on its own; we make more money out of that route.

So, Qantas Holidays helps develop and adds value to destinations, we do this through our brochures which are very important to what we do. Product development, we deal with thousands of suppliers throughout the world, be they hotels, car operators, ground operators, and we've put those into brochures and packages that will appeal to the market from which we're selling out of, and we have an intimate knowledge of those markets and do quite a bit of research in them as to what the customers are looking for. We also provide flexible packages as well; sounds like a bit of an ad, but just want to remind the Commission of what we do.

We distribute globally via the travel agent network in Australia. Travel agents account for, gee, over 90% of all the business that we do. We distribute globally via the GDSs, and we also distribute on the web direct to consumer and telesales and call centres.

CHAIR: Excuse me for just a minute, if you don't mind me interrupting. I just wanted to ask you if Qantas Holidays currently sells packages that include offerings from rival airlines?

MR BERNARDI: Yes, we do. We have another brand in Australia called Viva Holidays, which is what we package with rival airlines. A good example would be -- well, we do that at the moment with Garuda, with Thai International, with Air Pacific, and those -- and also with British Airways.

For us to be able to do that, we must get approval from Qantas, and they must be rival risk airlines that don't impact on the strategic direction of Qantas.

The reason why we were able to use those airlines -- I mean, Garuda is probably a good example. We're able to use Garuda because the Qantas schedules out of Australia to that market weren't suitable for the volumes which we were providing, and Qantas allowed us to use that particular carrier. There's a number of carriers that we're simply not allowed to use, one of them being Air New Zealand, and there are others as well.

CHAIR: And the reason for not being allowed to use Air New Zealand is?

MR BERNARDI: Basically, not in Qantas' strategic interest.

CHAIR: Is that because you think it would deprive Qantas of business?

MR BERNARDI: Yeah, it's more an edict from my owners rather than an edict from Qantas Holidays. It's something that -- there are a couple of airlines, Air New Zealand is one, that they simply will not allow me to sell. It's forbidden.

CHAIR: And why is it in your strategic -- consistent with Qantas' strategic objectives to allow you to do it, or to encourage you to do it under the alliance?

MR BERNARDI: Why is it...?

CHAIR: Why would it be?

MR BERNARDI: If you would like, Madam Chair, do you mind if I get to that, and if I haven't please pick it up at the end. Thank you.

CHAIR: Sure.

MR BERNARDI: Just to give you a quick snapshot of who Qantas Holidays is, and we do have a reasonable track record, we're a profitable standalone business within the Qantas group, 100% owned. We have consistent growth in our business, we have revenues exceeding $1 billion in our own right. What is interesting is, 70% of our profit comes from sources outside of Qantas, so it's not just a transfer of money within the group. We have 28 years experience, we have a global footprint which you have seen, and we carry or provide packages for over 1 million people annually on a worldwide basis, and we package more than 40 destinations.

Like any company, Qantas Holidays must have an upside or a growth story. The alliance who for us very much represents a growth story in terms of having access under the licence agreement to the Air New Zealand Holidays brand, which is integral, and we really see that brand as something that won't change our focus from Australia to New Zealand or vice versa, it's not mutually exclusive but will grow our total focus on both products, and we've got a track record of doing that in the past.

Also, the alliance sits very well with our strategic direction which over the next 5 years we are really concentrating on growing our in-bound business both to Australia as well as New Zealand.

The key to our success has been the ability to generate traffic, and I've got a few examples here which I'll quickly talk through. In Australia we've got preferred agency relationships with 4,200 individual agents, and we've got 27,400 worldwide, with over 350 people around call centres in Australia.

The Melbourne Cup is a good example where Qantas Holidays took this event over from Ansett Holidays after the demise of Ansett. We have grown the figures, you know, without any additional capacity, but grown the figures to that event one and a half times, and that was primarily by getting together with Tourism Victoria in this case and ourselves and coming up with a discreet marquee in the middle of the track which provided real value add for our customers and a reason to take the package.

Similarly, Canada in winter was an opportunity we saw to increase traffic in the off-peak season, and it's not a ski brochure but we provided a new Canada in winter brochure and we saw sales increase by 48% with that.

Likewise, in-bound to Australia, in the Middle East over the last 3 years we've been working very hard with our general sales agents and I'll explain what that is in a slide coming up, and our sales have grown to around A$3 million per annum in what is a very tricky market and diverse market.

The constraints on Qantas Holidays: As I mentioned, our mission statement, if you like, is to develop primarily Qantas routes. There have been examples where we've been able to, under other brands, sell other carriers that aren't considered not in Qantas' strategic interests.

For us, looking at New Zealand, we've got 40 destinations as I've said. There's really no extra incentive for us to sell New Zealand over other destinations; in fact, out of Australia it's quite a low margin for us selling New Zealand. This we believe will change under the alliance because it will go from being a short haul destination first of all to a long haul destination which has a better gross margin for us, but there's also less competition in the markets that we're looking at distributing New Zealand in.

In Australia there's multiple wholesalers; I think almost 100 wholesalers selling New Zealand. Whereas, in markets overseas, New Zealand is not well represented as well, and it's those global markets we see as providing a great opportunity to the in-bound to New Zealand.

CHAIR: Can I just ask you, Mr Bernardi; if you hadn't had this edict from Qantas Group to tell you that you couldn't sell Air New Zealand seats, would it currently be in your view something you would pursue in overseas markets if you could?

MR BERNARDI: No, it wouldn't, and the reason it wouldn't, Madam Chair is, what we need is the whole package, to coin a phrase, we need -- the branding is very very important. For me to try and sell New Zealand in the UK or somewhere else as Qantas Holidays, it doesn't say New Zealand, it says Australia Qantas Holidays. So, branding is very important and I certainly wouldn't recommend that Qantas Holidays would invest in the Qantas Holidays brand selling New Zealand in these other markets.

Now we do sell New Zealand now, we might have a page on Auckland hotels in our in-bound brochure or something like that as an add-on if people really want it, but we -- not that there's anything wrong with that, Madam Chair -- but I suppose I say that to just highlight, we really don't place the emphasis on it; we wouldn't invest on it because, without that branding -- branding's everything. If we had Bernardi Holidays in Australia we probably wouldn't sell a lot either. So, the brand is very important to us in promoting.

CHAIR: We see in other markets, network markets in particular reselling of other company's products, telecommunications is one, and while you might not do it under the Qantas brand, there are markets where companies sell under another brand, but you don't think that there would be any benefits in you doing that?

MR BERNARDI: Well, as I say, we do that in Australia with Viva and once again Viva was a recognised Australian brand before Qantas took it over, but really my main game is Australia in terms of the Qantas Holidays brand. If I didn't have the alliance, you've got all the problems Norm mentioned about getting here for a starter; the routings from some parts of the world are terrible in terms of the backtracking, and I'll very briefly show that a little bit later.

CHAIR: Is that going to change with the alliance?

MR BERNARDI: Absolutely. It's one of the main benefits I think, but I'll quickly show that.

CHAIR: Thanks.

MR BERNARDI: Incentives to promote arrivals to New Zealand or promote New Zealand. As I was saying a few minutes ago, our passenger arrivals to New Zealand are well below the full potential, I believe, of what we would do for this country because we don't place focus on it, so there's a lot of headroom for us were we to do so.

The additional arrivals, the 50,000 which we've put in the case, which is the Qantas Holidays business case, will give us a gross profit of about $67.7 million.

MR PJM TAYLOR: Is that net profit before tax?

MR BERNARDI: No, that's before tax. PBT after tax is somewhat lower, we probably make a 4 to 5% net margin on our gross sales. So, this is the gross profit line, which -- we're in a very small margin business, so 4 to 5%.

MR PJM TAYLOR: What sort of sales does that represent then?

MR BERNARDI: Well, it's based on the 50,000 tourists. In terms of dollars, Arthur -- sorry, we'll just get that for you. [**Pause taken while referring to document**]. Can we come back to you on what it is in dollars?

The Qantas equity stake in Air New Zealand and sharing arrangements there, incentivises us to deliver the business plan, because whilst we are independent, we're still 100% part of Qantas. And our distribution network has got identical incentives to promote Air New Zealand or Qantas flights. The great thing is, this gives us volume into this country via a number of different routings and if one's full you've got opportunities via multiple access points to get it to New Zealand.

MR HOFFMAN: It represents $60 million.

MR BERNARDI: So why will the market grow, why wouldn't it just being people that we were going to get anyhow coming to New Zealand? Our sales and marketing plan really has identified specific markets out of the source countries that we have looked at in relation to New Zealand. As Norm mentioned, there's quite a lot of people that come to this part of the world and have a dual destination cause. It's long way for people from the Northern Hemisphere to come from, either here or Australia, and what we need is incentive to get people back to this part of the world. A lot of those people are usually very time poor and that's why we need to fix the backtracking and that's where the network has an advantage; in some cases they pick up one to two extra days that they can spend on the ground.

There's many well worn tracks from source countries into Australia and New Zealand and this gives people the opportunity to start new well worn tracks between the two countries without backtracking.

This is how we arrived at our figures, and I'll try and keep this at a fairly high level because I'm not an economist, but I will try and make it fairly high level.

We looked at, from Tourism New Zealand figures, the expected growth to New Zealand and, once we had a look at that, we had a look at our businesses in each of those markets and applied, if you like, the alliance criteria and what percentage over and above that we would be able to get out of those markets. So, the net increase in sales, if you like, is irrespective of the baseline. We're saying that our businesses will be able to deliver 5 to 6% in Asia's case over the baseline for growth to New Zealand.

It's interesting, if you have a look at our sales outlets worldwide, if we were to sell just one New Zealand package out of each of them, we would easily make our target, and on average we're selling three packages out of the whole network.

MS BATES QC: I've just got a couple of questions for you. Just going back to your slide where you talked about incentives to promote New Zealand. Is the plan that the emphasis for you will be dual destination?

MR BERNARDI: No, it will be both. It's a very good point because --

MS BATES QC: Well, it's an impression I got from you when you talk about people coming from this part of the world and they do both Australia and New Zealand. That's the impression I gained.

MR BERNARDI: I'm glad you picked me up on it because it's not the impression I want to put forward.

Naturally, we see promoting the mono as really where we're gonna get the bulk of customers to New Zealand. The dual destination is more for -- more aimed at, if you like, the repeat customers; so, people who have been to New Zealand or for that fact Australia, we need a reason for them to come back to this part of the world, and I say "this part of the world" meaning Australia and New Zealand because it's a long haul particularly for Northern Hemisphere people.

But please, make no mistake -- get this on the record -- that we are very much focused on selling the mono destination of New Zealand through Air New Zealand Holidays, and the dual destination as, if you like, an opportunity for further growth.

MS BATES QC: Thank you for that, that's helpful. The last point on the left-hand side, you say that Qantas' distribution network will have identical incentives to promote both Air New Zealand and Qantas flights. I'm having a bit of difficulty with that and I'm just going to ask you to explain it to me, because I would have thought that from Qantas' perspective they would make more money out of promoting a Qantas flight because if they promoted an Air New Zealand flight, well they'd get the 22% shareholder but they won't make the money on it that they would promoting a Qantas flight.

So I see a sort of conflict position there and I'm trying in my mind to see how you'll overcome that.

MR BERNARDI: Well, I think I can help you Commissioner because, an example that we have today -- you know, if you look at the Qantas Air New Zealand under the alliance, it's similar to, if you like, the Qantas BA under the JSA where there's equal incentive to sell both and we do. If you look at the other example I mentioned before, which is the Garuda example where Garuda provides, if you like, feed to the Qantas Holidays business. We are able to sell Garuda in numbers to feed the Qantas Holidays business, just as we sell BA and Qantas in numbers to feed the Qantas Holidays business, I really don't see any difference from Air New Zealand.

MS BATES QC: It may be that I just don't understand, but I still think on the actual fare, that Qantas' interest is in getting as much as it can out of that fare and it won't do it if it's an Air New Zealand fare. That's the bit I have difficulty with. How have you explained that?

MR BERNARDI: Well, Qantas Holidays is a standalone company. Naturally, we have owners that exercise a very strong opinion on what we do sell, but in terms of the alliance and in terms of incentives there is no edict whatsoever for Qantas -- for me to one or other of the carriers, and my interest in respect to this is to advance the P&L of Qantas Holidays.

MS BATES QC: Okay, so I can understand what you are saying about Qantas Holidays, it still doesn't explain what Qantas' incentive would be.

MR WARBRICK: In addition to the shareholding there's also the operational revenue sharing under the alliance where we do share the earnings of the operations of the airline on the alliance part of our operations. So, there is additional incentives for Qantas to promote Air New Zealand profitability other than just the shareholding.

MS BATES QC: Okay, so can we just get down to the specific question about the fare. Which way would it be most profitable for Qantas to do it? To promote an Air New Zealand fare or to promote a Qantas fare?

MR WARBRICK: If we're talking about -- if you work through the actual mechanics and the capital investment that goes with it, and you trade the capital investment on our metal that they don't have to make, they pick up a very leveraged share of that earning, so we supply the capacity and they supply the passenger through this arrangement; they do get a very very high margin on that.

MS BATES QC: Air New Zealand does?

MR WARBRICK: No, Qantas would get a very high margin through the revenue sharing basis, yes.

If they had to supply their own aircraft to fly those passengers, they would have to carry all the operational costs of that as well, so it's not just the gross fare, it's actually the net profit and how we share the net revenue from the passenger that actually incentivise Qantas to actually promote the Air New Zealand flying.

MS BATES QC: I'll have to think about it, but thank you. I'll come back to that.

MR WARBRICK: It does work.

MR BERNARDI: I think also, the point I made earlier where Qantas Holidays gets 70% of its profit from the land also, if you like, diminishes the importance of the profit that comes from, you know, the air portion as well. We get a lot of our profit from what we sell on the ground. The air is a means to the end, which is important for putting the product there, but in terms of profit too.

MR PJM TAYLOR: Am I right in understanding that the long haul section of the extra 50,000 passengers, is largely going to be Qantas flights?

MR BERNARDI: Not under the alliance, no. It will be a combination of the two.

MR PJM TAYLOR: Both?

MR BERNARDI: Yeah, absolutely.

MR PJM TAYLOR: Have you done any estimation there?

MR BERNARDI: Look, I really haven't done a carrier split, but if you look at the routings through to New Zealand, and you're promoting New Zealand particularly through the mono destination, not much of that's going to be Qantas; most of that would be Air New Zealand, and with the dual destination you'd probably -- I don't know if it's exactly 50/50, but you'll get a combination of two depending on the itinerary.

MR PJM TAYLOR: Let me just follow through on the UK. We heard from Mr Thompson that there was a restriction on the capacity coming out of the UK, and yet you've got, I think, it is 5,600 projected there increase; that would surely largely need to be Qantas?

MR BERNARDI: Well, no, not really because you may use the Qantas services for example to Singapore and then Air New Zealand -- so you get a fairly direct routing.

MR PJM TAYLOR: Okay, thank you.

MR CURTIN: I doubt my -- I'm glad my colleague went back to that slide because I read the bottom point differently. I thought there you were talking perhaps about the internal sales targets and sales management incentives you might have for your own people, or perhaps the Commission structures for third party distributors, and while that thought is out there I just wanted to ask you whether, just as a matter of practice, you have priority products you're trying to push and you award the salesman more on them than on other things?

MR BERNARDI: Well, we do in terms of land product more than air, because we have a greater ability to organise that with land suppliers.

With air, we pretty much earn, you know, the same on most, so there's really no difference in the incentive. The main benefit the alliance offers Qantas Holidays in terms of Air New Zealand is access to the route network, and as I said before, access to the branding.

CHAIR: I just had a follow-up. You mentioned that the alliance would be similar to the relationship you have with BA, and I don't know if you used your experience in promoting BA as something to inform the projections that you did in terms of what might happen in the alliance. Can you tell me what you did?

MR BERNARDI: Yeah, not really -- the BA -- what I was getting at there was from someone in the reservations unit selling a particular flight. The incentives under the alliance, though, are quite different because with the BA relationship we don't have any branding for BA holidays, and so it's quite different in that respect, but from a sales respect the reservation agents are really trained to do what's best for the customer on the networks that we have available to us.

CHAIR: What I would like to ask you is if we could see the numbers of passengers -- the number of sales that you have done through that relationship with BA since the beginning of that and how it's tracked over time, please.

MR BERNARDI: Yeah, I think we can get that for you.

MR WARBRICK: Yeah, we don't have it with us, but we have to...

CHAIR: If you can provide it in the next few days we'll be grateful, thank you.

MR PJM TAYLOR: Just while we're digging around these particular areas, Mr Bernardi. The question of branding and previously there's been mention of the conflict of branding irrespective of the strategic direction of Qantas, but in a management sense handling different brands, and I can understand that as it is currently. What I'm not quite sure -- don't quite have it quite clear in my mind is how you handle that conflict in the future under the alliance arrangements?

MR BERNARDI: Yeah, under -- the alliance relationship changes dramatically and listening to -- reading what Geoff said on day one, it's quite a different relationship.

So, under the alliance there won't be that conflict. It's my understanding that that is one of the main purposes of it.

MR PJM TAYLOR: I'd sort of assumed you were talking about branding at the point of sale end and how you handle that through your agents.

MR BERNARDI: Oh, in terms of agents selling Qantas Holidays?

MR PJM TAYLOR: As compared to Air New Zealand Holidays.

MR BERNARDI: Yeah, it's not an issue. If I look at currently what we do in Australia with the Viva brand and the Qantas Holidays brand.

MR PJM TAYLOR: They exist side-by-side?

MR BERNARDI: Yes, they do.

MR PJM TAYLOR: So, you are seeing it exist side-by-side; no problem?

MR BERNARDI: That's right, and in fact in some markets, Malaysia is the one I'll use, we were able to last year grow our passengers to Destination Malaysia side-by-side with the Viva product, and not cannibalise the Qantas Holidays one. So, we're very confident of our ability to do that, because we have done it already.

CHAIR: Okay, if we could ask you to --

MR BERNARDI: I will speed up a little bit. Okay, we see four keys to our success here, expanded distribution, clearer branding, improved product and the global IT platform, which we see as critical.

The way that we distribute around the world is on four levels, if you like. There's our subsidiary companies, of which we have a controlling equity stake; we've got, for example, 75% of the Tourist Holiday Tours Group in Singapore, and these businesses distribute to consumers and travel agents in their market. We have franchisees who are licensed to use the Qantas Holidays brand but buy all their product off Qantas Holidays, and they distribute to consumers and travel agents in their market. There are general sales agents who are representatives in their market; they're local experts, they distribute to other travel agents as well as consumers, and Qantas Holidays in Australia which provides the global IT infrastructure does all the packaging for the worldwide businesses and our development of our web presence.

The map you've seen, we do have a sizeable global footprint which is important because selling in-bound you really need to be able to get that reach. These people also have local knowledge in their market of the distribution system, and will give us access to many touch points to sell New Zealand.

The New Zealand trip will -- the experience will be, we think, much better for consumers than what they've got now. There will be a combined Air New Zealand/Qantas network domestically, much more options internationally. So when flights are full we'll have the multiple routings that I spoke of before, much better connecting flights which I'll show in the next slide how that would happen. It will be more affordable, we believe, for customers because you won't be backtracking across the Tasman when you don't need to, so the airfare, or the net sum of the package would have to be lower than what it is today. Increased range in destination, we'll be expanding our product offering in our markets.

As I said, the ability to offer dual and multi-destination packages, and also develop a special events market which we're keen to do.

An example that we use quite a bit is, if you like, Japanese people travelling to either Australia or New Zealand. You have the mono destination. A lot of these people once they have done that mono trip tick it off and say, well, I've seen Australia or I've seen New Zealand, and that's why, whilst we will be promoting heavily the mono destination, it's also to look at the possibilities for the dual.

If you look at some of the itineraries that happen in the dual, I won't go into it in infinite detail, but you can see it's complicated and this is an example using the Air New Zealand network, another example using the Qantas network; both involving backtracks across the Tasman if you wish to go to both destinations; versus what we will be able to achieve -- I don't think the flights actually fly that way -- but what we would be able to achieve is a nice rounded package which allows people to do a new well worn track and see new parts of both Australia and New Zealand in doing that.

Branding is very very important. As I said, Qantas

Holidays piggybacks off the ATC branding, Qantas branding, to give it a bigger voice in overseas markets. We'd see the same leveraging effect happening in overseas markets using Tourism New Zealand's branding, Air New Zealand's branding and Air New Zealand Holidays branding. So, being able to get a greater voice in those markets where each one of us individually is quite small.

Norm mentioned the IT platform; we've invested heavily in our IT platform. At the moment it touches 18,000 Australian travel agents and 54,000 worldwide. It has full package functionality, which allows us to keep inventories of rooms. We have it centralised and hosted, maintained in our building in Australia.

We're up to its 46th version, which mightn't sound like much, but each one of these versions is -- spent quite a bit in putting them into play. We're up to 46, we've spent millions on it; it's very difficult to replicate for other operators even if they bought the system, the knowledge and experience behind that they need to operate it.

We're working on web applications and internet applications and I'll show you some extremely quickly in the next few slides going forward, and as Norm's mentioned, I won't go through that, but it's quite different to the Air New Zealand offering today.

The Air New Zealand offering today, for example, out of Australia, I've taken this example off their website, which is very static as you can see, and basically it's an information sheet that you can download from it. What we would see doing for Air New Zealand Holidays in the Australian market and other markets is access to our system so that you could make a booking on-line, not -- and I'll just flick through those examples, using Wellington, on how you would do so and pay for it on-line. So we give the opportunity to a greater offering for Air New Zealand Holidays.

So, a lot of competition by other national tourist offices, and I've just got up there the spend of those national tourist offices compared to Australia and New Zealand, so there's branding and joint branding and use of our voice is very important. Honolulu, for example, is $109 million they spend on theirs, which is up there. There's 175 national tourist offices competing for that.

New Zealand tourism strategy suggests that the representation of New Zealand and its products is diminishing and we feel that we can help this.

In summary, the alliance will deliver an additional 50,000 tourists per year. It combines our two strengths. Qantas Holidays, I feel, is very well placed to assist with this because of our global network, and our profitable business plan on which we can drive those 50,000 tourists to New Zealand.

CHAIR: Thank you for that, Mr Bernardi.

MS BATES QC: Mr Bernardi, we've heard a lot about in-bound tourism but not much about out-bound and I want to ask you a couple of questions about that and how it would work with the alliance.

The first thing I wanted to ask you is, how much of Qantas' business is out-bound tourism?

MR BERNARDI: The vast majority of Qantas Holidays business would be out-bound. The percentage?

MR WARBRICK: You mean out-bound out of Australia?

MS BATES QC: Yes, out of Australia, people travelling from

Australia elsewhere.
MR WARBRICK: It's probably about half our business.
MS BATES QC: 50%?
MR WARBRICK: Well, roughly 40%. PAX numbers and revenue is always slightly different because people tend to spend more on a long haul trip than short haul.
MS BATES QC: So, the 40% is numbers or revenue?
MR WARBRICK: It's PAX numbers, so passengers.
MS BATES QC: And what about for revenue?
MR WARBRICK: I think it's slightly higher; should be around 50%. I can give you the exact numbers if...
MS BATES QC: I might come back to that, but that's helpful. Mr Thompson, can you tell me what the position is for Air New Zealand Holidays?
MR THOMPSON: The Air New Zealand Holidays product in the New Zealand marketplace is primarily only sold by our own travel centres throughout New Zealand, which is -- we've only got 24 of those; they don't get sold through the indirect channels. As I said yesterday, the New Zealand market is very vertically integrated and each of the retail chains have their own wholesale operation.

So, far as Air New Zealand Holiday's share of the out-bound market in New Zealand, it would only -- I haven't got the exact figure at the top of mind, but it wouldn't be much more than around about 10% of the total holiday sales.
MS BATES QC: 10% of the holiday sales, and can anybody tell me whether -- what percentage of Air New Zealand's revenue comes from out-bound tourism; Air New Zealand's revenue?
MR THOMPSON: From out-bound tourism. I could probably give you a figure in total, but in terms of just tourism --
MS BATES QC: I can come back to that. I'm pursuing a theme

here, as I'm sure you can see, but I want to work out how the -- because I think a lot of business would be out-bound and we've been concentrating on in-bound, and I'm wanting to see how the alliance would impact on out-bound tourism for Air New Zealand.

So, I just come back to you Mr Bernardi, you're selling Qantas Holidays and you're selling Air New Zealand Holidays. For the out-bound position, do you have more incentive to sell Qantas Holidays for out-bound or Air New Zealand Holidays for out-bound?

MR BERNARDI: For out-bound New Zealand? Well, at the moment we don't sell Qantas Holidays access market currently.

MS BATES QC: But under are the alliance -- what will happen under the alliance as far as out-bound tourism is concerned?

MR BERNARDI: You know, out-bound tourism, it's really at the discretion of Air New Zealand because it's their brand. Now I believe Air New Zealand Holidays now does do some out-bound tourism from New Zealand?

MR THOMPSON: That was the figure I was referring to before, Commissioner Bates. What the thinking is at the moment going forward, is that given the alliance is approved and that we move into these offshore markets using the Qantas Holidays platform to be able to sell in-bound tourism to this part of the world, that here in New Zealand we would also pick up that platform as well to put our own Air New Zealand Holidays on that platform here in New Zealand.

MS BATES QC: To sell out-bound?

MR THOMPSON: Out-bound, yes.

MS BATES QC: So how would it work between you? I'm just not quite clear.

MR BERNARDI: If I could answer that, Norm. If that were to be the case Air New Zealand would do the sales and marketing as they do now. Qantas Holidays would provide the IT infrastructure so that they were able to book and book out of allocations. Air New Zealand would probably in conjunction with us produce the brochure as they do today.

MS BATES QC: So, working as an alliance is really concentrating on the in-bound and the out-bound stays much as it is now?

MR BERNARDI: Well pretty much, otherwise we would have done the out-bound before now -- you know, from our point of view.

MR THOMPSON: And I confirm that Commissioner Bates. This is very much a focus on in-bound tourism, 75% of our long haul business is in-bound into New Zealand. So, that's where the concentration has to be, that's where we see the significant opportunities, not only for Air New Zealand and Qantas Holidays and Air New Zealand Holidays, but for New Zealand as well.

MR CURTIN: I had an impression that over time web based booking systems will probably take a larger slice of the market rather than the traditional, you know, hardback in the travel agent. Is that correct, and how do you see yourselves positioned for in the future?

MR BERNARDI: Yeah, it's certainly something I lose a lot of sleep at night over, is the growth of web based agencies; both web based travel agencies, but also a lot of suppliers going direct on the web.

It's a concern for us, it's something that I don't think we're going to be able to stop, it's a global phenomena, there's a lot of overseas players getting into the market as well.

We have done a lot of work on how we distribute over the web, but also being very mindful of the travel agent relationships. As I said, earlier, over 90% of our distribution comes from travel agents, and we can't replicate that by using the web. So we're, if you like, working on agent supportive programmes through the web, and to date we've been able to achieve that, and that is our aim, to do that.

MR WARBRICK: But most of our investment these days are directed at e-enabling our technology platform, so there's a significant amount of investment going to the development of the on-line applications on top of the platform that we currently have.

MR CURTIN: The other question I had, if I can have one more follow-up: Again, I wondered if it's a trend globally for more of the independent traveller rather than the packaged buyer, and what your thinking was on that and whether it had been incorporated in any way into the forecasting?

MR BERNARDI: I think it's how you define a package, and packages aren't purely the structured, every waking moment is catered for, but packages have evolved to FIT packages which are modules or smaller packages; that's something that we're particularly good at, and in fact out of places like Japan it's very much a growing market and something that we consider ourselves experts in being able to deliver.

MR CURTIN: Thank you very much.

CHAIR: I'd like to ask Anthony Casey, please, to direct questions.

MR CASEY: I just have a few issues. The first is a quick one, branding; a lot of your projected tourism increases coming from Australia, branding is not going to be so much an issue for Australians, is it?

MR BERNARDI: Yeah, I'd actually disagree with you, with respect, on that. I think the branding is very important in Australia, mainly because there is so much competition into New Zealand from Australia. So, you need a brand that is very strongly focused on New Zealand and seen as an expert in that market.

Now, to places like Asia and other parts that we serve, we've got, if you like, that brand presence where we are recognised as experts in those markets, but to somewhere like New Zealand there are so many wholesalers promoting New Zealand at all different sorts of levels, it's a very sort of segmented message, if you like, so I actually see the branding as being quite important in Australia.

MR CASEY: You specialise in out-bound tourism; is this a problem in other destinations as well for Qantas? Do you have to overcome the branding issue?

MR BERNARDI: Look, I suppose it depends on the product that you are selling. You know, we sell an 18 to 35 year old product to Bali under the banner of Tropozone, which is a branding. It wouldn't necessarily fit the Qantas Holidays branding imagery, and we'd never be seen as the expert in that market segment as Qantas Holidays.

MR CASEY: That's fair enough. A view that's been put to the Commission in submissions and during our own investigations from the tourism industry is that they're more concerned about what's going to happen to prices and capacity and so forth, and we'll deal with the competitive effects later on, and they're less receptive to the idea that promotion is going to open up new opportunities.

I'm just wondering, a lot of the plan that you have outlined today almost takes the industry as a given and says that you will add value to the destination rather than work with the destination to create a more attractive product and bring people in. I just wonder why you haven't won over the industry and so forth to help create a better product to assist the plan?

MR BERNARDI: Yeah, I think it's a little bit chicken and egg. The plan we can't really implement until we get a decision. That was one of the main reasons I used that Melbourne example as well, with the Melbourne Cup, because that was a very real example where we did work with the industry about developing something unique for that event. And if we, for example, just sat in Sydney and said, look, we think this will be good, and this will be great down at the Melbourne Cup; we don't know the event well enough.

So, we rely very heavily on the local industry and, yes, we do provide a value add in terms of distribution and access points to New Zealand, but in the detail of the plan we aim to work very closely with the industry in development of things in New Zealand, with the industry here; not setting up our own.

MR CASEY: Another thing you touched on towards the end of your presentation was the intensifying competition among destinations.

MR BERNARDI: Tourist offers, yeah.

MR CASEY: I just wonder, if other destinations are going to observe the successes and efforts that you are putting into promoting New Zealand and compete with you there either attracting customers away or providing alternative services and so forth, and obviously Australian State tourism organisations and so on are very active, and I just wonder if you wanted to comment on that?

MR BERNARDI: Look I think, in terms of other overseas national tourist offices, they're doing it today, so there's probably no change, and it was interesting after the SARS epidemic we saw Malaysia, Singapore and Hong Kong get together as one voice, you know, to promote back into Asia.

The Australian States, I wouldn't see an issue from them because there's also benefits in this case for Australia as well. I mean, just as we've got dual destination traffic flowing through New Zealand to Australia, we're going to have an element of that the other way. So, I would have thought it would be something they could actually assist with, and we may even see co-operation between the two -- I know that's hard in our State system -- but co-operation between the two to promote the region.

MR CASEY: They won't try to hold on to the dual destination and convert them back into a mono destination tourist area?

MR BERNARDI: They're wizards if they can, but I can't see how that's going to really work.

MR CASEY: Fair enough. Also, I'm wondering, I appreciate that the strategic incentives will change, about promoting an Air New Zealand product with the alliance. I'm just wondering, will the strategic incentives change were the application to be declined? In other words, I mean --

MR BERNARDI: Yeah, look, that's an excellent point. I mean, if the alliance didn't go ahead, there's also some issues under the counterfactual which I can't mention here but I know the Commission's aware of, but yes, we probably would see an increase. But, that natural market increase, it will be nothing above that; there's no incentive for us to do anything more than that, in that it's still too hard.

We don't have the volume of connections, you know, and seats available to us, and we don't have the branding. And, I know I keep saying branding, branding, branding, but it is so important to what we do. You can have the best product in the world, but if no-one sort of knows about it, you can't do anything with it.

DR PICKFORD: I just have one point of clarification about the IT systems; I understand that the Qantas Holidays one is superior to that of Air New Zealand. Under the counterfactual will Air New Zealand have direct access to the Qantas Holidays IT system or will it continue to labour under its own sort of inferior system?

MR THOMPSON: We're left to our own devices, unfortunately.

MS BATES QC: I had to ask for that one, but this probably might seem a naive question, but...

MR BERNARDI: They're the ones that worry me, Commissioner.

MS BATES QC: On long haul out of New Zealand, are Qantas and Air New Zealand going to be competitors or are they going to work cooperatively?

MR BERNARDI: Under the alliance? I believe they will be working co-operatively.

MS BATES QC: I'm just not clear on it, would you like to...?

MR THOMPSON: Anything that touches New Zealand or the Air New Zealand operations in any Qantas operation that touches New Zealand, is in the alliance, so therefore you'd have Qantas working with us in the alliance on the long haul operations that touches New Zealand, which is for example --

MS BATES QC: So they're not going to be competitors on long haul?

MR BERNARDI: No.

MR THOMPSON: No, but they will be marketing their product, we'll be marketing our product and we'll be marketing it together also. The Qantas brand still very much exists under the arrangement.

MS BATES QC: So there won't be any fare differentiation out of New Zealand?

MR THOMPSON: Unlikely.

MS BATES QC: Unlikely or not?

MR THOMPSON: Well, we're going to be working on prices together if the alliance is approved so it's unlikely that there will be any differentiation, unless they have a product that's different from ourselves. For example, looking out into the future one carrier may have First Class and the other carrier may not have First Class.

MS BATES QC: Okay.

PROF GILLEN: This is more Air New Zealand. Why wouldn't it be possible under the counterfactual that given this superior distribution systems that Qantas Holidays has, that you would contract them and you would simply buy services from that distribution system?

MR THOMPSON: Because the Qantas operation, the Qantas management, will not allow that to occur. They have said no.

CHAIR: Okay, I think I'll bring this session to an end.

MR P TAYLOR: Sorry Madam Chair, there was a point of clarification, if we ask them why they say no.

MR BERNARDI: Well, very very very quickly. Once again, it's not in our strategic interests to do that and help -- in the counterfactual, following what Geoff said earlier on in the week, it's not in our strategic interests to help Air New Zealand promote their own services through this offering, which is quite unique, that Qantas Holidays have.

DR PICKFORD: But you would be prepared to do it under an alliance, and the reason presumably is because of the fact that you are sharing the profits that Air New Zealand would get.

If instead under a counterfactual Air New Zealand were to pay you to distribute its holidays, then what's the difference?

MR BERNARDI: We'd be prepared to do it under the alliance because it's a whole bundle of things; this is in the factual. In the counterfactual it is against the strategic position of Qantas to on-sell that to just anyone. In fact, it's not even in the strategic interests of Qantas Holidays to on-sell that technology and knowledge to people who could be rivalrous competitors in the future.

MR THOMPSON: If I could make the other point, the other part that would be missing in that formula would be the network benefits, that would not come into it. We'd also be still suffering under that scenario of not being able to have access to Australia Domestic, which is really important as far as the customers who are wanting a dual destination itinerary; that would not flow in.

CHAIR: Okay, thank you very much for that. I would -- before we move on to the next session with your external advisors, I would like to thank Mr Thomson and Mr Bernardi and your associates for being available; you bring a great deal of direct industry experience and it's been highly valuable to the Commission, so thank you very much.

We will now switch over to the next presentation; I don't propose to take a break at this stage. I would like to say that it is my expectation now that each of the two sessions that we have yet to cover with NECG, I would ask the speakers to summarise within 5 minutes; at the end of that period I'm going to break and we'll take questions and if there's any time left at the end of that we can return to presentations. Thank you. [**Pause**].

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CHAIR: Can I ask everyone to please be seated. Before we start, I'd just like to note for the record that the parties will be aware that an open letter from the Applicants to Virgin Blue was made available yesterday regarding airport access in New Zealand. There has been a response from Virgin Blue to the Applicants on the same matter, and that letter will now also be made available to all interested parties. So, the Commission staff will be distributing that letter to anyone who requires it.

Now, I'd like to proceed to the next session, and I do intend to ask you to summarise your submissions. I will allow you 5 minutes to do it and then I'm going to break for questions. So, could you please introduce who will be speaking at this session. Thank you.

PROF ERGAS: Thank you, Madam Chair. My name's Henry Ergas and I'm joined today by two of my colleagues, on the far left John Zeitch and sitting next to me on the left, Eric Louw. Eric will present the two topics that we will briefly address. First, promotional effectiveness and then, following the discussion of that, the welfare benefits of tourism expansion.

MR LOUW: Madam Chair and Commissioners, I will in the interests of time provide a brief summary and then very rapidly move through the slides so that we can come back to questioning as you suggest.

The promotional effectiveness section refers to an opportunity beyond -- the opportunities outlined in the Qantas Holidays plan. That opportunity, the Qantas Holidays/Air New Zealand Holidays opportunity is really focused on developing the package tourist opportunity into New Zealand for in-bound travel into New Zealand.

But we should bear in mind that only 25% also of tourists visiting New Zealand are on packages, and so there is a broader opportunity to attract more travellers to New Zealand, and in a sense this section captures those effects. Those effects arise from a number of sources, but to name two of the more important ones, there will be, as we've heard, better air product as a result of the network enhancements. So, from the consumer's perspective or the tourist's perspective, if you like, lower waiting times, streamlined itineraries, and indeed with respect to on-line flights, lower fares.

We should also note that this will help, not -- this will be enhanced air product available not just to the parties in the form of Air New Zealand and Qantas Holidays, but it will also help other wholesalers. That better air product will be in many cases easier to sell, which is why we could expect lower promotional costs or, if you like, greater promotional effectiveness.

Indeed, there's an additional effect beyond that which is that we expect a reduction, to some extent, in rivalrous promotion which tends to focus on capturing share from other providers. If you think about the situation currently, the incentive for Qantas, for example, would be predominantly to capture share from Air New Zealand rather than expand the market, simply because that benefits a rival. In the future we would see that effect being reduced to some extent and a shift in emphasis towards more co-operative market expanding type of promotional effort.

So, for all of those reasons we do believe there will be greater promotional effectiveness, and we've modelled this in, we believe, a very conservative way by looking at this logic here which is that, there may be some impact on promotional expenditure which we've not taken into account; we've assumed that promotional expenditure will remain the same although there are good reasons to believe that it will increase. Part of it was alluded to in the undertaking, but Air New Zealand has indicated as well that there will be an increase in promotional expenditure more broadly, and then what we've really focused on is this promotional effectiveness effect in that there's better air product to sell and a reduction in rivalrous promotion.

So to step through briefly how we quantify this: We estimated the increase in promotional effectiveness, which leads to an effective change in promotion, and again to emphasise, this is more broad than just the Qantas Holidays effect. We made an estimate of promotional elasticity on tourist demand and from that we calculated a change in tourist arrivals.

I'm not going to go through slide by side at this stage; I will simply quickly read through the top lines and then we can pause for questions. So, as we indicated, we estimated that promotional effectiveness will increase by at least 10% due to the lower unit cost of promotion, and some shift in focus from rivals to co-operative promotion.

We didn't assume to be conservative any increase in expenditure. We derived a promotional elasticity estimate through regression analysis, and this was within the range that the Commission's own research indicated as being reasonable. We then applied those assumptions through the modelling which resulted in an increase in arrivals to New Zealand, net arrivals to New Zealand of 13,300 additional tourists.

CHAIR: Thank you Mr Louw. I'll take questions on this part of the presentation, if there are any.

PROF GILLEN: I have a couple of questions. One is, when you look in the last presentation the incentives or the changes that would take place under the alliance, the first four really dealt with the notion of access to markets, and you've alluded to this, just the idea that better on-line connections, more destinations etc.

In looking at this, did you take into account that just as you can increase the access to New Zealand, you can increase the access to all sorts of other destinations, so that people from New Zealand can more easily visit the UK for example?

MR LOUW: That effect was looked at and was taken into account. Would you like us to go into it a bit more detail as to exactly how that was done?

PROF GILLEN: Yes, please.

MR LOUW: Perhaps I can refer to John Zeitch who did that part of the modelling.

MR ZEITCH: Basically what we took into account was that there would be an increase promotion effectiveness in Australia and New Zealand and, as a result of that, there would be a tourist flow from New Zealand to Australia, and those numbers were actually deducted from the calculation of the expansion in tourism in New Zealand. So, the 13,300 excludes those New Zealanders who will travel to Australia as a result of increased promotion effectiveness. There is no other adjustment for other countries.

PROF GILLEN: My second question is, when you change the access to a destination, the literature generally suggests that you can change the length of stay as well, so total expenditures go down. How did you adjust that in the results as well?

MR LOUW: We'll get on to this in a little bit more detail in the welfare benefits calculation, but we were aware of that possibility and hence we chose rather conservative estimates of increased -- of the additional tourists by taking an average across the board of tourist expenditure when we're well aware that many of the new tourists will in fact be travelling on packages, and package tourists have quite significantly higher average expenditure than the global average, if you like. So, we felt -- and I think the difference is of the order of 20 or 30%; we have the figures in the next pack. So, we felt there was, you know, a comfortable margin of error in that.

PROF GILLEN: The final question is on your promotional elasticity: Did you assume that it applied equally across all of the markets of Asia, North America, Europe etc; like, there was people responding in exactly the same way per dollar of expenditure and promotion?

MR LOUW: I believe so. John?

MR ZEITCH: Yes.

PROF GILLEN: What's the argument for that?

MR ZEITCH: If you -- we took a weighted average of the elasticities that we estimated in for the study. If you look at the elasticities, they don't vary that greatly, the ones that we estimated, and because it was a weighted average, I think that would be appropriate given that we're dealing at an aggregate level with the total number of tourists. We didn't actually split the tourists coming down from different destinations or different origins.

So, you couldn't apply disaggregated elasticities to those numbers. So the appropriate thing to do, I thought, was to derive the elasticities in the first place and then take a weighted average of elasticities from different sources and then apply that to the aggregate number you were working with.

PROF GILLEN: Would you expect that -- my sense is that a dollar spent in the UK might differ from a dollar spent if Asia simply because of the number of alternative opportunities available. So to try and convince someone who is currently in London to visit New Zealand, versus someone who is, for example, in Colorado, I think would be somewhat different. I'd just like your comment on that.

PROF ERGAS: If I may comment on that briefly. If you look at the promotional elasticity we used and you compare it to what is in the Commission's range, the promotional elasticity that we used was at the lower end of the Commission's range. Now, given that it was at the lower end, given that we were dealing with an aggregate and that, as we are dealing with an aggregate, you would think would be the weighted empty that would be appropriate. I would think that if there's any error in it, it's error in the direction of conservatism.

Had we used an elasticity towards the top end of the Commission's range then perhaps the argument would have been different, but ours is just barely above the bottom of the range that the Commission reported.

PROF GILLEN: Thank you.

MS BATES QC: Just a quick point of clarification. 13,300, that's per annum I assume, is it?

MR LOUW: Yeah, that's correct.

CHAIR: Any further questions on this point? [**No questions**]. All right, let's carry on then, thank you. That session gets the prize for the most efficient.

PROF ERGAS: Can you tell us what the prize is, because that might increase the incentive.

CHAIR: I'll have to think of something appropriate.

MR LOUW: I'll attempt to do something similar with this, in other words, provide an overarching summary and then move very quickly through the detailed slides.

In taking into account -- in translating, if you like, this increase in tourism from a numbers perspective into welfare benefits, one has to go through a number of steps, and I'll quickly run you through how this works. We estimated the net change in tourism numbers from three effects; the effect discussed in the Qantas Holidays and Air New Zealand submission that you've just heard, the one that we've just discussed, and then there is a pricing capacity effect as well due to the results of Cournot modelling. We also then, as we discussed briefly, need to make some assumptions about average expenditure of the different types of tourists going in the different directions, and then convert that to aggregate changes in tourism expenditure.

Now, what does that mean for New Zealand welfare? The only way to satisfactorily take account of all of the direct and indirect effects of this additional expenditure is to apply a general equilibrium modelling approach. We used three different general equilibrium models to develop estimates of the multipliers, if you like, the relationship between the change in tourism expenditure and the change of welfare.

Each of those models had their own limitations, but in the end we settled on one which we felt had the greatest robustness and part of that involved feedback as a result of the Draft Determination, and applying those multipliers to the change in tourism expenditure allowed us to estimate changes in welfare, which we measured as change in real private consumption.

Just to reiterate and make the very important point that, there are a number of separate effects here, there's the Qantas Holidays effect which is the 50,000, the promotional effectiveness effect which is 13,300 which gives you 63,300 in aggregate there.

Before we move on to the price and capacity effects it's reasonable to ask why that would represent an increase in tourist numbers rather than to some extent at least a shift in share. I think the reasons, I won't go into in great detail, but have been outlined in all of the discussions that have preceded this one, but I will make the point that most of these, if not all of these, would not be easily recommendable under alternative arrangements. These effects, the better air product, the effect of being able to cost effectively target new segments and tackle under-developed geographic markets and so on are really a direct outcome of the alliance arrangements.

In looking at price and capacity effects there's a rather, not enormous increase in absolute numbers of net tourists flowing into and out of New Zealand. However, it does have a reasonably material effect on the welfare benefits as you flow it all the way through the equations.

All that I'd like to touch on here is that the modelled increase, also the model change in price and capacity is -- at least in respect of the tourist end of the market -- really quite pessimistic. Really, what it assumes in a sense is that, the VBA entry will have a weaker disciplining effect, if you like, on pricing in the factual and the counterfactual. To allow these price rises to occur you would have to assume that.

Also, we haven't assumed in the modelling that there would be pass-through of the rather substantial cost savings that would accrue to the alliance parties, and indeed to the VBA entrant as a result of the entry facilitation conditions that are offered, and finally, we don't assume any difference in resistance, if you like, to price increases between the more elastic segments and the less elastic segments, and clearly you would expect the more elastic segments, predominant the tourist type segments to be very resistant to price increases.

In addition to that, of course, you would have fare reductions due to on-line fares, and I've seen various figures of that, but as much as 20% in many cases.

And so, taking all of that into account, it's reasonable to imagine a world in which fares don't increase at all in the relevant tourist segments or indeed even are lower. So, just to look at what the world would look like in this alternative scenario we've also looked at a world in which prices decrease.

By the way, just to say that, there's quite a lot of empirical research that finds that prices decrease as the result of major strategic alliances like this one. 5.5% was what was found by Oul and Park and so on.

Obviously that would lead to a change in the net inflows and outflows in the modern view versus the alternative view. And so, taking those capacity effects, together with the other effects, applying average expenditure figures which, as I've said, are conservative, we are able to then flow through to the equilibrium model.

Now, I'm not going to go into great detail here at all, simply because of the time constraints, but I understand there may well be questions on the specific technical details of the general equilibrium model, so let's see what those questions are.

The bottom line is that under -- really in our view at least, the most pessimistic view of the alliance's impact on prices in respect of the tourist segment, the Monash model indicates a net gain in real consumption of $73.2 million in year 3 of the alliance. However, it is possible to -- quite plausible to imagine a situation where you get considerably higher gains, welfare gains.

CHAIR: Thank you, Mr Louw.

MR CURTIN: Just under the Monash model, would it be wrong to think of it as a kind of an input/output model, or how would you describe it, just for a wider audience?

MR LOUW: Can I ask John Zeitch to address that. John conducted that part of the analysis.

MR ZEITCH: No, it's more advanced than an input/output model because it allows the structure of the economy to change as relative prices change, and it's a model that allows the demands that you're simulating to be fully supplied and the economy to adjust to those changes that result from the expansion in tourism, whereas the input/output model would not allow, you know, relative quantities used to produce outputs to change for example.

MR CURTIN: Okay, sorry; it's gone beyond the kind of fixed production coefficients?

MR ZEITCH: Yes.

MR CURTIN: Okay. But it's still in a family of deterministic rather than stochastic or econometric models?

MR ZEITCH: Yes, but when you set such a model up, you have to estimate various parameters; substitution parameters, export demand elasticities. So underlying these models there is a substantial amount of econometric work to parameterise them.

MR CURTIN: All right, and just one last question before we move on. That business of parameterising, if you like, the model, I think one of the criticisms has been that you do get rather odd things going on with things like the terms of trade, which suggests that -- the response there seems to be implausibly large. Can I suggest the parameters may not be a terribly good fit?

MR ZEITCH: That's an interesting issue, and it's an issue that I think has been debated ever since these models were used for policy analysis purposes back in the early to mid-1970s.

The issue of whether or not the terms of trade are realistic, you know, really does depend on your view of the world and the size of the export demand elasticities that are in that model. But, what you're getting out of these models is the terms of trade effect.

The alternative is, if you change the parameters into the model so that the terms -- the trade effects are smaller, what you tend to get is unrealistic specialisation in production, and there was an exercise done with, I think the Salter model of the world economy, which is a model similar to GTEM that we used for some of the simulations.

And what they did was, they examined the exact issue you are concerned about, that these models were generating relatively large terms of trade effects, and they said, all right, why don't we change the parameters in the model so that we don't get these large terms of trade effects.

What happened was, they ran the simulations, they changed the parameters in the model for every country so that the model's actually calculating effectively for Australia export demand elasticities based on the parameters in the other countries, and what happened when they did this experiment was, they got unrealistic, wide and strong changes in export volumes and input volumes and countries tended to specialise.

So, that led them, and this was done by the EPAC, Economic Planning Advisory Council in Australia, they did this work. What they came up with in conclusion in the end that the export demand elasticities, you know, were a realistic expectation of the parameters out there in the world and that if you tried to stop those terms of trade effects coming through you've got unrealistic specialisation around the world. So whereas you might not like, or you might think that these terms of trade effects are unrealistic, you know they have basically been derived through extensive analysis of the effects of changing the parameters in the model.

MR CURTIN: One very final question, if you could. You did at least have a stab at using the Infometrics model which is an econometric flavoured model, I presume?

MR ZEITCH: No, it's the same; my understanding is, it's based along an ORANI style type model.

MR CURTIN: Okay, sorry, my mistake. Okay, thank you.

PROF ERGAS: We looked at it because it was a model that had been specifically designed for New Zealand, and of course the results it gave were much larger welfare gains than those we were obtaining, from the Monash model. Hence, to be conservative, we used the significantly lower welfare gains that were generated in the Monash model.

MR CURTIN: I understand that. I just had a mistaken impression, I thought the Infometrics model was a more econometric multi-equation style model.

MR ZEITCH: I don't think so, but ADOLF refers to it as a variant of -- or, an ORANI style model.

MS BATES QC: The 50,000 tourists generated from the Qantas Holidays plan, are they going to be on package deals?

MR LOUW: Yeah, predominantly. That's my understanding of that.

MS BATES QC: Because you've said at the moment, or someone said only 25% of the people coming into New Zealand are on packages.

MR LOUW: Yes, and this is interesting because that's -- New Zealand is lightweight in that respect in the sense that there is only 25% as opposed to, for example, in Australia where it's about 35%, so that speaks to the opportunity to close that gap.

MS BATES QC: Okay, so, what percentage is it projected to be?

MR LOUW: I don't have those figures offhand, but it's -- what would it be, 25% of 1 million tourists, which is 250,000, plus 50,000, which would be an increase of 20% or just less than 20% in packaged tourists.

MS BATES QC: So the 13,300, that's going to come from non-packaged?

MR LOUW: That would be a much broader effect which is simply people who do DIY travel arrangements.

MS BATES QC: So it's going to be a major change in the mix?
MR LOUW: No, why would -- I don't quite understand why there'd be --
MS BATES QC: Perhaps that's because I don't quite understand, but if it's going to be 50,000 generated from package holidays and 13,300 generated from non-packaged holidays, I would have thought that was a change in the mix substantially from what it is now.
MR LOUW: Oh, I see; you mean these incremental tourists would be a very different mix to the current composition?
MS BATES QC: Yes.
MR LOUW: Yes, and that's because that's where the opportunity lies, is to increase package tourism.
PROF ERGAS: We have said in successive submissions that one of the impacts of the alliance that we believe would be of great significance in assessing the tourism effects would be to remove constraints on Air New Zealand's ability to sell packages to New Zealand overseas, and so the effect of that would be to move the mix closer to the mix that we observe elsewhere and in particular in Australia.
MS BATES QC: Okay, thank you.
MR CASEY: The modelling has just changed since the original application, you were originally using a GTEM model and now you're using the Monash model. Could you just summarise, or first the implications of the change and the reasons for it?
MR LOUW: Again, I'll ask John to speak to that.
MR ZEITCH: The reason we basically changed from using GTEM to Monash I think are threefold. The first thing was that when we asked ABARE to rerun the simulations for us and use a dynamic closure rather than a comparistatic closure, they ran into serious resource constraints, and so they did the

first set of simulations and were unhappy with the results because -- well for various reasons, and so, they wanted to go back and redo the work. But unfortunately in the time available and given the changes that were going on in ABARE at the time, they could not complete that work. Subsequently they have updated the model and redone the simulations and that has been supplied to the Commission.

The second reason -- so the first reason was that the time, they hadn't satisfactorily completed their work to a level that they thought was satisfactory.

The second reason that we moved away from using GTEM was that we sought advice from Professor Dixon from the Monash University on various matters related to how you measure welfare, how you treat the labour market in these sort of simulations, how should you measure welfare and was it appropriate to use GNP, real GNP as a welfare measure, and Professor Dixon responded to us on all those four issues, and we could provide that to the Commission if that would be helpful?

CHAIR: If you could do that today, please, and we want to be able to make that available to other parties.

MR ZEITCH: What Professor Dixon advised us was two points. That when you're simulating an expansion in tourism by just shocking the exports of commodities consumed by tourism, that can lead to inappropriate changes in the mix of resources used by tourists, and so, what's better to do is actually have special routines within the model that hold the composition of the tourist's bundle of expenditure fixed. ABARE wasn't able to do that; in the Monash model they do do that. So that I thought in terms of modelling a tourism expansion the way we were previously doing it wasn't quite as good as it could be done if we had more time.

The third reason why we decided to steer away from using GTEM for this exercise was that Professor Dixon advised that when you measure welfare using what ABARE calls "real GNP", that there is a problem in using that measure because it overstates welfare in the case wherein development's expanding in the economy which was happening in the GTEM simulations. And so, their proposed measure of welfare needed to be further adjusted to net out the effects of expansion in investment, which is really the cost of achieving the increased tourism.

So, at the end of the day, the more robust specification of the model pies could be derived from the Monash model basically because it had a well-established measure of welfare, it went to particular detail in specifying how you shock tourism, and the model's been tried and tested in the policy arena.

Having said all that, there's not a huge difference between the multipliers that we'll get out of the GTEM model and the multipliers we'll get out of the Monash model I believe at the end of the day.

MR CASEY: Thank you. Just talking about the assumption of full employment, there's -- one of the justifications given relates to a procedural issue and I'll just quote appendix 1 of your submission where you say that:

"Full employment may be a valid assumption if a very long term perspective is being adopted, but the Commission is required to assess the costs and benefits of the alliance over the period of time for which the authorisation is being sought."

I just wondered if you could interpret that sentence for us?

PROF ERGAS: What we meant by that was that the sensible way to measure the effect of the alliance is obviously to look at the change in welfare on an NPV basis that results from the alliance. So of course that stretches out in time and conceivably the alliance, even if it were only to exist or be authorised for a period of time, might have effects that went beyond that period of time.

So, we're not saying that you have to confine the consideration of impacts to the period for which authorisation is being sought. What we are saying though is that, in considering those impacts from the alliance, it is appropriate to start from the situation as you would find it were the alliance to occur; and the situation as you would find it were the alliance to occur is one where the assumption of continuous full employment is clearly not met, and given that it's clearly not the case that the economy is in continuous full employment, it would make very little sense, in our view, to calculate a welfare measure as if the economy were in continuous full employment, and hence we have specified the modelling taking account of the dynamics of a labour market in which you do not get continuous full clearing, i.e. In which involuntary unemployment can and does exist.

MR CASEY: Okay, I guess I just want to explore that a little further. I mean, how durable are the tourism benefits? How long will they last?

PROF ERGAS: Well, the point we make is this; that we have every reason to believe that, were the alliance to proceed, it would generate tourism benefits which are substantially greater than those that we have estimated. It's worth bearing in mind that the type of figures that we have used for changes in tourism numbers are extremely small. A 60,000 number corresponds to, for example, the annual in-bound passengers associated with a once daily 767-300 service. So, it would take only the addition of one, one daily 767-300 service to generate the tourism impacts that we have modelled.

When you take that into account, that we are looking at numbers that we believe are very small relative to what is likely and highly feasible, then we are quite confident that those tourism benefits would persist over the full period for which authorisation is being sought, and so, all we have done is to calculate the gain from that increase.

It's highly likely that were you to have stimulation of tourism during that 5 year period, that there would be an after glow effect. Promotion is a capital stock or it feeds into a capital stock, and where the capital stock associated with New Zealand's image and the understanding of New Zealand as a destination around the world to increase, you wouldn't expect the full benefits of that to solely accrue in the 5 years for which we've modelled the benefits. And so, there would be impacts that would go beyond that period, but those impacts are not being picked up in our welfare estimates.

CHAIR: Can I just ask a follow-up question. Would it be fair to assume that as the period of authorisation were reduced in time -- say it wasn't 5 years, say it was 2, would you expect it to be more and more difficult as you reduced the length of the authorisation to achieve those benefits?

PROF ERGAS: I suspect that that is correct with respect to all of the benefits that we believe the alliance would generate.

The experience with alliances is that it does take some time for the synergies associated with an alliance to be fully unlocked and fully exploited. That has certainly been the case with the Qantas BA Joint Services Agreement in Australia and we would expect it to equally be the case here.

So, in that sense, if the period of time were unreasonably reduced, we could not confidently expect the full benefits that this alliance can realise to be exploited.

CHAIR: Can I just pursue that a bit, because this issue always comes up and it's almost always played out the same way; the anti-competitive risks are greater in the short-run, and if people are right, for instance, about the impact of low cost carrier entry, it diminishes over time. The benefits are lower up-front but increase over time, but the uncertainty about what's going to happen as time goes on in terms of how much confidence the Commission can take about the ability to achieve the benefits or the reduction in the -- any concern about anti-competitive effects, the degree of confidence or certainty we can have about that is also quite -- lower simply because you're projecting further and further out in time.

It always poses quite a dilemma for a Commission, I would suggest, in terms of how to think about the likely dynamics of the benefits and the detriments and the uncertainty as you move further and further out in time about whether you will achieve the desired benefits, and the Act requires a fairly high test about the degree of confidence about achieving net benefits.

So, I'd just like your comment on that, if you would.

PROF ERGAS: Well, Madam Chair, I believe it's useful in considering that question to look at the experience with the JSA, that is the agreement between Qantas and Air New Zealand -- sorry, Qantas and British Airways. The experience with the JSA has been that over time two things have happened; first, that as the alliance has proceeded there have been new opportunities for efficiencies identified and exploited by the alliance parties. So that the aggregate benefits that were obtained under the alliance were, I would submit, greater -- significantly greater than those that one would confidently have predicted at the alliance's outset.

There's, as it were, a dynamic to the kinds of relationships that are engaged as an alliance is put into effect which allows the parties to, for example, by benchmarking against each other's operations, simply by the exchange of information between them to identify and exploit opportunities that obviously they would not have known when they were separate entities.

So, in that sense the experience that we have seen has been one where the benefits have increased over time rather than diminish over time. And equally I think it's fair to say that, even those economists who are most skeptical with respect to the strength of market forces and of competitive pressures, would realise the great truth in the old Roman or Latin saying, that gutta cavat lapiatem, which translated into the vernacular means that it's the drips of water that ultimately break even the biggest stone.

So, competition over time certainly develops and hence, if you look forward there are very few markets where, when entry opportunities exist, when there is scope for efficient competition to develop, where over a reasonable period of time that efficient competition does not occur, the experience with the JSA again is telling in that respect.

Having worked as the advisor to the ACCC at the time of the initial JSA authorisation, we had a view about how competition would develop in that market. The reality is that competition surprises us all and it developed in forms and with a degree of intensity that I certainly had not anticipated, and I would suggest that in that case, as in this case, looking over time the benefits tend to rise and the detriments to my mind tend to diminish.

CHAIR: Can I just ask you for your view on, why do you think it is, given -- I assume from your comments, you think entry barriers are low -- why have we not seen low cost carrier entry in New Zealand before now? It's been around in the world for decades probably. What haven't we seen it? On the face of it, it suggests that it's because, even if there are lowish barriers, if we were to assume that, they're not quite as low as they've been in other jurisdictions where we've seen this advance happen long before now, and in New Zealand there's talk of low cost entry but it actually hasn't happened.

So, if entry barriers are so low and there's -- forces of competition are so persuasive, in this market, why has it taken so long for a low cost carrier to decide to challenge this market?

PROF ERGAS: The reality is that the low cost carrier model, though it has of course been around for a good many years, is not a terribly easy model to implement, and the experience as both Michael Tretheway and Cliff Winston explained, has been that it has taken time in a very large number of markets for viable effective low cost carriers to evolve.

The situation in Australia is that low cost entry on a sustainable basis is a relatively recent phenomenon, and so, it's unsurprising in a way that, if you take a market as large as Australia's, with one of the highest reliances on domestic air travel, that if in such a market it has taken some time for the VBA model to emerge, it's unsurprising that it would not have emerged in New Zealand.

CHAIR: I guess that begs the question then, why did it take so long to emerge in Australia? It only transfers the question. What is it about Australia and New Zealand, given our heavy reliance on air travel, from what I can see, why has it been so delayed even in Australia?

PROF ERGAS: Well, it's always difficult to explain the pattern of diffusion of innovations including organisational innovations, and though it would be possible to have a lengthy and ultimately I suspect worthwhile discussion about that, I don't have an easy answer to that question.

But that said, it's worth noting that the changes that have occurred in both Australia and New Zealand are in many respects relatively recent. It's only been in the last few years that we've had the single aviation market in that with that market we've had the move to full integration of these two substantial economic areas.

Now, it's quite recent in Australia that we've had full liberalisation of domestic air travel. So, given that, I'm not entirely surprised that it did take some time for the low cost model to develop. What is clear, though, is that, that low cost model is now very well entrenched in the area, and represents significant competitive force throughout the region going forward.

CHAIR: I guess this goes to the heart of my questions yesterday. The Applicants put to us that the barriers to entry are low. It's been put to us consistently, and also that the barriers to expansion are low. Yet, I hear you saying this is an important question, and we could have a long discussion on it; well, I would suggest that we need to have that discussion during these hearings, because I think the Applicants need to explain to us what it is about the environment in Australia and New Zealand that has seen us lag behind if the barriers are so low.

Now, I take your point that this is not -- that there aren't costs and there aren't difficulties, but I also as an economist believe that incentives work and if they're not working there's a reason, and it usually has something to do with barriers of some sort. So, I just -- I'm grateful for your comments and I have waited to put them to you because I was interested in your views, but I think we do need to have further discussions on that in this proceedings.

So, I've sort of hijacked the discussion away from Mr Casey, so I'll hand him back the floor and let him ask the rest of his questions.

PROF ERGAS: Could I, though, make one brief comment, if I may, with your indulgence and Mr Casey's, I certainly don't want to cut him off.

I take your point that perhaps the low cost model could have developed earlier. I think it's worth noting, though, that -- two things; the first thing is that, even prior to Virgin Blue's successful expansion we had had a significant number of entry attempts into the market. So we had much the same kind of experimentation that occurred in the rest of the world, and as in the rest of the world, it took some time before the right combination was brought together.

A second point I'd make is that, I don't think that our experience in respect of the airline or air services market is terribly different from our experience in a range of other markets, and if I may give you just one illustration of that.

In Australia it took some time after the liberalisation of financial markets for the mortgage originators market to develop and to provide very strong competition, which it did, to the supply of mortgages by the commercial banks.

What's interesting there, and I think you could see this in a range of other areas and is true also in respect now of VBA entry, is that, though it takes some time for the phenomena to hit our distant shore, so to speak, and hopefully it doesn't hit it by means of convict ships, but it does take some time for it to hit the distant shore, but once it does do so it can spread remarkably differently.

So as in the VBA case or in the case of mortgage originators or in some of our telecomms areas, what is true is that, though the initial organisational or marketing innovation arrived on our shores somewhat after it did elsewhere, once it arrived it caught up with levels of penetration that we observe elsewhere extremely quickly.

CHAIR: Thank you for that. Mr Casey.

MR CASEY: Thank you. Just going back to your earlier statements on modelling, would it be a fair characterisation to say that, because the projections of tourism increases are modest, that it is fair to have a more optimistic model setting in terms of the general equilibrium model?

PROF ERGAS: Well, we would take the view that what we've done is, we've used reasonably conservative impact estimates, i.e. Estimates of the impacts in terms of tourism numbers, and then we've used a model to calculate the welfare consequences of those changes in tourism numbers, which is itself relatively conservative, and certainly extensively used and hence very well tested.

So, what we believe would be more appropriate is to recognise that our estimates of welfare impacts are conservative and that there is, to use the vernacular, considerable upside that those estimates do not capture.

MR CASEY: I'm referring specifically to the assumption of flexible -- flexible employment, of course. I wondered, what kind of sensitivity testing was conducted with the Monash model? Did you, for example, model higher numbers of tourists with more restrictive resource assumptions in the model?

MR ZEITCH: We haven't undertaken any sensitivity analysis using the Monash model. What I was concerned to ensure was that the application of that model was a standard application that would be undertaken for any policy analysis. So, the model is used by the Australian Productivity Commission which has a long history in the use of these models to analyse alternate -- or to evaluate policy changes for the Australian Government.

Just recently, the industry Commission has looked into assistance arrangements for textiles, clothing and footwear and they commissioned the Monash -- the Senate for policy studies to undertake that analysis for them. So I spoke to my colleagues in the Productivity Commission and they informed me that the basic settings that they used for analysing policy issues in Australia are basically the specification that we use and that Peter Dixon applies, and that is a sticky real wage in the short-run and then when labour demand expands to levels that are observed in the base case, then the real wage is fixed. So, the application of this model is the standard application that the Government's own body that analyses assistance issues in Australia uses.

If I was to look at doing sensitivity analysis, then maybe a more profitable way of looking at this may be, as Commissioner Curtin indicated, would be to look at what the export demand elasticities, alter those in the model and see how the results could change if you alter the export demand elasticities. The question when you do sensitivity analysis is, you have to say, well, what's the plausible range that I can change those elasticities over to, from what's the lower range and what's the higher range. I think that would be a more profitable area for sensitivity analysis than playing around with the assumptions regarding unemployment given that that is -- using a sticky range is basically the way these models are used to analyse policy issues. That's what's in the economy in the short-term. Wages are sticky in the short-term. We're not doing an esoteric exercise here, we're actually trying to model how the economy will adjust to the simulated expansion in tourism, so you've got to accurately reflect as best you can what circumstances are in the economy at the present point in time.

PROF ERGAS: I think there's another point which perhaps goes also to the question, which is this: That because the number that we have used in terms of the change in the number of tourists is relatively small, we don't believe that going somewhat above that number would imply that you would run into severe resource constraints at which point the welfare gains would be choked off by tightness, for example, in the labour market.

In other words, on a plausible calibration of the shock that we've given relative to the scale of the underlying phenomenon, you could build a considerable amount of upside into our estimate without running into resource constraints. And so in that sense we would think that, if you had a bit more upside the response of the model would be not perfectly linear of course, but would be approximately linear in the increase in tourism from the case that we've assessed.

MR CASEY: The Commission referred to a treasury memo in its Draft Determination where a preference was stated for the modelling environment for cost-benefit analysis and that basically stated a preference for assuming full employment unless there were exceptional reasons why you shouldn't.

I just wonder, just in terms of this application to a New Zealand authority, that it wasn't modelled that way for rhetorical purposes, even if you don't agree with the assumption from a technical point of view.

PROF ERGAS: To my mind, you would need to look fairly carefully at what the treasury paper was intending to capture in terms of the types of projects which were being evaluated, and it's obvious that the approach of assuming a continuously clearing labour market cannot make sense as a blanket precept in the area of policy evaluation.

For instance, if you took that approach you would never have labour market policies because since you would start from the presumption that there was continuous full employment, the only impact of labour market policies could be on productivity at the full employment level, which would be a relatively slight impact at best.

And so, when you look at the extensive literature on cost/benefit evaluation of active labour market policies, many of which are implemented in New Zealand at the moment, it's clear that that literature does not rely on the underlying assumption of continuous full employment.

It's a different situation if the question you're asking yourself is, should we build, say, a new major highway system that will traverse the country? In that case you're looking at very significant shock in terms of the economy, a very large edition to the economy's capital stock, that will have an effect that is genuinely a significant effect in perpetuity.

In assessing that kind of effect you have to take account of the fact that it's the very long-lived nature of the asset that is going to be most significant, and it's not only the transitional consequences that you need to worry about, but also what in the steady state the asset is going to contribute on net to the New Zealand economy.

In the context of evaluating that kind of project it would make good sense to my mind to say, let's consider the transitional macro impacts separately but in doing the cost/benefit evaluation of the project, look at it as almost in perpetuity that is being added to the New Zealand economy where we would evaluate its consequences assuming that in the long-run, as John indicated, in the long-run the labour market has sufficient flexibility to approach the full use of resources.

MR CASEY: Yeah, okay. The minute itself actually mentions labour market programmes as a specific exception to the assumption and things like that obviously.

Perhaps, with the Chair's indulgence we could pursue a couple of other issues. Multipliers, using the Monash model and the ORANI family of models and so forth used a matrix of multipliers at some stage; it does use an input/output table, in other words, I mean it has general equilibrium equations around that if I'm interpreting that correctly.

I just wonder, does the use of multipliers in this exercise assume fixed proportions of inputs and outputs and so forth?

MR ZEITCH: No, it doesn't. There are input/output multipliers, all right, which you can do your manipulations of the tables and generate those. These are not the same multipliers. What these are is just running the model, observing what happens to the variables you're interested in -- in this case, real consumption -- and then using that result to scale expenditures that we observe in our calculations. So what it's really doing is providing an approximation to the general equilibrium model's results and then applying knows results through the multipliers to other values.

And so, it's not -- it doesn't assume anything about fixed proportions, it's actually what we might call a summary of the model results that we then apply to other circumstances.

PROF ERGAS: The specifications of the Monash model do allow for substitution in production between different inputs in line with changes in relative prices, including changes that are endogenous, i.e. That occur as a consequence of the shock to which the system is being administered.

MR CASEY: Just one final question. I was just wondering, tourism expenditure is modelled as an increase in export expenditure in the Monash modelling. Is that offset anywhere by a reduction in foreign payments?

MR ZEITCH: Yeah, but the model has a complete set of accounts and the trade balances and prices adjust to achieve that, yes.

CHAIR: Thank you very much once again. I assume we'll be talking to you again further in the presentation. So, thanks for that.

We will now break for tea and I would ask everyone to be back by 10 minutes to 11 promptly, please, at which time we will have the session on aviation industry conditions. Thank you very much.

Adjournment taken from 10.33 am to 11.00 am

CHAIR: I'd like to reconvene this session of the Conference, and I will note that the issues to be dealt with are aviation industry conditions followed by consumer benefits from new direct flights and on-line connections, and I would ask the Applicants to please introduce the next presenters, please.

PROF WILLIG: My name is Robert Willig. My friends call me Bobby. It's a personal honour for me to be here to take part in your decision-making process. Compared to conditions back home, this is a very special process; it's very open, it's so interactive we just don't have antitrust decisions made like that in the US and it seems especially exciting for me to have the chance to be part of this process and to offer you my perspectives on the analyses that really should and will be going into your decision-making process.

If I may say a few words about why I feel qualified to some extent to offer those perspectives; I've been teaching for more years than some people here have been alive; of Princeton on public policy, of Government toward business and the use of economics in their policy making. This is really the main thrust of my teaching life and an important part of my research life.

In addition I've been practising what I teach, or what I preach as the case may be. I have worked as a consultant a lot on antitrust matters, regulatory matters, in the airlines industry as well as all other industries that I can think of, and I've had the chance to serve in the US Government Department of Justice as the Chief Economist of the Anti-trust Division with a lot to do with the formulation of how to analyse mergers and other combinations; and while in the Government we have the chance to practice a lot on airlines issues, which then too and still today are very hot globally.

It's a great pleasure for me to turnover the mike to Meg Geurin-Calvert, my partner, friend, former student, colleague in the Justice Department.

DR GUERIN-CALVERT: I would like to echo Bobby's words that it's a great honour to be here to participate in this proceeding, and to echo his sentiment that this is truly a unique process and we look forward to participating in it.

My particular background on airline industry is that I started work as an economist at the Department of Justice in 1979 and one of my first assignments was to participate as an expert witness before the then existing Civil Aeronautics Board to present testimony on the deregulation of the travel agent industry as well as on the further deregulation of retail pricing in airlines.

While I was at the Justice Department, including serving as an Assistant Chief during Bobby's tenure, we worked on a number of matters, including the United Frontier transaction, the US Air Piedmont transaction, the sale of PanAm's international routes, and a variety of issues. Perhaps one of the things that would be most useful is, we spent a great deal of time assessing the competition among connecting carriers particularly in looking at network versus low cost carriers in the US Air Piedmont transaction, and also participated in a merger follow-up study looking at the empirical effects of mergers.

I also, while I was in the private sector, worked on the Delta, Swissair, Sabena, Austrian code share arrangement which is something that went before the Department of Transportation and the Department of Justice. So, I'm very happy to be here.

With that, back to you.

CHAIR: Thank you both very much, and, as I said, to you before, we're very pleased to have you here to present evidence to this Commission. As with the others, I'll ask you to briefly summarise your submissions and the Commission, as is its normal practice, will ask questions, try to give you a fair bit of time to get through your summary, and I'm sure that there will be a fair number of questions at the end. So, please proceed.

PROF WILLIG: Thank you very much. We'd actually enjoy it if you break in, politely as you do, with your questions as they come to your mind, as long as you give us the right to say, oh we'll get to that in a little while, if that's indeed the case.

CHAIR: That's fine.

PROF WILLIG: There are, as you know of course, a number of quantitative models aimed at assessing the impacts of the proposed alliance that are in the record. I think the way the schedule is organised, at least I, Meg, other economists, will have the chance to focus in on those models later on today perhaps after the lunch break depending upon how you choose to schedule affairs.

I wanted to say that, at home the US experience, the European experience, is that we do use quantitative models to assist in the decision-making process over combinations in general and in the airline industry in particular. But I think it's fair to say that the predominant way that competition decisions are made for public policy is not totally confined to the use of quantitative models. That instead a more qualitative approach is adopted which may be thought of as an alternative but I think the two approaches are interactive. I think today this morning we should confine ourselves until we get to the later session to the more qualitative fact based approach to the assessment of a combination for the public interest.

I'm proud to say that I was personally deeply involved in the creation of the merger guidelines back home, and they continue to be the approach that is adopted by the agencies in the US, and increasingly in the European domains as well, as the guide post for how to go through the public interest analysis of a business combination.

If I may take a moment just to summarise the steps; this is the approach that we will be taking in the rest of our submission in this session and the approach that we adopted in our joint report on the consumer benefits and competitive effects.

The starting place for a guidelines analysis is to identify what are the relevant markets that need to be analysed. These are the universes of business activity in which there might be competitive effects of concern and, therefore, the domains in which the analysis ought to proceed.

The second step, having identified the relevant markets, is to identify just who are the participants in those relevant markets. And this turns out to be a very critical step particularly in the airline business as well as others, because according to the guidelines the market participants are not only those who are currently incumbents in the market offering supply, but also potential entrants who, according to the needed analysis, are those who stand ready, able and motivated to offer service, not just some time in the future, but in the event that there were a competition issue; in the event that the proposed combination were to treat consumers badly, raise prices, deteriorate service, then the potential entrant would possibly be motivated then and able to jump into the market and save consumers. So, there's no presumption here, but the guidelines instruct the analyst to look at the issue of who are those participants in the market, including those who are genuine potential entrants.

The standard is to take entry very seriously based on an assessment of the likelihood of entry, particularly if it's needed, to save the consumer; the timeliness of that entry, will it occur in time to save consumers from experiencing harm from some diminution in competition, and also the sufficiency of the entry; is it enough to actually replace what might otherwise be a loss of competition from the business combination? This is a very important core of guidelines analysis.

The next step is efficiencies, and that is an assessment of whether the combination creates benefits for the economy and particularly for the companies in a way that would enable them to serve their consumers better and predictably would actually serve consumers better. I highlight this here because in issues involving airline combinations, particularly alliances, efficiencies have been found to be of exceptionally great importance.

I'd almost say, although if I had a lawyer by my side the lawyer would slap my wrist, but I'd almost say that in the US an airline alliance -- oh, you're not my lawyer; you should see those Justice Department lawyers, they're tough; they've got handcuffs behind their back. There's almost a presumption that an alliance is a good thing for the flying public. And it's almost the case that the burden of proof is on the advocates of intervention because the going in position by the agencies is essentially that they understand that it's very important, efficiencies to be gained for the flying public, for the consumers, from the right kind of airline alliance, the kind that joins two networks and allows greater connectivity on-line by the parties for their consumers, and new consumers who would be attracted to the combined airline or to the alliance as a result.

So, I'm going to pass the mike back to Meg, if I may, because Meg has collected, I think, very powerful evidence on how it is that at least the US Government has reached the presumptive view that alliances are very important for consumers and ought to swing the pendulum away from the assumption that concentration is bad, to the assumption that the right kind of alliance is a really good thing for the public.

CHAIR: Just before you do so, I'd just like to ask you, in the jurisdictions in which you have been involved, was there a requirement to quantify where possible the effects of something such as this? Because, there is that requirement here.

PROF WILLIG: I think it's fair to say that the requirement in the agencies that I've practiced before, and inside, is that the analysis be extraordinarily closely linked to facts, and facts certainly include data and include the kinds of analyses of data that are an economist's stock and trade, that all participants in the process have come to understand and rely upon.

It's also true that the agencies now do, I'd say almost habitually if the data permits, and they don't always, actually run what we call a merger simulation model, which will quantify impacts and quantify impacts on social welfare as the bottom line. And I've certainly been involved, and so has Meg, in those kinds of analyses.

But I would not say -- this is an economist looking at the legal process -- but I would not say that it has become a legal requirement or an institutional requirement that the agencies in the US or in Europe actually come up with a quantitative assessment that specifically is geared to the decision.

CHAIR: I think part of what we've traditionally -- I mean, the courts have required it here, and my own perspective on it is, it at least makes transparent the assumptions that go into that. I think it's a fair point to say that it shouldn't be based -- your quantitative assessment shouldn't be based purely on modelling.

The question I would like to follow-up with is, there must be a range of economic issues that need to be addressed in coming to a view such as we have to come to here, where there is not an a priori answer necessarily whether an effect is going to be positive or negative, or even getting a sense of the magnitude; there must be a range of questions, that you need to at least test the direction of the effect and the magnitude through some type of model.

DR GUERIN-CALVERT: I would say in my experience before the US, including at the US Government and also in Canada and Europe, is that there is a sincere effort, as Bobby indicated, to try as best as possible, particularly to quantify the efficiencies. I've done a great deal in the contexts of bank mergers and hospital mergers, of which there have been a very large number in the US and there is a great deal of pressure on the parties to try to demonstrate where it is that those efficiencies are likely to occur and a great reliance by the agencies, both the Federal Reserve Board, the Department of Justice and the federal trade commission, to rely on academic studies that have examined both possible pricing effects and the factors that affect entry and pricing, as well as particularly on the efficiencies analysis.

So, there is both a case specific, facts specific as you suggest, to get the direction of change and a relative balancing between expected competitive effects and expected efficiencies, but also a reliance on the literature.

PROF WILLIG: You mentioned, Madam Chair, the use of modelling to help focus attention on the key issues, and I absolutely agree with that, as an advocate of trying to do things as logically and carefully as possible.

I'd also like to point out that the linkage between the two approaches also runs in the other direction, and that is -- and we'll have a chance to talk about this if time permits later today at some length -- every modelling exercise involves choices by the modeller, by the designer of the model, about how to structure the model, what assumptions to put into it; assumptions that are not necessarily evident to those who haven't spent 10 or 15 years playing with such things. Typical users of the models don't see under the hood the way economists who have taught and done modelling are well aware.

One of the important things about qualitative analysis is that it helps to teach which features of which models make sense to rely upon for an important decision in a particular context.

CHAIR: I can fully accept that point, yes. Thank you.

DR GUERIN-CALVERT: Let me just briefly state as I go into the slide, we heard you raise some questions earlier in the week about, was there significant empirical evidence on the benefits that have actually accrued from alliances that have occurred in the past. There have been a very large number of alliances that have been reviewed by the US Department of Justice and the US Department of Transportation, many of them international, since around about 1994/1995 many of those received antitrust immunity, some were not approved, and then there have been a relatively few number between continental and America West and Northwest and Alaska Air that were domestic alliances that were approved that did not involve antitrust immunity but were code sharing alliances, and there's quite an extensive academic record looking at that. And as well, there have been a number of decisions by the Department of Justice where they have been relatively forthcoming in their empirical analysis, in their evaluation of the benefits.

But we wanted very briefly -- there was a composite report done in 1999 by the US Department of Transportation that took a retrospective look basically looking at data between 1992 and 1998, essentially of the effect of three alliances which had received immunity; Northwest, KLM, United, Lufthansa and Delta, Sabena Austrian and Swissair, and what they did was very much parallel to the on-line benefits analyses that we will be talking about later.

They first of all looked at whether or not coincidence with the development of these alliances was there or was there not the increase in traffic that one would generally expect? This first graphic shows that indeed over the period, particularly after 1995 and 1996, there was an acceleration in the growth of trans-Atlantic traffic, which is where most of the benefits of these alliances were coming from in terms of volumes of traffic.

More importantly, what they tried to show as well, is an idea of, how many points behind the gateways of the participants, so on the US side it would be behind the Delta, the United and the Northwest hubs that were involved in the alliances, how many hundreds if not thousands of city points were being able to be connected within on the European side the Lufthansa, Swissair, Sabena Austrian and KLM hubs to points beyond. What you see here is that, by the third quarter of 1998 you had a very dramatic increase in the number of points served, the number of city pairs served due to these alliances.

They note as well in their study that what is going on here is, not only do you have a lot of traffic obviously that's local, say between Atlanta and Frankfurt, or between a United hub and Frankfurt, that you also have a great deal of connecting service that is accomplished, and indeed they show that a great deal of the increased traffic flow, the passengers, is coming from people who are coming, say, to Atlanta to go across to Geneva, and then people who are moving from Geneva beyond the gateway, so a connecting service which in this last graph then is shown as increasing quite substantially while the local is increasing some.

There are other academic studies which we cited in our paper, one by Dennis Carlton is an example of one that did a retrospective study looking at the benefits from the Northwest and the continental domestic code shares as I mentioned, and there are other studies that are cited there by Brookner and others that again try to quantify the expected benefits, much of which is from increased on-line provision, the development of new markets, but most particularly the ability to make it economic to serve large numbers of city pairs that would not otherwise be served.

This study notes that in many of these city pairs that are involved, almost 90% of the routes on which one of these carriers is serving, there is less than one passenger per day that is involved in trans-Atlantic traffic; so it's making possible the provision of a lot of connections to a lot of beyond gateways.

CHAIR: Can I just stop you there for a second. I guess when we look at these studies the question that always comes up is relevance to the fact situation that we find ourselves in, and I wonder if these studies, was there any market that was involved in these studies where the market effect only had two players and they were the two forming the alliance? Were any of these alliances that you have reported on similar in that sense?

DR GUERIN-CALVERT: In general my recollection on some is that, in doing the analysis on the particular gateway to gateway traffic, for example in the Delta Sabena Swissair, in general it was the case that in the particular gateway to gateway there were relatively few competitors other than the combining partners, and one of the issues that was analysed was the extent to which there was a significant competitive constraint, either by others entering on to that same city pair who are not there yet, as well as whether or not there were other gateway combinations through which people could go.

CHAIR: Can you give me a sense of what's considered significant? I have a suspicion that what might be considered significant in the US is something quite different than what we might. What was the sort of test that was applied there? How many participants would you consider significant?

DR GUERIN-CALVERT: I'll defer to Bobby as well; in general in looking at how the Department of Justice has analysed competition in airline markets, particularly in evaluating hub markets where two carriers at a hub are combining, or more particularly when one is looking at connecting service, on many of the city pairs in the US the number of actual competitors is usually relatively modest; it's usually only two or three from many connecting services. That was certainly the case in the US Air Piedmont transaction, that there were relatively few incumbents.

CHAIR: Is that pre or post alliance?

DR GUERIN-CALVERT: In that particular case, that was pre merger; for that merger there were relatively few incumbents, and often times what the Department would look to is, could they identify a sufficient potential entrant that would come in and act as a competitive constraint, and usually that could be just one additional competitor.

CHAIR: Can I just ask you to tell me what you think the limits on this sort of analysis are in terms of its application to New Zealand? What are the limitations that you would see there, in terms of what it can tell us and what it can't?

DR GUERIN-CALVERT: I guess in terms of the overall perspective, is my sense of the academic literature and this examination of benefits, is it's very informative about, do these alliances actually translate into increased on-line service benefits from on-line service? Is it something that consumers are responding to and that the suppliers are actually providing? And, is it of an order of magnitude to suggest it's a real benefit; I think that's one of the most important perspectives.

With respect to the competitive effects, a number of these studies do go on to show that there is the experience of fare reductions after the introduction of these alliances; that doesn't necessarily address directly the extent of competition one was evaluating in approving the alliance.

CHAIR: So you don't see any limitations to these studies in any way? There's nothing that you would want to qualify about them?

PROF WILLIG: I think it's most important to say in answer to that good question that I think, and I think Meg agrees, that the kind of analysis applies internationally, it applies in the US, it applies in Europe, it applies in New Zealand, and it should apply in Australia as well. That doesn't mean that the conclusions don't depend upon the local facts; they absolutely do.

It may be the case that a given alliance in Europe is viewed as competitively benign because the conditions of competition are such that, even though the numbers may be small, still entry could be predicted. Whereas, in South America the numbers are small but entry perhaps could not be predicted in South America in case the alliance in South America were to create a competition problem.

I think the framework for analysis has no limitations, but I think it's dangerous to just presume that a fact pattern that is relevant to one continent is also relevant to a different continent. I think the facts have to be examined within their context.

So, following the DOT analysis is a summary that the empirics show the benefits that alliances have had and that the US Government has organised that information to help inform its own policy making going forward, it's time for us to look at the competition analysis.

What we wanted to start by pointing out is that the traditional framework in the US and in Europe is to conduct a route-by-route analysis for the purpose of the competition assessment. The reason for that is pretty simple; essentially the relevant markets tend to be route-by-route, that's what people want to do, they want to go from an origin to a destination and one needs to be concerned about the degree of competition on a route of that kind.

That's why our agency chief, Hewett Pate before Congress recently emphasised case-by-case, market by market, and likewise Mario Monti has put out a similar declaration. That doesn't mean, though, that where lots of different routes do have the same features to them, that it wouldn't be convenient and practical and sensible to treat them all with the same analysis. If the routes are really pretty much the same in terms of the elements that should go into the competition analysis, then it is valid to analyse them together.

Here, though, it seems to me, and from the work that we've done, that it is useful to look at routes in some specific detail so as to see what it is about the routes that make them more or less prone, more or less attractive for potential entry, and also because the number and the nature of the current market participants may very well be different on a route-to-route basis.

And so, for that reason we are proceeding to detail our analysis route-by-route so as to provide you with that perspective from our work.

DR GUERIN-CALVERT: Just very quickly because it's set out in some detail in our report, the methodology that we used is a very standard one which was to focus our analysis, our detailed analysis on the routes on which both of the airlines involved in the alliance offer non-stop, regularly scheduled commercial passenger flights, as well as routes that are served by either carrier through a code share relationship, in particular Qantas with Origin Pacific.

What we did, was took a list of routes provided to us by the parties and we ended up examining in some detail 25 routes that met those criteria. There were 13 routes where in essence there was no overlap. The 25 that we examined included those that are at our report on page 20, the Trans-Tasman routes in table 3, and the domestic New Zealand routes which are on page 32 of our report.

What we did in each one of those is to examine, based again in terms of data that was provided to us, information on the identity of the competitors, their frequencies, their seat capacities, and whatever additional information was available to us.

What we found, for example with respect to actual competitors, is what is shown on the page here, that for Auckland-Sydney there were a number of current competitors in addition to Air New Zealand and to Qantas. In Auckland-Brisbane there were again a number of current competitors, these are Fifth Freedom carriers that are serving in addition to the two alliance partners, and similarly in Auckland-Melbourne there was Emirates in addition to the two.

With respect to domestic New Zealand, for the routes that we focused on which are shown on page 32, there were some of those routes that were served directly by Air New Zealand as well as Qantas; there were others where some of the flights provided for Qantas were done with their code share.

MS BATES QC: I just want to clarify one point and it's going backwards and I'm sorry about this, but it's puzzling me a little bit. The empirical evidence on alliances that you went through in the last section seemed to relate just to international traffic, not domestic.

DR GUERIN-CALVERT: The particular study was focussing just on the on-line benefits and the increase in traffic on international alliances which was the study of that. The paper that I mentioned by Dennis Carlton, which we cited in our paper -- and we can provide a copy to the Commission -- is one of the ones that comes to mind immediately that examined the benefits from the two domestic alliances in the United States.

Some of the international alliances do involve benefits accruing to domestic passengers in the US, and those that are domestic to Europe who are getting the advantage of increased service. So in that sense they do involve domestic, but obviously they are international alliances.

MS BATES QC: So, are you able to, apart from the paper you mentioned, point us in the direction of any empirical evidence on the domestic picture, and to tell us whether it mirrors the experience shown on the international routes?

DR GUERIN-CALVERT: The types of analyses that have been done -- I'm trying to recall for sure, the Brookner paper as to whether it's also looking...

PROF WILLIG: There's Morrison and Winston, Professor Winston can speak to that this afternoon, but he wrote a book -- several actually -- about the impact of airline deregulation in the US domestic airlines market, and he reminded me that one of their findings was that, as a result of deregulation there was a large increase in on-line service, that the airlines had rearranged themselves with the freedoms allowed under deregulation.

That if one measured the change, there's a large change in the direction of more on-line service just the way an alliance would create. And their empirics assigned a value to that movement toward on-line service of approximately $1 billion as I recall. So that was thoroughly within the domestic US environment.

MS BATES QC: So, in the US, just thinking about the -- you would have heard the evidence that Mr Webster from easyJet gave? Did you hear that?

DR GUERIN-CALVERT: I did.

MS BATES QC: You did, and it was really about the patterns evolving in the industry and what customers actually value, and what he appeared to be saying in general terms is that domestically and in short haul, that the connectivity isn't something that customers value, it's the price, price, price, but on long haul it may be different, and I'm just wondering how that pans out in the US.

DR GUERIN-CALVERT: Well, I think one of the things that would be -- it was interesting to listen to his presentation because I think he was particularly focused on the areas in which low cost carriers have been particularly successful in having a price constraining effect on network carriers, and that that certainly is occurring around the world.

One of the studies that is probably most useful is that, in terms of looking at the development of hub and spokes in the US Air Piedmont case is the idea that what the network carriers are still continuing to do is to provide a scale and a scope of service through hubs that really would not be able to be provided if there was not a hub and spoke system, and that's very consistent with what Bobby was mentioning in terms of the -- Cliff Winston's study in terms of examining that, as one went from point-to-point.

I think where I would respectfully disagree a little bit with Mr Webster's conclusion is, he seems to be suggesting that the outcome would be that there was never going to be, or there was no longer any demand for connectivity, or for hub and spoke types of carriers to exist. I think how I would interpret that is, I think those hub and spoke carriers have to be as efficient as possible and deliver their product at a low enough cost if they're going to be able to compete effectively with the low cost carriers.

MS BATES QC: I think what I heard him saying, and I might be wrong, that the short haul was very different from the long haul, and that what you're talking about is still valued and will continue to prosper on the long haul but not on the short haul. That's just what I thought he said.

PROF WILLIG: It wouldn't surprise me. One way to get a hold of that difference, I think with data, which is something we've tried to do, is to discern the difference between what we call local traffic and inter-line traffic; this is in a world without a more extensive alliance.

So local traffic is traffic that's just origin to destination, without having to change planes or without having to pass through an intermediate stop. And just sensibly enough when it comes to local traffic, there's not a big benefit to having that route flown by a carrier who was part of an alliance, because the passenger just wants to get from here to there. It may make a difference for frequent flyer miles or for branding or reputation, but the convenience of the trip is not a function of the connectivity of the carrier.

There's some routes on which there's a great deal of local traffic, and on those routes, whether or not there's an alliance will not matter all that much to the passengers, but on routes where passengers are otherwise taking inter-line service, where they're making an intermediate stop and having to change carriers absent the alliance, that's the kind of routing where the alliance is apt to be of particularly great benefit to the consumer.

MS BATES QC: I can see that. I suppose what I'm thinking of is, what we're dealing with here is, it seems to be an airline, Air New Zealand, that's really struggling on the international long haul stuff. It said to us it's been unprofitable until this year, I think they might make a 1 or 2% profit on it, so that they're really much more successful on the short haul than they are on the long haul. So, how will the alliance benefit what we are grappling with, and looking at the short haul and looking at the long haul?

PROF WILLIG: One of the things that we'll get to today, before or after lunch is, we've tried to quantify the benefits from the alliance in respect of greater connectivity, more on-line service. And we've been very careful to distinguish the impact on flyers who are local versus flyers who are today absent the alliance inter-lining between Qantas and Air New Zealand, and we've actually taken the latter group as the universe for the assessment of those benefits of connectivity.

MS BATES QC: Sorry, the latter group being?

PROF WILLIG: The group that are today without the alliance inter-lining between Qantas and Air New Zealand or vice versa.

MS BATES QC: Would that be mainly people outside New Zealand then?

PROF WILLIG: No, we've actually tried to understand the New Zealand perspective on those numbers.

MS BATES QC: But would it actually benefit those travelling into -- the in-bound rather than the --

PROF WILLIG: Well, it might very well have some -- sorry, if folks start out in Australia and come here and with the alliance that will be an easier more convenient flight for them, that would be additional benefits. But we've tried to separate the benefit to New Zealand passengers as opposed to Australian passengers. Of course there might be a tourism benefit to be more attractive to Australians to come and visit but that's beyond what we've tried to study.

MS BATES QC: I'm sort of thinking of the impact on consumers in New Zealand, but we'll leave it for now.

DR GUERIN-CALVERT: I think too, in terms of looking at -- Air New Zealand's domestic network does not exist in isolation of its long haul. A number of the passengers that are flying on the domestic network are those that have come in on long haul.

The other part is, again looking forward on a going forward basis is to what extent, as Bobby indicated, might one see some substantial efficiencies and reduced costs and improvement on the scale and the scope of network and the services that are offered, even within domestic New Zealand because of the alliance, that would have direct and immediate benefits and allow ways to cut costs, to continue to have profitability.

Then I think it's also important to look at what the competitive constraints would be there.

MS BATES QC: Thank you.

DR GUERIN-CALVERT: Basically, in terms of looking at the specific routes, what we've tried to do is again to focus on those routes that perhaps need a little bit less competitive analysis so that we could turn more immediately to address your concerns with respect to the routes that you really do want to have us address, incumbents versus likelihood of entry.

In general what we have found looking at the Trans-Tasman routes, is that there are -- some of those where there are significant Fifth Freedom carriers as the Australian Commission has found, is that those carriers have provided strong competition, they are a significant determinate and our view is that, were there to be an attempted price increase, one could certainly switch to one of those Fifth Freedom carriers, particularly on the three Trans-Tasman routes that I refer to where there's a significant incumbent presence.

Then, as well in the provincial routes, there are a number there where there's already significant competition between Air New Zealand and Origin Pacific, and that would then -- let us turn to, I think the most important step is, once we've looked at the incumbent carriers and identified those, to turn to potential competition.

PROF WILLIG: Right, and that's where particularly Origin Pacific is on its own not offering a code sharing service for Qantas, just to finish that off.

So now we've gone through the guideline step of identifying the markets, identifying possible markets which require further analysis, we've identified the incumbents who are presently providing service, and so the next step is to see if the group of market participants ought to be enlarged to pick up those who are not today offering service, but who predictably would begin to offer service, and that's the object of the analysis, not only automatically as time goes on, but in particular would be predictably offering service in the event that there were a competition problem; in the event the alliance forms and for some reason some business reason attempted to raise prices or to deteriorate service; question, is there somebody or some firms who would have the incentive, the ability, with likelihood timeliness and sufficiency to come into the market and make up the difference and rescue the consumers from that attempt to exercise market power?

I would say that, not only is that important in our view, to save the consumer once some harm has begun, but there's also the view that if entry is that potential, if it's so much on the threshold, then that would be able to deter any existing market players from trying to exercise market power. That it wouldn't be profitable to treat consumers badly if the carrier anticipated that the result of that would be loss of market share to a new firm coming in, de novo or a firm that's already there in the region or on that route expanding so as to eliminate the size of the market share of the incumbent.

So, potential entry acts as a rescue but also as a deterrence to the attempt to exercise market power in the first place if it's the case that the analysis shows that that potential entrant would find itself able and motivated to provide that rescue to the consumer.

So, with that said, we have done analyses that you will have the opportunity to hear, if time permits, asking ourselves well, what about Fifth Freedom carriers on routes into Auckland, do they have the capability of expanding and enter into new routes? What about Virgin Blue with respect to all the Trans-Tasman routes and the main routes in New Zealand? And what about Origin Pacific when it comes to coverage of the domestic route network in New Zealand itself?

CHAIR: Just before you go on; in the first bullet point you note that it's not always been accepted that a carrier should necessarily count if they're providing a one city and a city pair route service. I just want to find out from you under what circumstances has it not been accepted?

PROF WILLIG: I said the primary barrier that analyses have uncovered have to do with airport openness. Does the airport have the facilities, does it have the gates, and I think most confiningly in some markets are the slots available. For the carrier who is located at one airport to extend its network into another airport to provide the origin destination service.

The fact that the airline is there with a presence at one end of the route means that it has overcome a lot of what in other circumstances might be entry barriers. It's there, it's relatively a small commitment of additional cost to extend its network into an adjacent airport in the network of flights. The reputation is there, the business is there, the feed, if the feed is important on that route, is there, the facilities, the know-how are all there; most of what one usually fears as a competition analyst in the way of barriers have been overcome already by a carrier that's there at an airport, which is why these are typically the most likely potential entrants.

It's not the case that, oh we would just hope that some new airline would appear, grassroots-- I mean, that happens in this business, but it's a little bit more scary to have to rely on that sort of entrant than an airline that already has a presence on one end of the route. What could stop that airline from expanding its network? Well, what if it can't get into the adjacent airport on the network? So the number one barrier to assess would be the availability of what's necessary in the way of facilities and rights at the adjacent airport in the network.

CHAIR: Are there any other others that you're aware of?

PROF WILLIG: Well, I think all of the barriers that appeared in your own papers that we speak to later on in the presentation, are barriers that can be barriers under some circumstances, and they're ones that we have tried to go through and analyse in respect to the facts before us here.

CHAIR: Can I just ask you about the Fifth Freedom carriers on the routes into Auckland. If we were to -- and this is purely a hypothetical -- if we were to observe that, in periods where prices have gone up and the Fifth Freedom carriers haven't moved to increased capacity on that route because possibly their capacity is really driven, not by the demand characteristics on that route but on some other route, would you still take the view that you have expressed in this paper?

PROF WILLIG: I think it's certainly a good idea to look very closely at what are the conditions of a Fifth Freedom carrier's facilities and are the planes there and do they have enough of a time slot available to them back for their international long haul to add on another segment. This is all highly relevant I believe. I would be cautious about applying history to the predictions of the future because it could be that some of those conditions were different then than they are today.

CHAIR: I understand that, but let's just say the conditions aren't different, and the Fifth Freedom carriers put capacity on because the economics are driven by the routes that connect, not the Trans-Tasman. If I put it to you that way, would you still come to the same conclusion that they should be counted as a potential competitor.

PROF WILLIG: I think I would reach the same conclusion that they should be considered as possible potential entrants and more likely ones.

CHAIR: Would you consider that they would exercise the sufficient constraint?

PROF WILLIG: We'll take this one at a time and we'll look at them, say, can this carrier do it, does it make sense given the other things that it's doing. The fact that it didn't do it three years ago doesn't necessarily mean, unless issues are exactly the same for it, that it wouldn't do it today.

CHAIR: I understand that, but that wasn't my question.

PROF WILLIG: I know, I'm trying to answer the question truthfully, which is to say, you've got to dig into the facts to look at it and we're not saying across the board, oh that is the saving grace; this is part of the picture that needs to be analysed.

CHAIR: Okay, let's carry on then.

DR GUERIN-CALVERT: If I could add two other quick things. One is probably the most significant constraint that the Fifth Freedom carriers exercise is given that they have gotten the plane to New Zealand or to Australia, they are there serving the connecting passengers with additional excess capacity, and have an incentive as incumbents to operate as a constraining advice. So, for whatever reasons that they added a flight or two flights from some places long haul, once they're there they essentially obviously want to deploy as much -- sell as many seats as possible.

I think I would agree with Bobby, that I think it is involved in terms of looking at the individual incentives, whether they now have enough idle time of the planes and that there's enough perceived demand to -- and enough pricing and profitability to add another segment on, would be the analysis that I would say, and that again could be very different now than at a period when prices increased before.

CHAIR: I understand that, but with respect I don't think that was my question. We can come back to it if we need to, so please proceed.

DR GUERIN-CALVERT: In terms of the second part of the analysis with respect to Virgin Blue; again, our sense of listening to the questions and the concerns that have been raised is that you have actively sought information, data, that would provide you confidence that the kind of experience that one has seen elsewhere by a Virgin Blue is indicative of the fact that they would be credible, significant and using Bobby's phrasing, timely and likely competitors both on the Trans-Tasman and on the domestic New Zealand routes.

Very briefly what we looked at first is statements that they have made as to their incentive to engage in that action, and just would like briefly to say that the statements that are there in the record is that they have stated that they have the incentive to enter those routes and are essentially planning on doing that, and that as a general rule the kinds of cities that are available for consideration are similar to those that have encouraged their entry before.

But let's try to test it out. What else do we see that they may enter into a timely fashion and then how do the facts assist? Again here just very briefly, they say that they have taken steps and they think they can do it relatively quickly. We'd like to compare that to their experience in Australia.

Do they have sufficient aircraft to be even thinking about an expansion, and there we know what's already on the record, that they are going to be receiving 10 new 737s and have an option on 40 more.

Then what we would particularly like to focus on, because we think it provides a good empirical basis for thinking about it, is that they have had the experience as an existing carrier of the ability to enter new markets in rapid succession, competing with Qantas on their routes.

What the next chart shows, and I apologise for the little bit of confusion of the data here. What we tried to do is combine two things in one chart. What this shows is, starting with the third quarter of 2000 going all the way up through the second quarter of 2003 what has Virgin Blue's track record looked like with respect to their entry in Australia?

What we see is that there's some variation in the number of passengers -- these are all incremental -- so for example the first observation in the third quarter of 2000 shows you that a very large number of passengers per day were added on at their initial entry, and that's not surprising given that their initial entry were in some relatively large cities.

There was then smaller numbers of passengers added, another big peak added in the third quarter of 2001, and what the bars show you is that they enter a number of city pairs at a time. Two in the third quarter of 2000, one -- additional one in the fourth quarter and then in rapid succession, two more in the first quarter of 2001, two more in the second quarter and so on, with a very large number of new routes added in the fourth quarter of 2001.

I think it's helpful to try to kind of put it in perspective; I deal somewhat better sometimes in graphs, but often times find maps a whole lot easier. Their first routes do what a lot of low cost carriers have done around the world, which is basically to start and hook together a relatively small number of very large cities; in this case Brisbane, Sydney, Melbourne and Adelaide all connected in through Brisbane, attracting a very large number of passengers, modest number of routes, a modest number of aircraft involved.

In 2001, these are the new routes that were added in, and very similar to what Mr Webster was talking about, easyJet's experience, the incremental routes in 2001 again build on Brisbane, go up to Darwin, to Cairns, to Townsville, down to the south, add on additional ones from Melbourne, and additional ones from Adelaide over to Perth.

Then in 2002 you have again augmenting, at this point, you're moving into somewhat smaller cities, but at the same time connecting some larger cities. So you add on Perth to Brisbane but you also add on Brisbane to Rockhampton, so a very small route and a much larger route but a much longer distance route.

Then for, of course, the truly -- I thought I was getting to the truly messy one, but in 2003 much longer haul routes. Again, this time from some of the larger cities to some smaller cities, much more remote, much more long distance.

I would note that what you can see here is a combination of what Virgin Blue has stated on the record, is that there are two things going on; one is the density of population at each end point and the attractiveness of the market; the other thing is the distance of the market. That again, some of these are much longer haul routes, many of them 2200, 2800 kilometres long; others are much shorter routes.

Then what you can see as a result is, this is the combined route map that Virgin Blue has in Australia.

CHAIR: Can I just ask you a question there, if I may. How do you think -- I know on slide 21 you say that the pattern of expansion suggests that Virgin Blue would likely enter the major New Zealand trunk routes after it entered the Trans-Tasman, and I understand the point that's being made.

But the question I'd like to ask you is, how do you think Virgin would weigh up further extending its Australian routes, as opposed to entering the domestic routes within New Zealand? And, what are the opportunity costs or benefits of them from taking one strategy to develop the Australian market faster, or now move more aggressively in the New Zealand market?

DR GUERIN-CALVERT: I tried, hearing you ask a somewhat similar question before in the hearing, I tried to marshall whatever evidence we could have from the data that was available to respond. I think one of the best ways to do it so to kind of think about two things. One is, in terms of thinking about them doing further expansion. They're already at the end points to go across Tasman; in other words, they're at Sydney, they're in the Brisbane, they're in the Melbourne, they're at a number of the major cities.

So one set of questions is, how similar is a hop from say Melbourne to Christchurch or Melbourne to Wellington or Sydney to Auckland and so on as compared to some of the pattern of entry they have, and then again to proceed from there into further into the trunk routes into domestic New Zealand, versus, what's the opportunity cost exactly as you've said.

What I tried doing was, looking back into the data, the schedules that have been provided to us by Qantas of all of the routes that they serve in Australia that are not currently served by Virgin Blue. There are relatively few that are of any significant consequence in size that are not served.

So, in terms of thinking about the possible combinations, many of them are ones that are served with relatively modest number of frequencies per week by Qantas. There are a number that are relatively small combinations of more remote airports that would seem to be less likely to be preferable candidates, and I would be happy to try to finalise that list, but there are some examples of the one that would seem to be kind of smaller is Gladstone to Rockhampton, Alice Springs to Broome, Adelaide to Kalgoorlie. I mean, obviously what they could do rather than entering new routes, they could go deeper into the routes.

The second way I tried to get a handle for you is, if they were to go deeper, they would be making the choice, for example, to have another flight out of Brisbane perhaps to add more into Adelaide; increased frequencies into Adelaide, it's a city that they serve, has a population of about 1 million, it's about 1,600 kilometres away in distance.

Basically you have about the same population combination in terms of Auckland to Brisbane. It is about 1 million in population, it's a little bit longer distance, it's 2200 kilometres, but again if the choice is seen between additional frequency in Adelaide as opposed to a frequency into Auckland, it would seem entering a new market picking up all that service would be worthwhile. Similarly as compared to Sydney to Adelaide, Melbourne to Adelaide, looking at Auckland for both of those, again about the same population would seem to be about the most attractive option, or at least some data to be thinking about.

I also tried doing a combination of not only size of population at the end point, but distance, knowing that distance matters. A good example there would be, currently Virgin Blue serves Adelaide Perth, it's a route that they entered into January 02. Adelaide, as I mentioned, has about 1 million population, Perth has about 1.4 million, the distance is about 2,000 kilometres. Two routes that are fairly similar are Christchurch-Sydney, and Wellington-Sydney; again, about the same distance, and fairly similar population on the Christchurch -- Christchurch excuse me is much smaller, but Wellington about the same size.

So again, I don't know exactly what's sitting in their mind. Perhaps -- I know that there are some confidential submissions that might let you test the hypothesis as to whether some of the routes, the trunk routes and the domestic New Zealand routes as well as the Trans-Tasman are ones that they would feel would provide sufficient traffic and sufficient attractiveness, but my sense is that the pattern is very similar to what they have done here, which is largely to go as much as possible early on dense to dense, albeit longer distance, and then adding on somewhat of the smaller routes, would be consistent with a good next step now, would be to go Trans-Tasman and then trunk routes.

CHAIR: I'd like to pursue this a little bit further. Having listened to the gentleman from easyJet, he talked a lot about relative cost structures as a very important determinate in where a low cost carrier might enter, and we've heard a fair amount of evidence that suggests that the cost structures in New Zealand, particularly with Air New Zealand, are lower and some of the changes that Air New Zealand has put in place has been an attempt to basically close the gap there, to lower the incentive for entry.

This has not happened in Australia. How would a -- how do you think Virgin Blue might weigh up the relative cost structures in terms of where there's potentially the most -- where they might have the greatest competitive advantage? How important is it to them in terms of what strategy they take in terms of which routes they develop first?

PROF WILLIG: One economist's answer -- I don't mean it to sound quite as mechanical as it may sound -- but for me the bottom line is not so much trying, with a feeling of great accuracy, to predict where precisely a given entrant will actually choose to enter should the alliance form and should the alliance price in an aggressive way that meets consumers' needs for low prices and good service. If the alliance were to offer low cost service at low prices, with an attractive package for the consumer, as a competition analyst I wouldn't be concerned if I thought that in that scenario an entrant like Virgin Blue would not choose to enter those routes.

CHAIR: I understand that, but we didn't hear evidence that suggested that the gap had been closed completely. We heard evidence that it had been closed at most 40 to 50%.

PROF WILLIG: You mean, the cost gap?

CHAIR: The capped cost gap, so there's still some advantage to be had by consumers by another player. However, there is a bigger advantage to Virgin Blue to expand their routes if they are still there to take advantage of in Australia.

And I would suggest to you that the evidence suggests that that's been precisely their strategy, that for some reason the benefits were greater from further and further expansion in Australia before they've even considered contemplating crossing the Tasman. So, it doesn't seem to me the case that the potential threat of entry has been enough to close the gap completely, there's still a difference there.

So -- and the other thing; I suspect you might want to look in Australia, how Virgin Blue has fared in different markets, and why is it they have had trouble in particular markets? What's happened in some of the markets where they have not fared so well? Markets even where dare I say they may have had to exit, and I think we have to be very careful to assume that the pattern of expansion that occurred in Australia is necessarily going to happen here, and will take priority over further expansion in Australia.

DR GUERIN-CALVERT: I think part of it is, looking at having had the experience particularly of studying Southwest in some detail and their pattern of expansion, it really is not dissimilar to Virgin Blue's experience. We did try looking at a route-by-route basis, a tracking over time the amount of capacity that Virgin Blue had when they started in a route, what they had acquired later and what they have based on the most recent data, and some of it does suggest that in some markets they entered with a little bit more frequency then consolidated and now have a little bit less frequency.

And I think as the experience of airlines worldwide, every now and then someone goes into a market, discovers it doesn't turn out to fit in quite as well, or there are better aircraft deployed some place else so they choose to redeploy it to a more efficient place but may have the option to go back in at relatively low cost.

I think in terms of the question that you raise, one of the things that struck me in studying this is that is the rapidity with which this expansion has occurred and the size of the operations that Virgin Blue has now, and again looking at Southwest's experience, I would suggest that what I see Virgin Blue doing is kind of consolidating their brand and their name and their reputation in their home turf, really understanding it well, which is important to be able to be able to expand into other areas.

And so, I think it does go into looking at now what does the evidence suggest as to the likelihood that they are well positioned, have sufficient capacity, have the motivation and that these markets are once that are attractive for entry, and as Bobby suggested, once that one could confirm that there are no significant impediments that keep a carrier from expanding.

CHAIR: Can I just ask one follow-up question, and I don't want to get into a debate about somebody else's regulatory problems, because it's certainly not ours what's happened in Australia. But there's at least been allegations in Australia of strategic behaviour by the major airlines to Virgin Blue, and there are allegations that in some places it's been successful, that there's been significant increases in capacity and they have forced Virgin Blue either into a very small place in the market or actually forced them to exit.

And, what I really want to ask you is, do you accept that those sorts of concerns are ever relevant and, if so, in what circumstances should this Commission be concerned about that sort of behaviour by very large participants who have a great deal of market power?

PROF WILLIG: I think actual predation is always a proper source of concern for competition agencies. I'm not that kind of economist, and I think Meg is not also who would say predation cannot happen, it should never be anything that any agency should look at. I think there have been episodes of economic history of real predation and something the authorities ought to be ready to investigate.

With that said, I think there are times in airlines markets where it makes ordinary business sense for the incumbent of a low cost carrier entry to expand its capacity. Fares will go down, traffic will go up, and it's an appropriate time for ordinary business reasons for the incumbent, under some circumstances, to expand.

And so, capacity expansion in itself to me doesn't spell predation. What spells predation is capacity expansion whose principal motivation is to knockout an entrant so that after the entrant is knocked out, then prices can go back up, capacity can be constrained again, and market power exercised.

The other case is where capacity expands, perhaps the entrant can't make a go of it on that route under those competitive circumstances, but where the consumer continues to receive the benefit of the active competition for a while and the continued threat of the continuation of that competition even after the entrant were to contract and maybe even pull back that route away from its network, but stay at one of the end point airports and, therefore, ready to make a foray out again should market conditions change.

So I think just the ability of the incumbent just to expand capacity is not a red flag, it's not necessarily a matter of concern; the question is, would the entrant be driven far out of the market so it couldn't come back if consumers needed it? And I think what Meg has been saying in a way is that Virgin is clearly poised at the edge of the New Zealand market, poised at the edge of the Trans-Tasman routes, and then New Zealand trunk routes as well, and should conditions warrant -- and I think according to the public statements of Virgin -- it thinks conditions do warrant, it's ready to come and is ready to expand responsively and do its job of keeping prices competitive.

MS BATES QC: Just following up on Commissioner Rebstock's line of questioning, because I've been thinking about this too, is that we heard from both Qantas and Air New Zealand that, if Virgin came in with I think it's 15 to 20% lower fares than the express fares, both of them said they'd have no option other than to close the gap.

PROF WILLIG: Sorry, other than to close?

MS BATES QC: Close the gap; that they would offer the same.

PROF WILLIG: Oh, that Express would come down?

MS BATES QC: That they would offer the same fares as Virgin; that's what they said. So, given that piece of information then, I'm wondering how attractive the prospect is for Virgin.

From what Mr Webster and others have said, it seems that staying power is pretty critical to the VBA coming into a new market, especially in the first period. I'd just like to read you something from the ACCC's Draft Determination and ask you to respond to it, and that's this:

"The Commission does have concern, however, with the potential impact of the combined resources of Air New Zealand and Qantas under the proposed arrangements. Under the proposed arrangements the alliance partners can strategically allocate their resources in such a way as to maximise the competitive pressure on Virgin Blue at the critical early stage of entry while at the same time minimising the financial risk associated to either partner, especially the risk to Air New Zealand whose capacity to absorb losses on the Trans-Tasman route is certainly lower than that of Qantas."

PROF WILLIG: So, this was about the current phase, I take it?

MS BATES QC: Yes, this was the ACCC's Draft Determination. I'm just putting to you where they got to and asking you to respond. Do you think there's some merit in their view, or do you think that they're wrong?

PROF WILLIG: I wouldn't be so bold as to try to entirely gainsay the ACCC in anything, but that certainly wasn't the kind of interim conclusion that we've reached; not being in your seats with the responsibility that you face, but being analysts looking at the pattern of available evidence.

Virgin is not a new player, Virgin is really quite well-established in the region. Virgin is certainly well-backed financially, they have programmed they have a "war chest" of funds, they have committed themselves to taking delivery of 10 new aircraft; they're not folks who can, according to the evidence available to us, kind of lightly be blown away from a competitive episode.

MS BATES QC: No, I don't think they are people who would be likely blown away, but if you're looking at what

Commissioner Rebstock was talking about and looking at what's the most profitable things for them to do; well, if they're going to have to spend a whole lot of money in fighting off the competitors on Trans-Tasman and Air New Zealand domestic, why would they do that if they can have an easy go at it by expanding their Australian market?

DR GUERIN-CALVERT: I think one of things again looking at the comparison is that -- my understanding from looking at the information is that, what they would be going into the Trans-Tasman with is a significantly lower cost structure. And so, going in, you know, again as Mr Webster indicated, with the kinds of fares that they can achieve profitability with relative to a lower cost structure, is can they by having a certain number of frequencies actually get a rate of return on that that justifies that investment, and that is that over a larger revenue base than say adding on another flight from Perth to Adelaide?

My sense of looking at the traffic numbers is that, by going in with a low cost, low fare option into Auckland-Sydney, or Auckland-Brisbane, even if it were to ultimately be close to being matched by Freedom Air -- excuse me, by Air New Zealand or Qantas, would nonetheless seem to be a profitable opportunity for them. It's not a loss operation.

MS BATES QC: So that's taking into account what they might have to spend and what ACCC calls the initial critical period of vigorous competition?

DR GUERIN-CALVERT: I think in terms of the expenditure, you know, we've tried to think about what would their incremental cost be. It's the deployment of the aircraft, it's obviously some additional advertising and marketing; low cost carriers typically do more over the internet and through direct distribution. And so, there certainly are the incremental costs associated with the expansion, but then they have very efficient aircraft that they would be flying in a relatively low cost structure. So, I can't think of whatever -- I know that there would be some resources involved in setting up at the other airports.

PROF WILLIG: Right, which brings us back to the facilities, but I would also add on the thought of looking at the sunk costs; this is what we usually look at in thinking about the kinds of barriers to entry that would dissuade a carrier from taking the shot at it, even though it might be concerned that its entry would be met by a lowered price by the incumbent.

What is it that Virgin would anticipate having lost in the way of dedicated entry costs from trying out the Trans-Tasman and on into the trunk routes? I think Meg has said very well, the conclusion that because they are so well poised on the edge of the New Zealand market, on the edge of the Trans-Tasman market, there's very little in the way of substantial sunk costs that they would need to put at risk in eliciting what is, whatever would be the response of the incumbents across the Tasman and in the trunk routes in New Zealand.

MS BATES QC: I understand that, I admit. One final question is, how important do you assess the demise of Ansett as has been to the success of Virgin Blue in establishing itself in the Australian market?

DR GUERIN-CALVERT: In looking at the record of expansion by Virgin Blue, I think certainly in terms of, as a brand new de novo carrier getting set up, the demise of Ansett may have facilitated that. In terms of their expansion since, they have done quite a bit of expansion, a lot of addition of capacity since Ansett was gone, but I think it would be more relevant to the, did it make it easier for them to set up in the first place as opposed to, is it relevant now for their ability to expand further into additional routes. I see them expanding longer distance routes and now even though Ansett's been gone for a while.

MS BATES QC: So you basically see the position as, Ansett's been able to enable them to some extent to establish and --

DR GUERIN-CALVERT: Get started.

MS BATES QC: And get started in that you don't see this as a getting started situation, do you?

PROF WILLIG: Exactly right. Meg, would it be fair to summarise your route-by-route and city analysis to say something very overarching and correct me if I oversimplify.

But, I think part of the answer to your question is that the trunk routes in New Zealand on their face by ordinary measures is very attractive routes compared to the ones that are left in Australia for Virgin. We have a chart showing the count of seats flown; this is page 27. These are the routes on which Virgin entered in the years 2000 on to 2003, and it's interesting but expected that in fact the desirability of the routes diminished over time to any carrier, because they're less and less thick routes in terms of available traffic. So evidently Virgin over-simplifying in terms of distance and the connectivity of their network, but they started with thicker routes and worked their way on down as one would expect because there's more traffic to be gained the thicker the route.

The trunk routes in New Zealand which don't appear on this chart are up near the desirability of the average rout entered into in 2001. These are attractive routes compared to the ones that Virgin actually got around to entering in Australia in the later years of its evolution.

DR GUERIN-CALVERT: As I'd shown on the map there's some exceptions; every now and then there's one thicker rout that only becomes possible as they made an expansion into it, but most of those were the ones, as Bobby says, that went in in 2000 and 2001.

PROF WILLIG: What I know you've done is added to your understanding, not just the thickness of the rout in terms of seats flown but also in terms of connectivity of the existing network of Virgin and also in terms of the distance that they would have to be flying, so all of that just confirms the simpler picture that we've just alluded to.

CHAIR: Interests of time I'll ask you to quickly move to key findings and conclusions so that we can get some further questions in from our staff and advisors. So, if you could take us through now please to your major findings.

PROF WILLIG: Can we spend a little time -- well maybe this is not in the ambit of what you're speaking to, but the efficiency?

CHAIR: Yes, please. Cover your key submissions, but try to do it in a summary way, if you can. I just got nervous when you were going backwards in the presentation.

PROF WILLIG: Just following you. Just kidding.

So, instead of summing up this part alone, let's fly through the benefits section. Or do you want us to sum up on the detriments of, or the lack of detriments?

CHAIR: Yes, that's what I was meaning.

PROF WILLIG: Leaving the benefits aside? Okay, and we'll get to that later.

So I think the bottom line is that, yes, the analytical approach that we're familiar with from our practice in Government and private practice before the US and European agencies, is that it is plain that the proposed alliance would in fact cause an increase in concentration among existing incumbents, those who are presently carrying passengers on a number of routes in the region.

It's also true that the way the competition authorities do their analysis is not to confine themselves in analysing concentration just to those presently involved in supply, but also to include in the relevant market participants who are predicted entrants in the event that there would be a competition problem posed by the combination. And, the standard analysis takes that into account.

Our analysis here suggests that Virgin in particular, and to some extent the Fifth Freedom carriers in their own domain serve as very important sources of that kind of market participation. We think that Virgin stands as a likely and sufficient and timely entrant to contain most of what we have understood to be the competition concerns from you folks and from your counterparts in Australia as well.

We've gone through the list of the barriers to entry that have been identified by you sitting as a Commission, and it's our analysis that those barriers are not significant enough to deter potential competitors from successfully acting as the protectors of competition with the alliance going forward.

We would add to that that we think that there's very substantial benefits from the alliance and we'd like to speak to that analysis whenever you think it's appropriate.

CHAIR: I didn't mean to push you right to the conclusion, that was not my intention, but I think we do need to cover off that section and I'm happy for you to do that now.

Just before we go on though, can I just check if there are further questions at this stage?

MR CURTIN: Just one in passing. Obviously you're aware of the work that Dr Morrison and Winston did on the impact of Virgin. You've mentioned it, do I take it that you agree or disagree? What comments would you have on their modelling?

PROF WILLIG: We understand their finding that prices were driven lower in Australia on the routes where Virgin Blue actually has operated. I think it's fair to say we haven't gotten into the nuts and bolts of the econometrics that they used, although my personal experience with the authors is that they are reliable econometricians but we haven't taken within our ambit to either take apart their work or endorse it or contradict it. It's a plausible conclusion to be sure, but it's not one that we have an independent view on as experts.

MR CURTIN: That's fine, thank you.

PROF GILLEN: I have a couple of questions. Is it fair to say that most of the alliances that have been analysed are end-to-end alliances as opposed to parallel alliances, and also the environment in which the alliance ultimately is formed is one in which there are competing alliances? I'm thinking particularly the North Atlantic right now.

PROF WILLIG: It's certainly true that among the various alliances that have been analysed in our experience by the competition agencies, have been separated by the analysts into their end-to-end properties and their overlap properties. It's understood that it's the end-to-end properties of alliances as they are proposed to form that create most of the benefits, and it's also the case that where there are overlaps, that's where the concerns arise that are subject to the kinds of analysis that we've been describing.

DR GUERIN-CALVERT: If I could add too, I think that the ones that have received the most close and careful analysis are the ones in which they have involved, particularly on the local gateway to gateway traffic but as well beyond and behind gateway traffic where it was perceived that the alliance partners were directly overlapping and there were some substantive questions as to whether or not there was sufficient competing alliances for particular kinds of traffic flows.

For example, even though there is a gateway in New York that goes across to Frankfurt there has been some concern that for a number of consumers in the southeast, from Savannah or New Orleans or whatever, that that may not be quite so practical of an alternative, whereas for somebody coming from San Francisco, they may be perfectly indifferent as to which gateway they flew over.

And so in those cases there has been careful scrutiny as to the extent to which there could be expansion even on the given gateway by other carriers or by a nearby gateway; so the entry analysis does get looked at.

Certainly in domestic airline mergers the issue of alternative competitors on overlapping network analysis has focused a great deal on whether or not there is indeed entry that's likely.

PROF GILLEN: Thank you. A second question is, is it fair to say that the majority, if not all of the benefits that come from alliances in the analysis has been demand side benefits as opposed to cost efficiencies?

PROF WILLIG: The ones that we've focussed on here, and the presentation hopefully to come, was confined to the demand side benefits. We just didn't take on the cost side issues at all.

DR GUERIN-CALVERT: I think, though, that a lot of what has been presented at times is in terms of looking at the cost savings that can occur by particularly deploying larger aircraft is, you know, it's responsive to a demand side, but it may be a very significant supply side savings, or being able to serve frequencies with more efficient use of aircraft by running one back and forth a little bit more so as opposed to having to serve a number of different points with the same aircraft.

PROF GILLEN: I understand. One of the concerns that I have is, if you look at alliance relationships, they tend to be pretty amorphous and there are all sorts of partners changing all the time and so in some senses the value is really on the demand side because as you get into the costs deficiencies that requires a fairly substantial commitment, and unless you can assure that that commitment is going to be ongoing, you could end up investing a lot of resources and not recouping the investment that you make, whereas in code sharing or other kinds of marketing agreements within an alliance, these are, and I stress, relatively easy to get in and out of.

PROF WILLIG: I think you raised an important distinction, because we use the word "alliance" all too all encompassingly when we're speaking too casually. There's alliances and there's alliances.

One important distinction that we forgot to mention is alliances, where there's anti-trust immunity amongst the partners versus a code share where they're not expected to co-ordinate in ways that would otherwise be offensive to competition codes. Of course here we understand we're talking about a much more entangling alliance than a mere code share. Our understanding is that this is an alliance where the parties are expected to co-ordinate in their operations that are touching New Zealand and where there's the equity arrangement as well helping to bind this into what we would take to be a more complete kind of alliance than some of the more ephemeral ones that you are alluding to.

DR GUERIN-CALVERT: And I think the Department of Transportation in the study we mentioned and referenced in our slide, that it was particularly trying to look at that. There was a period of time for some of these alliances where they operated as Bobby has indicated with that looser affiliation and then subsequently received in some cases a few years later antitrust immunity, and you saw a much more significant increase in the benefits that were actually accomplished once they could co-ordinate more effectively and integrate their operations much more significantly under antitrust immunity as opposed to having the looser affiliation, and the empirical evidence and the academic literature suggests the same, that there are benefits from code sharing but more significant ones to the extent you can act in essence a little bit more like a single operation.

PROF GILLEN: I understand. Also, could you comment on the following: Would it be fair to say that the ability of Virgin Blue to expand in the Australian market was certainly facilitated by Ansett both directly in a sense that it failed and provided lots of market for it to enter, but also it assisted it because there was all this market that had to be taken up by Qantas, and so in some sense Qantas' capacity was used to meet that demand that had been vacated by Ansett in part, and so it was in a sense preoccupied, and so Virgin was able to establish itself in the market, so very much in the same way that Southwest is a big player and other airlines respond to it differently than other low cost carriers, then Virgin Blue is in that position as well?

DR GUERIN-CALVERT: I guess, you know, obviously we haven't been privy to what was in the kind of business plan of Virgin Blue when it set up originally and whether or not it would have even contemplated -- whether its contemplation of setting up envisioned that Ansett was going to fail. And so, to the extent it embarked down the road before that was a reality, would again be consistent I think with what the experience is around the world, that low cost carriers have entered and developed and set up well, particularly recently, when they have a good business model that really is low cost and have done so successfully even without that kind of problem.

So, I'm -- I just can't give you a precise answer as to how important Ansett's failure -- it might have given them more room for opportunity to perhaps gain more share more quickly, take it up from Ansett, but it -- I just don't know what was in their minds when they set up originally.

PROF GILLEN: My thought is only that, you might expect a different strategic response from Qantas and/or Air New Zealand now than what we observed in the Australian market in part because of this pre-occupation on the part of Qantas, and I don't know the answer to that, but I just wonder about it.

PROF WILLIG: Again, the concern is that the alliance, if it's allowed to form, will act in an anti-competitive way. And I think Virgin has said, and other low cost carriers have said, they welcome markets where monopoly power is being exercised, these are very very good grips for their entry and for their profitability, which is somewhat analogous; if they were to face an alliance that's acting like a monopolist in an anti-consumer way, that would be a real thrust to the profitability of entry in, I think Virgin's own words, but certainly according to economics. So, it would be very helpful to them if there were bad behaviour.

PROF GILLEN: I understand that and I understand the economic argument, but, for example, is there any evidence that low cost carriers have a higher probability of entering high margin routes rather than low margin routes?

DR GUERIN-CALVERT: Again, you raise a good question. There certainly are high margin routes where low cost carriers have entered, but I think as we heard from Mr Webster, there's a little bit of idiosyncratic nature as well in terms of, if their cost structures are sufficiently low, routes that are low margin for incumbents, network carriers may actually be much more attractive. So, it's overall the issue of, does it fit in with the aircraft, does it fit in with the operation, does it make sense as compared to perhaps solely the value of a lot higher profitability versus a lower margin for the incumbents.

PROF GILLEN: Thank you.

DR PICKFORD: In one area of your analysis you haven't seemed to place particular weight on, but I may be wrong so please correct me if I am, is in the nature of product differentiation in these markets. To what extent to you conceive that the product has been differentiated or not? If differentiated, how does that impact upon the competition between the FSA incumbents and the VBA entrant?

PROF WILLIG: When we get to the analytic modelling this afternoon one of the questions that comes up is how to handle quality differences that consumers might perceive between a Virgin or some other VBA and the alliance partners, if they become one in that sense and whether there ought to be an offset in the modelling to production marginal cost advantage of a low cost carrier arising from the possibility that their service is viewed as less desirable than that of a full service airline to the typical consumer.

So in a way the modelling gets into that. But one feature of that market, and I think of today's trends worldwide is that, even though we used to think that the low cost carriers were not attractive to the business community as a sign of product differentiation, that in fact that era seems to be over, or rapidly dwindling, and that at least for relative short haul flights of the kind that predominate here, that the business community is very interested indeed in service on a low cost carrier, and are increasingly availing themselves of the discounts that are available, even if it might be a slightly less comfortable ride.

With due respect to the airlines here, I was a victim of Express service on the way into town; it's bad.

DR GUERIN-CALVERT: This is a confidential session, isn't it?

PROF WILLIG: In contrast to the long haul which was absolutely delightful. So, I think some of that product differentiation is disappearing.

MS BATES QC: I can't help saying; you get what you pay for.

CHAIR: But right now there is another option on the connecting flight that offers a more -- a different service and product, I might add.

PROF WILLIG: I somehow didn't find that.

CHAIR: No, you didn't, and you might not in the future either if this goes ahead.

DR GUERIN-CALVERT: I think the other part on the service is that it's not just -- I have the advantage of having short legs, so I'm never bothered by Express carriers, but I think it's in addition to the quality of the seats or whatever. I think the other aspect of competition is similar to, as we all approach market definition, is not every single business traveller has to switch from a network carrier to a low cost carrier in order for the low cost carrier to have a disciplining effect, and there still is a very high demand and lot of service provided by network carriers in terms of frequencies and connectivity for which there is still a great deal of demand, hence I think the continued existence around the world of hub and spoke systems.

DR PICKFORD: So given these relative strengths of the LCC model versus the FSA model, can you speculate as to how you see the airline markets panning out in the future in terms of; is it possible to conceive of some kind of equilibrium between the two types of carrier and what proportion of the market shares would be split between them potentially?

PROF WILLIG: As a matter of theory, and there have been some very elegant theoretical works done as you may be aware. In theory the market has both kinds of reactions to these elements of service differentiation. The theory says there may develop well and market equilibrium, you know, a general one full scale equilibrium with an interconnected full service airline, and maybe even only one the theory says, where there are point-to-point low cost carriers operating as well among the most important of the rest; the thickest routes. Coexistence between the low cost carrier architecture and the connectivity, the high connectivity architecture of the hub and spoke network, coexisting, competing with each other in equilibrium with both active competition on some routes and on some routes no active competition but very important potential competition where the low cost carrier can extend if in fact prices go too high or service becomes too bad by the high connectivity carrier. As to what the market shares would have to be, this just goes beyond the theory in my own can as well.

DR PICKFORD: In terms of the experience in Australia; you were implying or saying that it seems to have reached more or less a kind of ceiling in terms of its market share almost, because now it's starting to look overseas as to where it might expand next rather than to carrying on expanding in Australia. I mean, does this imply that there's a ceiling on these VBAs? Looking around the world they don't seem to get more than about 25-30% of market share. Was that the long-term ceiling on their market share?

DR GUERIN-CALVERT: You raised a good point. I did not mean to imply that there was a ceiling but rather trying to address Madam Chair's question as to how might one look at where might they go next and would the economics and the information suggest they would only expand in Australia first versus expanding across Tasman and domestic New Zealand.

And, you know, while a lot of the logic indicates that a very good next step is a great deal of traffic that would be logical to move to from a very large number of end points that they already have put in place across Australia, I would say that there probably still are a number of opportunities for them. One of the things that I learned working particularly on carriers on the East Coast of the United States is that, you can in relatively smallish areas with a limited number of aircraft serve a large number of routes, just by moving the same plane around multiple times.

So, as they get, you know, a total of 50 aircraft, there's still a lot of possibility for adding more frequencies and perhaps even more cities in Australia that would not be mutually exclusive with putting a large set of planes over into domestic New Zealand as well as across the Tasman.

DR PICKFORD: Can I just ask you a question about market definition in this case. You've analysed markets in terms of single routes but you've also said it's appropriate to aggregate them in some cases. I just wondered what the appropriate stance should be from an antitrust viewpoint in relation to the geographic markets? Is it appropriate to analyse them on an OD basis or is it better to analyse them on a group basis, such as the Tasman market, and if it is the Tasman market then how do you account for the fact that the Fifth Freedom operators only operate into Auckland for instance and not into Wellington or Christchurch? Is that providing a basis for distinguishing between an Auckland based Tasman market versus the rest, or could we still conceive of it as being a Tasman market?

PROF WILLIG: What I was alluding to earlier was that the right starting place, at least conceptually, is O to D markets and where practicality dictates, it could make sense to aggregate individual O to D markets into groups where the considerations are much the same, so as to just compress the analysis and make it more practical.

But instead, if there are differences among O to D markets both in demand and in competitive characteristics then it makes sense to analyse those markets separately because of those differences.

We were relatively cautious in our description of the Fifth Freedom carriers' competitive impact to stay with what we could see in the market now, namely Auckland as an anchor for those routes because that is where they seem to be operating. There may be cross-effects, there may be the ability of some consumers to cross the Tasman from a different gateway depending upon prices. It's conceivable that the demand side market is broader, but at this point we couldn't know that as a matter of conclusion, it's just something for analysts to think about.

CHAIR: I might just interrupt now and we'll take further questions after the lunch break, and we'll also have a chance to talk to you to make sure I didn't rush you through something that you needed to cover, because I think that was a bit of an unintended consequence. So my proposal at this time is to break for 45 minutes and we'll return at half past the hour. Thank you.

Adjournment taken from 12.48 pm to 1.30 pm

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CHAIR: I'd just like everyone to be seated, please, and we'll resume this session. Before we start the next session, I'd just like to indicate to all interested parties that, when I went up to my office at the lunch break, I had a fax from Auckland International Airport who, in light of the discussion about the availability of slots at Auckland International Airport, they have decided to put in a short submission on the negotiations that are currently underway between all interested parties in that context -- I don't mean in this one -- and I rang Mr Hughes and he's agreed that we make that letter available to anyone who's interested in it, and Fritha McKay will be here shortly; she's having copies made. So, if you're interested in having access to that submission, please see Fritha. Any questions on that? My colleague's just asking me if I've turned my phone off.

I'll now turn back to the Applicants, and if I could first ask for you to give me an indication of what we are going to start with and how you propose to proceed, I'd find that helpful please.

PROF WILLIG: If it's up to us, what we would like to do is complete the last few slides on the issue of competitive effects which are basically the entry barrier slides, and then slide right on in to the question of the efficiencies on the demand side from the alliance and how to quantify them or understand them qualitatively and quantitatively.

CHAIR: Just before you proceed -- you're happy to? Okay, we can come back to the other questions that Dr Pickford has after you've finished this part of the presentation, please. So, if you'd like to continue Professor, that's fine.

PROF WILLIG: Okay, thank you. So, we now proceeded in the sequence of analytic steps using the standard framework from the Merger Guidelines to ask whether barriers to entry exist in these relevant markets, and it's always useful for me to remind myself that the issue of barriers to entry does not involve actually predicting whether entry will occur in all instances, but rather, the purpose of this analysis is to understand whether, in the event there were to be non-competitive behaviour after the combination were formed, whether entrants could be relied upon to save the consumer and at the same time if they could be so relied upon, then it's a matter of economic logic that the incumbent, even after the combination, would be deterred, would find it unprofitable to undertake non-competitive behaviour in the first instance. Because, the logic would be that one would lose too much market share as a result and so it would not be a profitable venture into what they might otherwise perceive as the chance to earn higher margins in a non-competitive way.

So, barriers to entry are about the opportunity of other players, particular ones to respond to the market need for them to protect the consumer. We looked at a number of categories of barriers to entry. The first I would highlight is availability of infrastructure, landing slots, gates, airport facilities -- I wonder what the letter said from the Auckland Airport. What I wanted to emphasise, aside from, of course, understanding that you folks are much more aware of the specifics of what's going on today and yesterday, we've not been exposed to evidence that suggests there are serious problems in that regard. But, we understand that you've got better evidence on this than we're likely to have been exposed to.

The more general point that I wanted to make is that, in my experience, Meg's too I think, in the US, and in Europe, that's the area where undertakings and consent agreements have been the most successful and where the authorities have been most willing to accept undertakings and consents, even authorities that, in my view, are very naturally properly reluctant to accept behavioural constraints as undertakings.

The US Department of Justice, for example, is quite reluctant to accept as an undertaking, oh, don't worry, we'll price low, the consumers will be okay. Justice says, maybe you believe that, but we're not going to turn ourselves into an ongoing regulatory body for the sake of your deal, nor would the Justice Department be inclined to accept undertakings with respect to additions of capacity, or constraints on capacity for that matter, because the Justice Department at home, Federal Trade Commission as well would take the view that it's a very difficult sort of an undertaking to monitor to understand what the real capacity is and also because of the possibility that an undertaking like that might actually supplant competition with regulation where the authorities have not decided this should be a regulated industry in the first place.

Even with that philosophy in place, nevertheless the agencies have been quite ready, in my experience, to accept undertakings and consents with respect to airport facilities. I think the reason is that it's a one time agreement, it's out of the way, it doesn't need to be regulated subsequently, and the parties who need those facilities perhaps are certainly on top of the situation, and it's they who can perform the monitoring and the ongoing oversight that may be necessary to make sure that the undertaking is adhered to.

So, among undertakings I think the international experience is that that's the kind of place to go to give that last degree of assurance, if it's necessary, that the entry barriers are not there so that entry can protect competition and the consumer.

DR GUERIN-CALVERT: The one thing I'd add too is that in my experience at least, there have been relatively few transactions that have actually been conditioned on -- there have been some, but there are relatively few that have been conditioned on provision of gates, because a large number of the transactions, the findings were that there was sufficient gate capacity; not necessarily the perfect set of gates, but sufficient gates and it was not a slot constrained airport. But certainly in those in which there were concerns about various substantial impediments to entry, as Bobby suggests, they were remedied by consent.

PROF WILLIG: I think there is a reasonably high threshold that the agency have used to be convinced that undertakings were necessary, but where they are thought to be, the agency seems to be been willing to jump in and accept undertakings of that kind.

Other categories of barriers that we've looked at are the viability of the route for additional competitors in view of the characteristics of the route, the nature of the passengers, what is evidenced by analogies to other routes with similar passenger patterns, as well as the nature of the origin and the destination point in terms of size, demographics, the amount of traffic between the OD pair.

These are all valid issues to be looked at in the context of entry barriers, and we've tried to do that from our vantage point. We've also looked at the other factors that the Commission has expressed concerns about in respect to entry barriers, as per the next slide.

You folks have raised the question of capital requirements -- this is a valid possibility of course, as all of these are -- and general things that should be looked at. Here our impression is that capital requirement is not a problem for Virgin Blue, its said it has a war chest, it's backed by a publicly traded company and by Branson who certainly shows that he has ample capital for a valid business venture.

Regulatory requirements: We are not aware that there are indeed any extant barriers of that kind. We understand the process is underway; you'd surely know better than we exactly where that stands and whether that is a problem or not, but we've seen no evidence to suggest that it is.

Scale and scope of entry, that could be a barrier in other circumstances; doesn't seem to be here. Virgin Blue is not a new arrival; there's not a chicken and an egg problem as there sometimes is in network industries. Virgin is well established, it's got the platforms for competitive advantage and success on the routes that touch New Zealand from its existing network in Australia.

We don't see any barriers that arise from the need to access distribution services, in part because Virgin uses the internet so successfully. Its chosen business plan doesn't mean that it needs anything that could possibly be subject to entry barriers as far as our knowledge goes. I think the Commission has agreed already that that applies as well to CRS services; this doesn't seem to be a barrier to Virgin.

Virgin has an established reputation, it's got a brand name, loyalty schemes and brand awareness don't seem to be a barrier to Virgin as far as we're aware, and besides we've seen facts that suggest that frequent flyers are only a modest percentage of the passenger base across the Tasman, which are the first avenue of attack. When it comes to size of market, Meg spoke to that at some length earlier going laboriously through her analyses showing that the routes in question ought to be very attractive routes to Virgin, or indeed any other entrant in terms of the amount of traffic that is available and in terms of the criteria that we understand Virgin has used in the past to guide its own pattern of entry and entry evolution.

That's back to you, Meg.

MS GUERIN-CALVERT: One of the particular barriers to entry in addition that had been raised by the Commission was whether or not the response by the alliance partners would perhaps deter entry. In our analysis that we've been through earlier today, as well as detail to a greater extent in our report, leads us to believe that this is not likely to be a barrier to entry on the Trans-Tasman routes, and indeed on the other routes by Virgin Blue, that it has not currently, in terms of particularly Virgin Blue's initial entry and then its more recent expansion and addition in a number of routes in Australia, has not deterred them from expanding and from adding successfully.

Our understanding is that, in the case of the relatively few routes that they may have pulled back either in terms of capacity are actually exiting the market; the prices there are still very low, which again is consistent with the fact that they are regarded as a potential entrant back into those routes.

In general I think, as we think about it as economists, it really does not seem that the market conditions are conducive to the theory of predation that Bobby set out earlier, because it's unlikely to result in a circumstance that would force Virgin Blue to exit from the market, particularly given its cash reserves and its financial resources, and also in particular because the incumbents would not have the opportunity to benefit from the recruitment phase.

As we talked earlier this morning, were it to be the case that post entry that capacity were to be expanded, or prices were to be lowered to uneconomic levels by the alliance partners, it still appears that the cost advantage of Virgin Blue is quite significant, and from everything we've seen it looks like they would continue to have the incentive to at least remain as potential entrants if not actual entrants on the Trans-Tasman.

Again, just very quickly since we have touched on this a lot, and to be able to move on, we've tried -- looking back at the evidence we have read all of the airport submissions, we've read the Commission's Draft Determination very carefully, and it appears to us -- and as Bobby suggests you probably know much better -- that it does not appear that there really is a concern about access other than the ones expressed by the Commission about Auckland and Sydney. The other airports there seem to be adequate facilities and really no concerns raised.

We would just point out we've tried to look for what evidence is there that expansion has been able to occur, and there we point to the Emirates and Royal Brunei having expanded, and that again is consistent with the point of, we're talking here about entry but we also would be looking at expansion of seat sales. Certainly at very low sunk costs, carriers like Emirates and Royal Brunei and others who are already serving on the Trans-Tasman could offer additional seats on the existing aircraft because our understanding is they have relatively modest load factors now, but are having a constraining price on pricing. And then we would note that a number of competitors do have facilities, such as at Sydney.

Just again, what we tried doing was, looking back at the evidence we had read, that you were particularly concerned that for Virgin there may be a concern that they may have difficulty getting access to feed, and feed essentially would be non-local travellers where you have -- and we have the example here; if you have those that are flying from A to B and are solely flying from A to B and are not on the aircraft because they desire to go on to some C, D, E or F, and we have looked at the evidence that was available to us to try to get a handle on, for the Trans-Tasman routes, what percentage of the traffic is local; going, for example, between Sydney and Auckland as opposed to beyond or behind traffic, and found that the percentage of local traffic is about 70%. In general, on no route is the percentage of local traffic less than 59%, and on about half the routes it's about 75%. That suggests that there's a fairly robust demand for a local service point-to-point service on the Trans-Tasman, which is precisely the kind of traffic that Virgin Blue looks for as a first best alternative, and so that would be again consistent with the fact that feed is not an impediment to barrier -- excuse me, an impediment to entry.

It again suggests, however, that that's again focusing just on that internal statistics between, say, Sydney and Auckland. I think we need to take into account the map that I showed for Virgin for 2003. It has a very large number of routes already coming in to Brisbane, to Melbourne, to Sydney, to Perth, to Adelaide, so there are a number of cities where it already has traffic coming in, particularly the first three, and those again provide it some type of feed that it could rely on as well.

PROF WILLIG: I'll jump in for a minute with the thought that you asked before, and I just didn't remember this part of the presentation; what else might be the barriers even if a carrier is at one end of an OD route? And one of the screens that the Department of Justice uses to make that assessment about just how good a potential competitor of an airline would be, if it is that one end of the route, is the character of the passenger base of the incumbents on that route. And the percent of local passengers; the higher it is, the more likely it's thought to be that the carrier at one end will be a very active competitive constraint on the incumbent, even if it is not yet flying the route itself.

The reason is the one that Meg just explained, there's the possibility that, if a lot of the passengers, a majority are coming in through the incumbents' own network, then even if the network were to raise prices those passengers are apt to stay on-line because of the on-line benefits, and therefore not be available to the entrant, and so the competitive force of the carrier who is still a potential entrant is lower than it would be if there were relatively more local traffic on that route.

So, the percent local is viewed as an important screen for assessing the impact of entry. There's actually good empirical work in the literature, in part done by a Department of Justice economist, but in the public domain, actually proving out that the impact on price on a route holding constant lots of other variables that affect price, that the impact of potential competition is almost as good as the competition from a carrier actually on the route, depending upon the extent of the feed, and if the feed is quite low, local traffic is quite high, the potential entrant should be counted fully as the market participant because the empirics bear out that it has the full impact on price that an actual supplier that's currently active would be in terms of determining price relative to costs. So, Justice uses that as one of its criteria.

CHAIR: What would be considered to be --

PROF WILLIG: The threshold; as I recall, it's a sliding scale, there's a lot of different specifications of the econometrics.

CHAIR: Give me a little bit of a sense.

PROF WILLIG: I think the 70%, 59% are good numbers for the impact of potential entry. That's why we highlighted them here.

CHAIR: No, I meant the threshold for determining when you might be concerned about how much of the feed is local, or not?

PROF WILLIG: Where the percent of traffic on a given potential O to D pair is largely feed coming uniquely to the incumbent then it's viewed that the carrier who's still located at one of the nodes of the O to D pair is left at to be able to just jump in and perform the competitive service against the incumbent.

CHAIR: So, largely means the majority; is that what you mean?

PROF WILLIG: I don't think there's a short break of 50%, I think it's a sliding effect. And here what's exciting, of course, for thinking of Virgin as an active and very tough potential competitor, is that on the Australian side of the Tasman, of course it's got its own feed coming in so the local traffic is available to it, but its own feed is also available to it.

MS GUERIN-CALVERT: I think the other part, in part on the supply side, is looking at network effects. One of the things that can make a given entity a more credible potential entrant, even in a circumstance where there is less local traffic, is if they have a network of aircraft already on the ground that can be much more easily redeployed.

So, for example, in looking at the US Air Piedmont merger which had a number of hubs that the two carriers had an overlap, it was regarded that a carrier like United, which had a large number of aircraft already deployed in that area, even though it wasn't serving a lot of those end points, was a much more likely entrant on a whole large number of routes that did not have that much in the way of local traffic, because it could move them around from many points.

I think, looking back at the map of Virgin Blue, it has many different points from which it could deploy aircraft including, you know, leaving them overnight for -- to take early morning flights and so on. So that, it makes it more than just looking at what it has at, for example, Sydney or what it has just at Melbourne.

CHAIR: I'd just like to go back to a comment that you made some time ago, and I don't want you to do anything with the slides, because we're not going to go back to that particular issue, but you talked a little bit about the fact that other jurisdictions had generally been comfortable to accept undertakings with respect to airport slots, and that there wasn't the normal concerns about ongoing regulatory role.

And, I know this is off the topic, but I want to ask you anyway: I want to get a sense of what the other undertakings are that have been offered and accepted or rejected that you're aware of?

PROF WILLIG: A range, across the wide range of cases. Probably the most frequent one is where the parties come in and say, we understand your concern is that we're going to raise prices because of some proposed deal. And we -- "we'll write it down, we're not going to raise price. It's not in our plans, we're not going to do it, you can hold us to it, you're the Government, you must have the power to hold us to it, we promise.”

And in my experience the anti-trust authorities say, "well, we're worried about your incentives, not about whether you're going to do it or not, because we don't want to have to watch you. And besides costs might go up and then you'll say you have to and we don't want to have to weigh whether the price increase that you put into place in the future is cost justified or not; that's not our mandate, we don't want to turn your industry into a regulated industry. So your promises not to raise price, while they may be indicative with good intention of what your business plans are about, we will not accept that as an undertaking to solve what we might otherwise see as a competition problem.”

Likewise output. "We promise to expand, we'll go right on producing, we're not going to cut back, and that will control price; you don't have to worry." And the Justice Department will again say, "I hope you do, that will be very nice for the consumer, but we're not going to sit here and count your output and worry about whether the contraction is somehow warranted by market conditions or not. That's not the kind of fix that will persuade us that your deal is okay when we think it's not otherwise.”

CHAIR: What about promises to not expand capacity?

PROF WILLIG: I think that's pretty much in the same category. It's one that the Justice Department would regard as rather difficult to oversee, and frankly on the face it's in the opposite direction from what at least the US Department of Justice thinks is pro-competitive. We like to see more output and lower prices; not the opposite.

CHAIR: What about time limits on authorisations; is that ever an issue in the other alliances that have been?

MS GUERIN-CALVERT: Can you explain what you mean by "time limits"?

CHAIR: Well, the Applicants noted yesterday that the Commission could consider authorising this arrangement for a fixed period. So, for five years for instance, or two years or anything else that we might consider.

PROF WILLIG: And make it revocable under your own authority?

CHAIR: Yes. Is that ever looked at in other jurisdictions?

MS GUERIN-CALVERT: My sense is, I think there have been some contexts in which joint ventures, or other kinds of ventures that have been before the agencies have proposed a particular time limit, and I think the balancing that's usually looked at is the Government agency working with the parties to ensure that there is a long enough time period for the parties to really feel like they're able to do what it is that they need to do, but on balance looking at a short enough time period for the regulatory agency to believe that it's not irrevocable; so, there's that kind of balancing.

So, I have seen it in, particularly in certain kinds of joint venture constructs, but I think the focus is always not having to be so short that there's no opportunity to really accomplish what needs to be accomplished. Because, the other part is, usually some of the investments that get made are almost irrevocable and can be ones that may not necessarily be made if the parties knew that it was going to end tomorrow. So, in terms of the extent to which there's the incentive to integrate well, is to have a long enough time period.

CHAIR: Can I just ask one follow-up question. From a competition perspective, how do you see this arrangement? Is it virtually like a 100% merger?

PROF WILLIG: I'm really not on top of what the governance arrangements are promised to be, although I understand the top level headlines that one of the virtues that has been touted for the arrangement is that the carriers will maintain their independent identities regardless of the alliance, and regardless of the equity investment, and that's a good thing for a wide variety of reasons going beyond competition.

CHAIR: A lot of companies have more than one brand; is this any different?

PROF WILLIG: I really --

MS REBSTOCK: I'm talking from -- I don't mean from a legal perspective, I mean from, in terms of the way you might approach competition analysis?

PROF WILLIG: From the point of view of competition analysis within the relevant markets, at least for the time span, an issue that you now raise with your last question; our analysis proceeded as if this were a full merger on the routes in question, the routes touching New Zealand. But, I'd like to echo your answer, Meg, you thought much more quickly than I about our common experience.

MS GUERIN-CALVERT: Happens sometimes, rarely.

PROF WILLIG: All the time, I'd say.

MS GUERIN-CALVERT: Laboriously, but rarely.

PROF WILLIG: But that's true, we would see arrangements before the Government and we would need to decide whether to analyse it as a merger or as something different, and there the timeframe of the contract that established the combination would be a critical decider of whether we should regard it as a merger or as something with more limited impact.

MS REBSTOCK: I understand that, but you have analysed it as if it were a merger.

MS GUERIN-CALVERT: I think very much in terms of trying to put the greatest pressure on ourselves for evaluating the competitive advice versus the benefits so as to really evaluate the competitive concerns that you had raised.

CHAIR: So, what would have been your reasons for not adopting the merger approach, full merger approach; if you think this is sort of taking the safest most conservative way, why would you not have done it from a competition perspective? Why would you not -- are there any reasons why it shouldn't be treated as a merger?

MS GUERIN-CALVERT: I guess I would distinguish a little bit in terms of analytical framework the kinds of competition issues that are raised are similar to the same kind of analytical framework that one uses for a merger; to the extent, as Bobby was indicating, there are certain kinds of governance constraints or some issues in which there remains certain kinds of independence and certain kinds of additional brands and actions that would be different than in a merger.

I don't really see those as necessarily posing more competitive risks, but they may add some different dimensions on to the -- possibly than the benefits from the arrangement or the perspective, say, from New Zealand's perspective of continuing to have a separate corporate identity for an airline as opposed to having it consolidated into a single entity.

PROF WILLIG: Scrambling the eggs metaphor, I think, comes to mind. That when the agencies in my experience judge the timeframe of the arrangement as an element in deciding whether to apply merger analysis or something else, one criterion that I think is at the forefront is whether the eggs are scrambled by the deal, depending upon the timeframe of the deal.

In other words, if it's a three year deal for example, that's all that's authorised; if after those three years the parties cannot realistically be pulled apart to become once again independent competitors as they had been, then the relevant analysis would be merger analysis. But, if instead over that timeframe it is viewed that the parties, once they came back for re-authorisation, if they did, realistically the answer could be no and the parties could once again be managed or forever seen to return to their independent status as competitors than it might be analysed with a very different set of eyes than a merger.

CHAIR: Thank you for that. I know it was a diversion, but I'm grateful for your input on that. Please continue with the presentation.

MS GUERIN-CALVERT: And again very quickly what we did is -- and I just want to clarify something I had said this morning. The routes that we had looked at involving Origin Pacific are those that we had analysed in detail; just the ones in which there was an overlap between the alliance partners, and so again what we did is to try to look at and gather the same kind of information as to whether or not either incumbent response or access to feed was of a particular barrier to Origin Pacific.

Starting with the second; what we did do is again the same kind of analysis, is to look at the individual routes, Wellington, Dunedin and others on which Origin Pacific was a competitor, and again found in principle -- and we went in more detail in the paper -- as to the proportion of local traffic that there was on those routes and found that on many of the provincial routes there was a high proportion of local traffic. It again has feed from its own smaller networks of smaller airports around New Zealand, and there are also routes that we did identify; for example, Christchurch to Queenstown for which feed is -- does appear to be a little bit more of an important factor. There's a higher proportion of non-local traffic, and again that -- and as well in terms of the issue with respect to incumbent response -- is we identified that one of the possible things that Origin Pacific might consider doing post alliance is enter nearing a code sharing arrangement with Virgin Blue.

We had looked through, and again understanding some of the testimony that has been here as to the fact that in general low cost carriers typically do not enter into alliances; our understanding is that Virgin Blue has one with a regional carrier. We don't know all the specifics of it, but we know from what we've heard at least in part some of the rationale for that alliance is that there are some airports and some city pairs that are served by that regional carrier with aircraft that are different than the aircraft that Virgin Blue has, and it seems to make that an economic relationship.

So, that was again one of the factors that led us to pose that perhaps Origin Pacific could consider such an arrangement, either -- as a possible response to the alliance if it were to feel it would need some additional resources or additional partnering above and beyond the 20 routes that it does operate on.

That, I think, leads us into the benefits section.

MS REBSTOCK: We'll just pause there for a second and I just want to see if there are further questions from my colleagues.

DR PICKFORD: If I could just return to the theme before lunch about market definition and product differentiation. Do you think there's room for arguing that there may be different product markets for business versus leisure passengers?

PROF WILLIG: There was a time when that was a consideration that was given serious weight in airline combinations. There are places where it does come into play. The evidence that we've seen in the record, and we go into it in some length in some of the footnote paragraphs of our report, are that it seems that globally and particularly here the business community has been turning to low cost carriers in large measure. There's no cloistered business market any more it seems anywhere, and here particularly, especially when it comes to trips of moderate and shorter length, which seems to be the characteristics of this market, and it's in part for that reason that we elected to get single market route here instead of dividing things up for the qualitative analysis between business and leisure.

MS GUERIN-CALVERT: I think it does very much comes down to the fact that it appears, based on the evidence, that a sufficient number of business passengers switch, so as to kind of benefit those who don't switch, given the presence of low cost carriers.

PROF WILLIG: As I sat in my little seat on the Express flight, there's an awful lot of people who sure look like they were on business. I didn't.

DR PICKFORD: I just wondered if you had any evidence about the extent to which business passengers do travel on these low cost carriers. It seems to be quite hard information to get, because airlines don't necessarily know what purpose the travellers are travelling under; but I just wonder if you had any information on that?

PROF WILLIG: We didn't get systematic passenger counts one category to the next, we did not. But we do, I think, make reference to quantitative evidence of the substantiality of the use of low cost carriers by the business community in the report, and I'll find those footnotes and then call them to your attention later if you like.

DR PICKFORD: Just one last question on entry barriers. You seem to have adopted quite a liberal approach towards including various factors as entry barriers; I'd just like to ask you, how would you define entry barriers from an anti-trust viewpoint?

PROF WILLIG: I would say I've laboured over these words from time to time. It's something that stands in the way of a competitive response to anti-competitive behaviour.

DR PICKFORD: So, you wouldn't subscribe to the sort of narrow Stieglerian approach to entry barriers?

PROF WILLIG: I think there's a lot to be said for the Stieglerian approach and I think -- I can remember writings of mine that identify what I just said with the Stieglerian approach. Stiegler talks about costs being non-symmetric. But if costs avoid that kind of non-symmetry then one can expect a competitive response to non-competitive behaviour. So, I think at end of the day those two come down to the same thing.

MS GUERIN-CALVERT: I think also in the airline context, you know, similar to banking cases, there has been so much repeat business that just in a pragmatic sense people I think have come down to a relatively shortlist of what are the things that actually have been, or could potentially be significant impediments to entry.

MS WHITESIDE: I'd just like to go back to that business leisure split just for one particular issue, which is, you know on page 15 you're talking about routes where the Commission doesn't have to worry because of the competition, and you refer to the Trans-Tasman routes with Fifth Freedom carriers. We've just been exploring this issue to do with business passengers, the fact that all the information that we've got so far shows that the Fifth Freedom carriers, including Emirates, do not fly in or out at times that suit business passengers, though you know we're still checking that out. I just wonder if you have any comment on that, where that might be a problem on the Trans-Tasman routes?

PROF WILLIG: We actually did a count of the Fifth Freedom carriers Trans-Tasman flights as far as their departure times. It's referenced in our report some place. It's referenced in our report, I think on the Hazledine model, because I think it was Professor Hazledine who mentioned that concern or indeed that conclusion -- I think he went further than a concern. In response we actually tried to find the schedules and see if indeed the take-off times were markedly different or seemed inconvenient. And I think two-thirds of them, I'm speaking roughly without looking at the actual numbers, I think roughly two thirds of the departure times of the flights across the Tasman by the Fifth Freedom carriers were within half an hour or an hour of the departure times of Qantas and Air New Zealand. So, by-in-large, two-thirds were pretty much in the same area of timing as the existing carriers.

MS WHITESIDE: I think some of the problem was coming back too. If that was an issue it's just something we've got to check out, and I actually don't have the times with me. How would you say that should affect the way we should look at that split?

PROF WILLIG: I guess there's two ways to look at it. One is that might be seen as a reflection of the different business operations of the Fifth Freedom carriers. Obviously those planes have come to the region from international places and they have their own constraints, so one question is, do those constraints stand in the way of their competitiveness?

So, it's certainly a valid thing to look at.

But, another thing is to look at what their market share is; how are they doing? Do they actually attract passengers? Are they seen as competitive constraints on the operations of Qantas and Air New Zealand on the same routes, or even on other Trans-Tasman routes? I think the evidence is that they are seen as a competitive constraint.

MS WHITESIDE: That brings up the question of which fare classes we're talking about too, so that gets a bit complex.

PROF WILLIG: Airlines are complex. I think we had a quotation from the ACC that the Fifth Freedom carriers have provided strong competition. I don't recall them particularly narrowing that conclusion in respect of tourist travellers instead of business travellers.

MS WHITESIDE: It is something we have had to look at because this is information we've had coming in; that's why it was just interesting to explore it with you.

Just a couple of questions about Origin Pacific. I notice on page 14 when you're talking about, you know, determining actual competitors on a route -- on routes, and you talk about domestic New Zealand; you say Origin Pacific serves all of the routes. Were you actually just talking about the routes that Origin Pacific is on, or are you saying that they serve all the domestic routes?

MS GUERIN-CALVERT: No, I'm sorry, I thought I had just clarified; it was on the ones we had examined, thank you.

MS WHITESIDE: Further on Origin Pacific.

MS GUERIN-CALVERT: That's where the overlap is, where they would be an incumbent. They do serve some additional routes to the ones that we looked at, but by no means were we claiming they were on every domestic New Zealand route.

MS WHITESIDE: For instance, Wellington to Auckland or Wellington to Christchurch where they're not -- which of course are two important routes.

When you talk about Origin Pacific at page 34 you're referring to the two particular barriers. We have heard, and I'm pretty sure it's in the Draft Determination, Origin Pacific tell us that there is no way they would ever be in a position to be able to expand on to the rest of the main trunk; in particular those two routes I've just talked about.

Do you have any comments on that? They say that they're simply not in a viable position to do so.

PROF WILLIG: From the point of view of the nature of their equipment or the nature of the feed?

MS WHITESIDE: Just, the size of the operation, I think was what they were talking about, and their equipment, because they don't have the jets that the others have.

PROF WILLIG: I would certainly take seriously an assertion like that from a market participant, particularly if the reasons make sense, just the bald statement we can't do it, never did it, not gonna do it, that doesn't go very far for me because we're actually trying to analyse what would happen; whether the alliance and if the alliance tried to exercise monopoly power.

So, just their own view of their own operations in the current environment is not necessarily indicative of what would happen in the event of a competition problem. But if their reasons are reasons that would nevertheless be compelling, even in that hypothetical environment, then it's certainly something to take into account.

MS WHITESIDE: Just one final comment. On page 32 you're talking about access to facilities and you refer to the fact, one of the reasons why the Commission is concerned about facilities is inconsistent with the facts, is the entry of Emirates and Royal Brunei. Did you take into account the actual times of arrival and departure from Emirates and Royal Brunei as against the times that Virgin Blue would be wanting to arrive or depart?

MS GUERIN-CALVERT: Again, primarily what we were looking at there was the concept of coming in and being able to have access to gates and facilities. We had not done a really detailed analysis in our experience, particularly in my experience, working even at slot constrained airports, New York Laquardia, Washington National and Boston Logan and other airports. It typically is the case that newer entrants come in initially perhaps at a little bit more flexible times and then build their way into more peak times. We have not done a very very detailed analysis of specific, you know, half hour increments. I've done that in other cases, but we didn't have access to that kind of information.

MS WHITESIDE: The reason I ask that is because the situation seems to be quite different at peak times at Auckland Airport for a non-peak time. So, we've really had to sort of focus on non-peak times and in general around that.

MS GUERIN-CALVERT: In general I think you raise a good point, that in for example what Southwest has done is, they have chosen in some cases to come in either in airports that were not necessarily the primary airports, but nonetheless important airports, like Baltimore, and set up peak hour operations there and then at busier airports set up off-peak operations so that they don't necessarily take the same strategy at each airport that they're entering into.

MS WHITESIDE: Except, of course, we don't have the choice of airports to the same extent.

MS GUERIN-CALVERT: Certainly that works best where you're looking at going in in operations where you have a nearby airport that's a substitute airport, but I was speaking more broadly in terms of entry into a broad region, to go into one airport in one State at a somewhat less convenient time if that's all that's available, and then in another airport in another area if there's no congestion problem, picking a different schedule.

MS WHITESIDE: That then raises the issue of the timeliness and extent of entry by, say, Virgin Blue when it comes to talking about constraint on the incumbents, particularly if the alliance went ahead.

MS GUERIN-CALVERT: Again, part of it is obviously to the extent and the limit one has the ability to fly absolute wingtip-to-wingtip and match frequency and scheduling one for one, then you completely overlay. That may not necessarily be the optimal strategy for an entrant, because again, depending on what they're planning on doing with their aircraft and where they're planning on entering, that may not actually suit their own scheduling. That may be something that could be fixed, as Bobby suggested, with some sort of undertaking, but there's also evidence that, even if an entrant is coming in at a slightly less preferred time, that they still can have a significant effect.

A very good example of that is America West. There's a lottery for new entrants at New York's Laquardia and Washington National and a certain number of slots are reserved for new entrants; in some case they have gotten less optimal times and yet nonetheless have very significant operations; and basically try to pull enough traffic off-peak with somewhat lower prices in order to be able to discipline pricing.

CHAIR: I just might pull up the time. Can I just -- sorry.

MR P TAYLOR: Sorry to interrupt, but we've really got to try and, without trying to reduce the number of questions, get quite a bit of material through between now and --

CHAIR: I understand that, but we do have one more question. Dr Berry, please.

DR BERRY: I just have a brief point of clarification on the principles relating to entry barriers. I'd like to start out by reading to you, Professor Willig, a statement as what is being held out as a universal principle here based on one of our recent Court of Appeal judgments. The statement is this:

"Anything is capable of being a barrier to entry or expansion if it amounts to a significant cost or limitation which a person has to face to enter a market or expand in the market and to maintain that entry and expansion in the long-run, being a cost or limitation that an established incumbent does not face".

PROF WILLIG: I was afraid that last clause was going to be omitted and wondering how to be --

DR BERRY: How would you react to that, for universal definition, for entry barriers?

PROF WILLIG: Universal is hard to embrace in any of these areas of economics because somehow there's always some exceptions that come up here and there.

But, with the latitude to recharacterise say a legal barrier, for example, as a very very very high cost, suppose -- and this comes up in Telecom, that there are barriers to attaining access to telephone calls or conduit, and that means that the costs of an entrant being able to build a parallel network are literally overwhelming. Does one say, well there's a legal impediment to the conduit and it's equivalent to an infinitely large disparity in cost, if you'll allow me to reinterpret some kinds of barriers that way, then I think that's a pretty good characterisation. [**Pause**]

DR BERRY: "Barrier to entry or expansion reflects the extent to which an established firm can in the long-run raise price above marginal cost without inducing potential competitors to enter or to expand in the market."

PROF WILLIG: I would just say that I would be cautious about the use of the word "marginal cost" there; the term "marginal". I believe you're reading it correctly, but as an economist I've actually written, and quite properly so, that in some industries marginal cost is significantly below average cost, even in the long-run for a variety of reasons that I take it you understand, and there I would say it's the average cost or it's the pertinent average cost over the timeframe that's the right measure of whether a price is indicated to be high or low relative to its competitive level and, therefore, part of what ought to constitute our understanding of an entry barrier.

DR BERRY: You mentioned before you were involved at the Department of Justice when the Merger Guidelines were formulated, and there would have been subsequent revision s to those since your time there, but can I --

PROF WILLIG: Nothing substantial.

DR BERRY: How would you characterise the approach to the general principles as to defining entry barriers? Would you see the approach of the guidelines consistent with this passage from our Court of Appeal?

PROF WILLIG: The guidelines I think quite properly define a course of analysis aimed at understanding whether potential entry of one kind or another would be a sufficient constraint to keep prices at their pre-merger level, without necessarily taking a view of whether those prices pre-merger were ideally competitive based on marginal cost, based on average cost of one concept or another.

A much more practical point of view of let's ask to see whether we think prices are going to be driven up by the business combination, or whether instead among other influences will potential entry hold prices in line to where they were. So, the threshold for judging what is an entry barrier relative to the price level is different in merger analysis than it might be in some other frames of analysis.

CHAIR: Thank you for that. We will move on now to consumer benefits from improved scheduling, and new on-line flight options. I would just like to remind participants that the purpose of these proceedings is for the Commission to test the evidence that has been submitted to it, and so, for that reason I will not be limiting questions from Commission staff, experts or Commissioners for that matter. But, I will continue to ask parties to believe us when we say we have read your submissions, and what we are looking for are brief summaries of the key points and not a full resubmitting of those submissions. So, on that basis can we proceed please.

PROF WILLIG: Speaking as quickly as I can...

CHAIR: We don't want you to speak too quickly because the transcripters cannot handle it.

PROF WILLIG: Slowly but concisely.

MS REBSTOCK: That's it.

PROF WILLIG: Right, so we're in the new presentation -- different presentation now called Consumer Benefits From Improved Scheduling, and the beginning point for this presentation is our understanding that the Commission has estimated thus far a very limited view of the benefits from the alliance with respect to scheduling and on-line flight options, and also new non-stop flight options, with a total benefit in our understanding estimated at $360,000 per year.

What we have done is tried to develop an independent view of what might lead to a quantification of the benefits from the improvements in scheduling and the new on-line flight options in these markets that would result from the alliance.

Let me skip right to page 4, which is a concise rendition of various categories of on-line flight benefits in general. They certainly include broadly the improvements from better connectivity. That's better connections through better co-ordination of flights from the point of view of passengers; less chance of missing connections from the point of view of passengers; more variety in take-off times made possible by the adjustments of flight schedules, both on legs for the departure and also return legs on return trips, which I understand to be quite important for the passengers who find it hard to predict when the return voyage needs to be made, especially on a business trip because there's exigencies that get in the way of precise planning; lower fares which we'll come to in a moment, but it's very interesting that it can be expected that more on-line connectivity leads to lower fares; the ability to purchase a single ticket through the entire itinerary is widely viewed as a benefit to passengers, and in many respects on-line travel is seen to be a more seamless travel experience for the passenger with respect to gates and check-in and just the harmonisation of the arrangements necessary to fly.

Let me turn to the question of lower fares from on-line flight options. There's two legs here before we turn to the empirics. The first leg is the economist's understanding of why this makes sense, and to me it's really very interesting that it is predictable based on economics that fares for an on-line trip would be lower than the sum total of the fares for the two segments, were they inter-line instead of on-line.

Two separate airlines setting prices for two separate segments don't take into account the benefit of lowering the fare, which builds traffic, but it builds traffic for both legs, and if the two legs are managed by two separate carriers that's not a benefit that accrues to either party in its pricing, but if they are in an alliance then the benefits become internalised, and by economic logic you would think that that would lead to lower fares.

Secondly, there's a good deal of empirical literature on this question, and we cite here Bruckner and Whalen which come out in the year 2000 with an estimate that code share alliances drop on-line fares by about 25%; on the segments that change from inter-line to on loan.

We were able to look at pricing data here in the Australia/New Zealand region and we were able to compare what the inter-line sum total of fares would be for the inter-line passenger with what are the current on-line fares for that same route on cross-Tasman routes.

MS BATES: Could I just ask you, before we look at this; I'm a bit puzzled as to how you come to the actual number for a particular fare. Is it -- I'll tell you why, because on the Auckland-Melbourne-Perth route, I've just purchased one for $900, so I find that puzzling as to how you got to $775 for an on-line fare. The practice makes me wonder -- ask you to explain how you got to the number?

MS GUERIN-CALVERT: What we did is, in the interests of trying to have a consistent data set, often times when you're looking on-line through Travelocity, Expedia, one of the websites or even going direct onto a Qantas or Air New Zealand website, you have difficulty if you're looking at economy class with restrictions, or even without restrictions, even for a date somewhat far out as to what the actual rate is. So, what we chose as representative, because we knew it would be consistent across the categories, is to choose business class on a restricted round trip.

MS BATES QC: That explains it.

PROF WILLIG: You weren't flying business class?

MS BATES QC: Not for me.

MS GUERIN-CALVERT: At least we had a consistent and representative sample to compare between inter-line and on-line. If we could have had access to doing it in a reliable way with economy, we think the proportions would be probably about the same, but obviously much lower.

PROF WILLIG: Actually, I think this understates.

So, yes, these are all business fares for the comparability problem. Cheaper fares tend to have restrictions; it's hard to match up the sample that way, so we just went with unrestricted business fares for the round trip on these 20 sample routes and we came up with an average reduction in fare between on-line and inter-line of 21%.

So, we're going to use that number later. We're also going to use the 25% number from the literature, which we're comforted they're so close together. And my sense, without having done this empirically, is that it's likely that the business fair assessment may understate what is the percentage savings for the more discounted fares.

MS BATES QC: Well, this is just anecdotal, but there wasn't very much -- not very much difference between doing it on-line and doing it inter-line for the Auckland-Melbourne-Perth route; I think there was about $200 in it.

PROF WILLIG: On the base of $900?

MS BATES QC: Yeah.

PROF WILLIG: That's about 25%.

MS BATES QC: Yeah, that's right; I suppose you're right.

PROF WILLIG: That's what being an economist does for you; rapid calculator.

MS GUERIN-CALVERT: I think the other thing that was of interest to us was the Department of Justice, in looking at a proposed alliance between American Airlines and British Air, had done an evaluation over a much more extensive set of data and came up with a relatively similar kind of result in the 20 to 25% range.

PROF WILLIG: We tried to do various other quantifications that we get beyond just the assertion s that are very common in the academic and the international competition literature, but actually get some numbers to get some sense of what might be the base line for benefits here.

The next slide shows that we counted up some 855 routes between New Zealand and Australia for which there is only now inter-line service available but which with the proposed alliance would become apt for on-line service without any changes in the deployment of aircraft, just in terms of stitching together the two parties' current inter-line service into genuine on-line service. So, that struck us as a sizable number.

MS BATES: I just have to say to you though, 25% sounds right, it's a bit different from your 41.7% that you found on the same route.

PROF WILLIG: Okay, that's interesting. You're right.

MS BATES QC: That might make a difference throughout, mightn't it?

PROF WILLIG: It might or it might just be arrayed differently.

MS BATES QC: We'll just have to speculate on that.

PROF WILLIG: Or actually suffer through trying to do the study, which we haven't done, frankly, because the restrictions were so hard to decode, but perhaps we can get that done.

Another example is cases where there is already on-line service but where, due to the alliance, there would be an expansion of the on-line service because of the greater degree of ability to match up different flights, which today are inter-line even on routes where there is on-line service available, and we have an example here and there's more in our report. In terms of counting up more indicators of the base line for benefits, we found something like 12 or 1300 new directional on-line routes for flights originating or terminating in New Zealand that would come about as a result of the alliance, again without any changes in aircraft deployment.

Even where there is already on-line connections available, we tried to use the schedules to understand how much better they would become from the point of view of travellers if the new interconnectivity came about as a result of the alliance. So, we found 226 directional city pair routes that touched New Zealand where there's already on-line connections, and where if we splice together the schedules of Qantas and Air New Zealand, the minimum travel time would become reduced among the on-line options. And, what we found was an average decline in the on-line travel time of some 10%, again not because of rearrangements of flying schedules, but just because of the new connectivity made possible by the alliance.

We would understand that this is really an understatement in large measure of all of these base lines for benefits, because actually the alliance might well be moved to rearrange its actual flying times, and NECG has done some of that to understand what the better timing would be if in fact passengers were able to react to departure times that are more spread out as a result of the alliance, because when there's an alliance there's no need for flights to take off very close together. It makes more sense to separate their departure times, and that will yield substantial savings in waiting by the passengers.

Now we moved on to this slide, Meg you put me there right away, to try to give some quantification of these effects. The calculation needs a number of elements, the first and base line element is an estimate of the total expenditures on Air New Zealand Qantas flights that today are inter-line for the passengers. And so this base line of expenditures is taking out the local passengers. As we were discussing earlier this morning, one wouldn't expect that much in the way of connectivity advantages to the local passengers, so we tried to estimate what is the spending on flights, on flight itineraries that are to the inter-line as between Air New Zealand and Qantas.

We asked the airlines, they came up with estimates for the percent of their Trans-Tasman passengers that are on the flights on an inter-line basis and we applied that to the market, and we got the $114 million figure. We combined that with an estimate of what the percent benefit would be relative to the expenditure on fare from moving from an inter-line basis to the on-line basis.

One part of that is the expected reduction in fares, the 20 to 25% that I alluded to earlier. Another element of that is a 10 to 20% benefit that passengers experience, literature confirms this; there's some evidence in competition authorities record that supports the acceptability of a range of numbers of that kind for the benefit passengers' perceive from on-line versus inter-line, even at a constant price.

Applying those numbers together with a base line price elasticity of demand, that's familiar on this record, the 1.3; we arrived at total estimates of the benefit to all passengers, Australian and New Zealand, ranging from $42 to $66 million per year, and then applying the 50% factors to narrow that down to New Zealand passengers, we come up with our estimate of benefits just from the new on-line options ranging between $21 and $33 million per year.

We think that's an underestimate for a variety of reasons. Perhaps most importantly because that's confined to the demand side. Those benefits are expected to build traffic, that traffic builds profitability of the routes and so there's apt to be additional producer benefits arising from that on-line connectivity.

Meg earlier mentioned there's additional cost savings from building traffic density that would result from these benefits. We did not account for that, and also different margins, added margins earned by the airlines, the alliance, which we have not accounted for in this calculation. So, we think that's a legitimate lower bound, the best we could do on the available data.

MR CURTIN: Just to clarify if I could, you applied a percentage to total revenues based on what the airlines told you were the inter-line passengers?

PROF WILLIG: Right, we took the inter-line portion of totally revenues on the routes.

MR CURTIN: So the total revenues are based on the flight schedules that the airlines currently operate?

PROF WILLIG: Yes.

MR CURTIN: You did mention somewhere that there's some vast number of new point-to-point connections that are theoretically possible, but the existence of those flights is not in these calculations, other than in the value -- no, it's not even in the value of improved connectivity, so that's somewhere else.

PROF WILLIG: We didn't quantify that at all except just by counting up the number of new on-line routes. So, this is the routes that are currently flown on an inter-line basis that would become on-line. It's all Trans-Tasman itineraries, all of these.

So I did speak too quickly but I think the reporter has done a great job by the smile on her face.

MS REBSTOCK: You might be misinterpreting the smile.

So to conclude that portion we think we've made the best crack that we can at partially quantifying and partially just organising the information to show that there are very substantial benefits of connectivity of consumer convenience and indeed of expanded traffic that are apt to arise because of the alliance from the demand side. This is all from the demand side. Although there are counterparts that we have been unable to quantify at this time on the producer side that would be consequences.

We put this forward against the backdrop of your own estimate of $360,000 per year which we understand to be what your estimate is in these same categories. And so we submit to you that you have underestimated the benefits of the alliance to the consumer by numbers that are in the kind of range that we are putting forward for you.

MS BATES QC: Can I just ask another clarification question from your schedule that you put forward with the sample routes.

PROF WILLIG: Please.

MS BATES QC: How many of those would be not on-line now but would be coming on-line?

PROF WILLIG: This is from the price survey?

MS BATES QC: Yeah.

MS GUERIN-CALVERT: These are ones where there is an on-line option existing but where you could have movement from inter-line to on-line.

MS BATES QC: But you're talking about ones subsequent that --

MS GUERIN-CALVERT: Once the alliance occurs, that you can get what is right now an inter-line option.

MS BATES QC: I was just trying to work out which ones those were that they are going to become on-line where they're now only inter-line.

PROF WILLIG: Survey was routes where today one can have both, or either inter-line or on-line. The 114 million as the traffic base for the estimate, that is the expenditures that we estimate by consumers today for inter-line travel where one leg of the itinerary is flown on Air New Zealand and another leg of the same itinerary is flown on Qantas today. So, as soon as they're --

MS BATES QC: So on-line is not available?

PROF WILLIG: I can't say that. I'd say that these are consumers who today are flying on segments, one of which is Air New Zealand another which is Qantas, and which after the alliance that same itinerary would become on-line.

MS BATES QC: So they're choosing to go inter-line when they could go on-line for some inexplicable reason?

DR GUERIN-CALVERT: In some cases it might be the case. We did not, in getting that number, try to break it down into how much --

MS BATES QC: I just have a -- I might be being confused, but if they've got the ability to do it now on-line and if it's substantially cheaper, then how is it a benefit, an extra benefit to just look at the on-line position after the alliance? They can do that now surely?

PROF WILLIG: Presumably this particular combination of segments is better fitting the timing needs of the flyer if there is an on-line option also available on that same route, and Lord knows what time that option --

MS BATES QC: These are all examples, on this schedule, of ones where you say on-line's available, but you're saying there people aren't choosing to do it for whatever reason. Are you saying the additional benefit additional to what they can't get now, is simply a scheduling matter.

MS GUERIN-CALVERT: Not sure I understand the question.

MS BATES QC: Just from what you say it seems if one wanted to one could go on-line and get the economic benefit you're talking about. So, what is the difference between now and what the situation will be once the alliance comes through?

PROF WILLIG: When we matched up the schedule frequencies, which is another element of what we did to see what the savings in end-to-end time would be on-line as a result of splicing the schedules together, we found lots and lots of examples where the on-line connection is pretty narrow in terms of its timing and its availability, but where there's a lot of other inter-line options and a much different day part.

MS BATES QC: So it's really a scheduling advantage we're concentrating on here?

PROF WILLIG: No, these are customers -- if there is an on-line flight available say early in the day and this is somebody taking off in the early afternoon they're deciding that the better timing for them is worth the difference in convenience between inter-line and on-line. But if the alliance were to occur they would get both the on-line benefits and the timing.

MS BATES QC: So it's a timing issue?

PROF WILLIG: No, it's the convenience issue or the benefits of on-line generally, or even a price break that's being balanced in a person's own decision-making between the more convenient inter-line and the less convenient on-line. But the detriment of the inconvenience of the on-line would disappear with the alliance because the inter-line flights, which are what's appealing to the passenger because of its timing, would become on-line also.

MS BATES QC: Because they're on better times is what you seem to be saying; that the passenger then is able to choose the time the passenger wants on an on-line basis rather than --

PROF WILLIG: Yes, on the on-line, so you get both.

MS BATES QC: I do understand that.

PROF WILLIG: Sure, but I wouldn't say that's only a timing thing, because then the passenger gets both the timing, which the passenger's getting anyway by using the inter-line, and the other benefits of on-line itinerary.

CHAIR: Have you finished that part of the presentation Professor?

PROF WILLIG: Yes.

CHAIR: Were there some final comments you want to make?

PROF WILLIG: No, I think that's it for the benefits alone, now we should just say a few words to put the two together.

CHAIR: Can I just check if there are any other questions on that part before we go on. But I won't ask Commissioner Bates.

DR PICKFORD: Just in connection with your page 13 the estimates of consumer benefits, can I just clarify, does this include transfers from producers to consumers? Is it a broad consumer gain across the full spectrum of purchases, or is it a sort of dead weight welfare loss type?

PROF WILLIG: No, this is really from the consumer's perspective, because part of what's in here is the price decline, which is being voluntarily offered by the on-line carrier, so it's not a negative from the carrier's point of view. Because again the empirics say the carriers, as a matter of their own bottom line choose to offer the better price for the on-line connection. So, there's no countervailing harm to the producers here since they're voluntarily doing this. But this is all the consumer benefit.

PROF GILLEN: The schedules that you looked at here are current schedules or not, the schedules that would appear under the factual or counterfactual under the economic model?

PROF WILLIG: Right, this is July or June base line.

PROF GILLEN: Okay, thank you.

MR CASEY: I wonder if we could maybe get an idea of the traffic levels between the city pairs that you've estimated, if that's possible.

PROF WILLIG: You mean for the price comparisons?

MR CASEY: Yes, and the scheduling comparisons if possible. The things like counting scheduling benefits for someone going from Wellington to Canberra via Melbourne for example rather than via Sydney, I mean it would seem to me if they're going via Melbourne they might be going for a reason to have that extra time.

MS GUERIN-CALVERT: I think in part we had chosen these routes as representative sample routes to use to get an idea of what the distribution of percentage difference in on-line versus inter-line and to try to find as many where you could make this comparison.

So, we didn't, I don't think -- would not hold any individual one of these out, I think we could separately try to go back and identify the volumes. That was when we went to try to sum up the estimate we were again trying to look at a little bit more of an idea as to what's the overall volume of actual inter-line, taking into account all of the perhaps idiosyncratic as well as, you know, true inter-line traffic. I don't know Bob if you have any additional...

PROF WILLIG: I just say that the $114 million figure is based on actual booked revenues, so to the extent different routes have different weights, that's taken into account in that calculation.

MR CASEY: It was just this is kind of in a way so we can answer the criticism that if the services are valued by consumers why don't they exist now, why isn't someone providing them now, so pardon me.

MS GUERIN-CALVERT: I think one of the difficulties on some of these, given that where Air New Zealand's patterns are, you know, it's not so easy to have on-line service, explains some of it as to the extent of inter-line traffic.

MS REBSTOCK: We have one more follow-up question please.

MS BATES QC: Sorry, I have to say it's from me, I want you to look at page 9. And again there might be an obvious answer to this. When you're looking at Cairns to Christchurch, okay?

PROF WILLIG: Yes.

MS BATES QC: And it looks like there's going to be an additional three flights under the proposed alliance.

PROF WILLIG: [**Shakes head**]

MS BATES QC: No?

PROF WILLIG: It might look like that, but that wasn't the intention. It's three additional ways to splice together the existing flights into an on-line itinerary. So the new flights are new on-line flight options which today would be inter-line but with the alliance would become on-line. So, new on-line options become available even without changing when the aircraft take off.

MS BATES QC: So that accounts for the time difference between the current Qantas flights only and additional flight options under the proposed alliance -- I'm just trying to understand, because, you know, taking the most extreme example, leaving at 4.10 and getting there at 1.50 the next day, compared with leaving at 5.40 and getting there at 6.25, there's quite a huge difference there, and I'm just trying to identify where it comes from.

MS GUERIN-CALVERT: In part what it is, is if you look at the top half of the grid those are current Qantas flights that you can actually take those flights and make that particular schedule.

MS BATES QC: But those ones are -- those top ones, are they on-line or inter-line?

MS GUERIN-CALVERT: Those are currently on-line.

MS BATES QC: So they're on-line?

MS GUERIN-CALVERT: And then what the bottom half is, is that if you could now piece together an Air New Zealand and a Qantas flight you could actually do better than you could have done.

MS BATES QC: Well, I'm still trying to grapple with this huge time difference and how it actually -- where does it come from? You're flying the same distance you're flying it on-line, where does it come from?

PROF WILLIG: Because the schedules don't match up very well, so it's waiting around for the next flight. It's not flying time, it's the interconnection time.

MS BATES QC: So this -- the bottom three, the advantage is a reduction in the interconnection time?

MS GUERIN-CALVERT: Yes.

MS BATES QC: I understand.

CHAIR: Any other questions? [**No comments**]. Okay, we can proceed from your putting it together part.

PROF WILLIG: Thank you, in 30 seconds, well, make that a minute and 30 seconds.

MS GUERIN-CALVERT: You can have it all.

PROF WILLIG: Oh no. I would take us to the conclusions page that we went through earlier. The first conclusion is that while there seems to be an apparent increase in concentration that would result from the alliance, in fact if one looks at potential entry and analyses market participants the way that competition authorities in the US would and in Europe in some matters in any event, then in fact there's not evidence of a real loss, significant loss in competition that would harm consumer welfare or harm New Zealand welfare resulting from the alliance.

This comes down I think most importantly to our analysis of the absence of barriers to entry into the routes that touch New Zealand, particularly with regard to Virgin Blue. We spent a good deal of time documenting why we think there are no important entry barriers that would stand in the way of Virgin Blue's entry were that entry needed in order to protect against anti-competitive effects on consumers.

So, we come out from that part of our analysis thinking there's not a lot of reason for serious competitive concern about this alliance. On the other side of the ledger we think the $360,000 number for consumer side benefits is a very significant understatement of the benefits that should be expected from the combination. So we see less of a competitive risk and we see far more from the benefit side to consumers than at least so far we understand the Commission has decided. And so on that basis we would urge you to rethink what the balancing is apt to be.

My personal conclusion is that there seem to be so many benefits possible from an alliance providing interconnectivity across the two countries that this is a kind of opportunity that one should try to grasp if valid competition concerns don't stand in the way. A good competition authority like yourselves will always consider that and weigh the risks to the public and come to a balancing, but it seems to me that you should consider the possibility that this is a particularly fortuitous opportunity to bring the benefits of the kind of connectivity in a full service airline to both countries, particularly from the New Zealand perspective, that this alliance will make possible.

It's a particularly fortuitous opportunity because of the advent of Virgin Blue eliminating the significant risk of competitive harm. This may be a particularly fortuitous opportunity relative to the past and relative to the future to permit this kind of an alliance to provide the consumer benefits and the benefits that others have testified to, and that we think the competitive risk is absolutely minimal compared to other times when this kind of movement might be permitted by the competition authorities. Meg?

MS GUERIN-CALVERT: No, nothing to add.

CHAIR: I'll see if there are any further questions. [**No comments**]. I understand that you both will be speaking to us again later in the afternoon.

PROF WILLIG: No, we're not leaving.

CHAIR: Otherwise I would have done the formalities, but also it almost goes without saying that we're grateful to you for your input into this matter, but we can come to that later.

PROF WILLIG: Thank you temporarily.

CHAIR: Thank you for that presentation, and we'll move on to --

the session with NECG I believe is next which is an introduction to economic argument, since we haven't had any thus far.

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CHAIR: I'd like everyone to please be seated. We are now moving into the session with NECG on an introduction to economic arguments. Sorry for laughing, but given the extent of economic arguments that we've had, this title is a slight stretch, but I'm sure there's ample room to extend the discussion. Can I ask the Applicants to please begin, for the record, to introduce the speakers.

PROF ERGAS: Madam Chairman -- rather, Madam Chair, let me just start off by noting a slight technical problem; that we had intended that Professor Willig would introduce this session and unfortunately he has not quite yet returned to the room. I'm sure he'll be here shortly, but let me --

MS REBSTOCK: You can just introduce yourselves and then hopefully he will be back by then.

PROF ERGAS: Again, for the record, my name is Henry Ergas, I'm the Managing Director of NECG, and I'm joined by two of my colleagues, immediately on my left is Alexis Harden, and seated next to her is Olivier Renard. We also have here Professor Willig and Meg Guerin-Calvert.

Madam Chair, in the original programme I had intended to give an overview of the arguments that we were going to present. In view of the time constraint I won't do that, but will pass directly to Professor Willig who's going to introduce the context and background to the economic modelling. He will be followed by Alexis Harden who will set out our main points in respect of the calculation of allocative efficiency detriments. If you bear with me one moment, I think we'll need to get up the slides for Professor Willig's presentation. [**Pause**]

PROF ERGAS: Thank you.

CHAIR: This is the paper that's titled Allocative Efficiency? No. [**Documents distributed**].

PROF WILLIG: So my hope, my intention, although my timeframe may not permit, is to have the chance to share with you my perspective on all the models that you've been exposed to, that the record has been exposed to, and that you might become exposed to -- who knows as this process winds on -- to give you a sense from my vantage point of what you should be looking at when you're comparing different ones of the models, and asking yourselves which ones to give different amounts of weight to in terms of your own assessments, deliberations and your felt need to look for quantifications of the detriments as well as the benefits of the proposed alliance.

So, starting at the very beginning, as you probably understand if you've heard this sort of thing before, a model is a simplification of reality; it can't be reality, reality is too big and too impractical to analyse easily and certainly to quantify, and so models have to be a refinement, a simplification of reality. And how that model is constructed is in the hands of the body designing the model, and the first slide identifies some of the criteria that a good model designer will bring to bear in choosing exactly what kind of model to construct for a given purpose.

The first of the elements is to balance simplicity and completeness. In some sense the more complete the model is, the more accurate it is, and yet the more intractable it's apt to be, and the more opaque it's apt to be, and so a balance has to be struck between keeping it simple to be understandable and making it more complete so it will be more accurate.

In what respect does it need to be accurate, in particularly a model that's well designed for a purpose, has to capture the key elements of the markets that the model is trying to describe. At the same time the models ought to be grounded to reality so that it's applicable, so that it has a place for available data in it, so it actually is telling us something about the reality that relates to the decision that's before us.

A model ought to apply economic principles, especially if it's an economic model, but this is the only kind I'm really interested in. A model ought to be robust, and what we mean by that is not well exercised; well, in some sense the model should stand up to small tweaks, that if it were a little bit different if some of the parameters were changed by just a bit the answer shouldn't be quantitatively sensitive to those changes in a way that overturns the basic thrust of the model.

The model ought to be transparent so that users of it, like yourselves, can discern what it's really saying and what goes into it; transparency. The model has to be feasible to implement. I've seen lots of models that had 1000 equations and no-one really understood what was inside of it, and one couldn't actually implement answers from it because it was just too complicated and, very importantly, the model, because it is an over-simplification should not be over-simplifying things in a way that bias the answer.

Random simplifications, sure those are necessary, but leaving something out that is apt to swing the answer in a particular direction significantly ought to be avoided in the model construction.

So, if I advise you as decision makers, you should be giving different degrees of weight to different models depending not only on the beauty of the model to an economist, but importantly how apt is the model and its design for your purpose, which is illuminating the key issues that this matter raises and that you need to resolve in order to make the decision that you want to make for the public interest. So, how apt is the model for its purpose.

Let me now take you through the various elements of model design in this record and point out as we go a little bit, but more pronouncedly shortly how the different models vary in important ways, or ways that I find important in these elements of their design.

So, first of all the elements of model design in this record include how the models define the relevant market, what is the scope of the relevant market, how big is it and how granular is it; how much detail is there in the definition of the market? For example, how many routes are treated together versus treated separately? The models in this record differ pronouncedly on that dimension of design.

Second, the models differ in their design as to what market participants are considered by the model. Are any important competitors left out? This is going to be significant because, of course, the issues before you are all about competition and so one has to look pretty carefully at that element of model design for the purposes before you.

Another element of design is, how are the firms who are in the market assumed to behave with regard to their objectives? Are they modelled as if they're interested in profits or instead are they thought to be what we call revenue maximisers, not out to maximise profit but instead just the total gross amount of money coming in. Interestingly, the models in this record differ in that respect in their designs.

Models will differ and on this record they do in terms of the competitive interactions among the various participants in the market. Now, with regard to the incumbents in the market, all of the models in this record by-in-large make use of the Cournot framework; this is an economic jargon that you may have been exposed to before. I once was in a case where somebody presented a Cournot model and a counsel immediately ran out and tried to engage Professor Cournot to be on their side. Unfortunately, he's not available.

But this is a particular name to a particular economic model; it's a standard model. Cournot models are no panaceas, they have definite limitations which I won't take time to talk about unless you ask me, because I know my time is short. You should know they have limitations, but nevertheless all the models in this record substantially employ the Cournot framework among current suppliers in the market that they, the models, permit to be included in the analysis. So, evidently that's not controversial here.

Another element of the model design is the treatment of entrants. First, who is in as an entrant and who is out, and in what scenarios, and also for those who are treated as in, how much are they in, with what capacity, with how much quantity sold. An issue is the entry decision with regard to in out and how much is it modelled in the design, is it analysed or is it preset by the party putting it forward? They decide what they think it will be and put it in versus allowing the model to figure it out for itself. The models differ in that respect.

Sorry, there's more; these models are more complicated than they look depending upon how they look to you. On market demand: Well, the products of a full service airline and a VBA, are they viewed as the same or different as their product differentiation, as we've been talking about today? What about the price elasticity of demand, is business and tourist is separated out? Interestingly, as I understand the models that have been put forward, there's no key controversy in this respect among the models. Not to say there couldn't be, but apparently those putting models forward have not actually bumped heads on these issues.

This is a real specialist issue, but it's going to be one you're apt to hear more about today, so I call it to your attention. Calibration of the model's parameters, particularly the marginal costs of each firm. So, to make a model work the model has to have within it a view, not only of the things we've been discussing, but a view of what are the marginal costs that each firm experiences; because given the firm's objective, profit maximisation, even revenue maximisation -- erase that, profit maximisation, the marginal cost will importantly be a factor in the price or the output that the firm chooses. So the model needs to know the marginal cost of the firm, where does the model get its view of marginal cost?

Now, some models might deduce it from data on this record, some might deduce it from capacity shares -- which I will tell you is a vehicle for deducing marginal costs through the lens of the Cournot model -- where are those capacity shares to come from? Do they come from the base case? Do they came from someone's view of the counterfactual? Do they come from someone's view of a factual scenario? It's very important to know how a model is calibrated because that affects the marginal cost which can affect the answers that the model gives about pricing and about output in the market and, therefore, profits and impact on consumers from the New Zealand perspective.

Another element of model design is how to assess the impact of the alliance. Now, all of the models in the record do agree on comparing cases with and without the alliance; running the model without the alliance; running a similar model or the same model in with the alliance, with and without; and comparing what are the models' view of market outcomes, within without, with particular respect to impacts on New Zealand consumer and producer welfare. So, everyone seems to agree on that as an overall methodology for using the models to judge impact.

Nevertheless, the details of the way the models make those assessments can differ in important ways; for example, how do the models treat a transfer of 22.5% of Air New Zealand's profits over to Qantas? Is that a negative from the New Zealand point of view? Is the model to handle it that way? And, on the other side of that ledger, what about the one time $550 million payment to Air New Zealand from Qantas? Is that part of the balance, or the assessment of the impact of the alliance from the point of view of the model? Does the model assume that the equity transfer and the cash transfer balance each other out, or might one be ignored? These are issues that you should, if you want to do your own assessment of the models, keep your eye on and decide which you think is most appropriate from your perspective.

Finally, and this is often more of an issue than it is here, what is the treatment of the efficiencies from the alliance? Are the efficiencies built into the modelling and allowed to actually change the way the model estimates the outcomes in the market, or are the efficiencies assessed in a separate analysis and then compared or averaged in or balanced against what the model says? In some sense the ideal model would put it altogether -- maybe that's too complicated, but here all of the models in the record as I read them actually do separate out the benefit side from the model's calculations, mostly for the ease of the calculations. Is that an overall weakness? Probably, but models are not perfect and all seem to agree on that treatment here.

So, my review of the models suggests that the models of Professor Gillen and Professor Hazledine and NECG do differ in many of these design elements, and I do have my own judgments about which of those design elements are particularly problematic for an important decision like the one you have before you to rely upon. In fact some of the models -- some of the runs of the models have design elements in them that I would say make them inapplicable to your policy decision on the alliance.

CHAIR: Can I just clarify one thing, Professor? I'm just wondering if you have written up this in a wider paper, because --

PROF WILLIG: It's lot of stuff.

CHAIR: No, I'm happy with what you're doing, I just want to know if more detail is available in a further paper, because I think the --

PROF WILLIG: Yes.

CHAIR: The review you've done of the NECG model in particular was done after submissions closed, so just for the record, and for other interested parties, I want to be clear on what is available; is there a wider piece of work on that.

PROF WILLIG: Good question. I didn't understand you at first. My commentary on the models put into the record by Professors Gillen and Hazledine are in a report that I have submitted not too long ago, so you have that. I have not written up my reactions to the models put into the record by NECG. I'm going to say a few things about that if you think it's appropriate.

CHAIR: I'm happy for you to do that.

PROF WILLIG: I could write about it but of course NECG has its own presentation that meshes.

CHAIR: I understand that, that's fine; I just wanted to know if there was actually a further piece that you had done. Thank you, please proceed.

PROF WILLIG: Good. So, as I read the models by Professors Gillen and Hazledine, by design of the models these models omit treatment of all the current competitors of the parties, Air New Zealand and Qantas, on the Trans-Tasman and in the domestic New Zealand routes. So, the models do not treat, I think as I read them, the Fifth Freedom carriers on Trans-Tasman routes, and they do not account for Origin Pacific on the routes inside of New Zealand.

I know from my experience with models generally that this omission has a clear bias, that any negative impacts on consumers of a merger or of an alliance that has anti-trust immunity is more apt to show harm in a model that leaves out other competitors than it is apt to show harm in a model where other competitors are present within the model in.

And so, this is an element of design of these models that has a clear bias against the proposed alliance and I frankly, and I've covered this in my report, I don't really see why they made that design decision. They may have the view that this competition, as I think Professor Hazledine said in one of his written statements, he has the view that these elements of competition are not very important, and he's entitled to his view. I think he's wrong about that.

But nevertheless, the model ought to be calibrated based on some foundation and then, if we're simulating the impact of the alliance on competition, the model ought to be allowed to confirm or deny that conclusion through its own analysis. So, I think that omission is a very troublesome one for this purpose, for the purpose of making an assessment about policy that deals with competition.

Likewise, the models of both Professors Gillen and Hazledine, with one exception which I'll come to in a moment, fail to include analysis of VBA entry, and I emphasise "analysis". Both of their models do take into account some possible entry, some output by an entrant VBA, but where they do permit the entrant to emerge in the model, the extent of the entrants' activity is preset. The modeller has taken, in a hard wired way, the modeller's own view of the extent of entry capacity or entry ticket sales and placed that inside of the model instead of allowing the model to analyse what the expected outcome of that entry would be.

It's particularly important in the setting because, as you heard us discuss what seems like all day already, the important way that entry comes in to appropriate competition analysis is not just, well who's coming anyway; it's rather, well, will the entrant have the opportunity and the incentives to respond to any competitive problems that might arise? And so, the flexibility of the entrants' activity level is exactly the key issue in assessing the importance of entry barriers and the constraint that potentially places on an organisation like the alliance in the factual case. But, instead of allowing the model to do that analysis, both Professors' design presets the level of entrant activity. I think this really disqualifies, along with the leaving out of actual competitors, the use of the model for the purposes that you have before you.

There is one exception, which is interesting. One of his factual scenarios, which he calls F2, Professor Hazledine's model does permit the level of entrant activity to be determined inside the model; what we say endogenously. Henry used Latin earlier; I can say "endogenously". And actually, in some cases this is interesting to me because it shows that the good professor is able to do this, and did it relatively well in that model as far as I could tell.

There are other issues with the way F2 was used in Professor Hazledine's submission, but that was one scenario that permitted entrant activity level to be determined inside the model. So, it can be done; there's no doubt about it.

We go on to a lot more detail here which you may or may not want to listen to; Professors Gillen and Hazledine did use some calibration for the parameters of their model; remember my discussion of calibration. In important ways they use calibrations that were based on incorrect market shares, non-factual market shares, factual about the real world as it is today.

As I read Professor Gillen, he assumed that Qantas and Air New Zealand have symmetric costs, which is not consistent with the market share data that we see in the market today, while Professor Hazledine assumed that Air New Zealand's costs are lower than Qantas' costs. In reality, Air New Zealand has a lower share on the Trans-Tasman routes than does Qantas, as far as I understand the data, and when run through a Cournot model that would say that Air New Zealand ought to have a higher cost, higher applicable marginal cost than does Qantas in order for the model to reflect reality.

So, in that respect the model does not actually reflect what we see in the reality of the marketplace.

Ordinarily -- well, nothing's perfect, you know, but this turns out to be a crucial assumption, as I understand Professor Hazledine's model, because in his model, when he runs factual 2 verses counterfactual 2 -- and remember factual 2 was the model where entry activity is endogenous in the way it's best treated, so this is, of his models, the one that I think passes the other test the best.

When he actually makes the comparison between that factual case and a counterpart counterfactual case, he finds that the alliance improves the welfare of New Zealand consumers, as I read it. But there's an offset in his model where there's a diminution in Air New Zealand's profits, which stems precisely from his cost assumption which doesn't add up to reality, and in fact as I understand the way the model works, and I think we've done some experiments with it, if he had used the actual data on Trans-Tasman market shares to calibrate the model instead of taking the other approach, which I'm not quite sure what he actually did, but I'm sure -- I hope we'll hear from him on that subject -- but had he used the actual data and used the specification that analyses the level of interconnectivity I believe the model would have shown that the alliance was beneficial to New Zealand interests when the producer side and the consumer side was put together.

But I understand that wasn't one of the case that's ran. Instead, he ran the case where the Air New Zealand costs are lower, which is what led to even that comparison leading to detriments to New Zealand interests.

Both Professors aggregate the routes; they deal with only two different sets of market shares; one for domestic New Zealand routes and one for Trans-Tasman routes. So, instead of looking at a whole complex of many many different routes, instead they run through the model only a two market analysis and each of those markets is based on the aggregate market shares of all the individual routes that go into those two categories.

I can explain to you, but I won't try right now, but that does tend to generally overstate the competitive effects of the proposed alliance, because it has the implication of averaging out market shares and making the two firms look like more even competitors in the counterfactual case and, therefore, the model shows more of a loss of actual competition in moving from the counterfactual to the factual than the model would reflect if the real details of comparative advantages of the airlines were reflected in the model on a route-by-route basis.

It might be said, and I think it has been said in the record, that aggregation of that kind has a benefit; apart from this problem with it, it's a biased assumption, but it's been said, I think, that such aggregation perhaps improves the ability of the model to capture network effects, which of course have a real importance in airlines; that by aggregating all of the routes, then the entire weight of the competitive ability of the carrier in the whole complex is somehow represented, and that's a feature of the network interconnections among the routes, and maybe that's a better way to go I've heard it said. I don't think that's right at all actually; certainly not with a constant marginal cost model where increasing returns to scale are ruled out as part of the endogenous workings of the model.

And that in fact, if the marginal costs on a route-by-route basis were calibrated from the base case, that would take the network effects into account accurately, whereas this aggregation really just smooshes things together, in the vernacular, and loses the ability to represent the network effects.

Professor Gillen's modelling assumes that the parties, instead of maximising profit, maximise revenue in the counterfactual case and that in the factual case those same parties, once they've formed their alliance, change their objective and become profit maximisers within the alliance instead. I'll only point out quickly that this is a very unusual assumption when it comes to merger or alliance analysis. I think I've never seen such a thing before, but one keeps learning.

I see no foundation that's valid in the economic analysis put forth for such an assumption. And, what's upsetting is, this is a very very biasing assumption. Unless there were very strong evidence to support why it might be true, and I've seen no such, this really drives the answer, even if nothing else would.

The reason for that is, behaviour that maximises revenue is rather forthcoming with output more so than a profit maximising firm would show on its behaviour, because costs don't count if you're a revenue maximiser. You don't care about the cost side; there's no reason why. But the model of revenue max says that you're not concerned about costs, therefore you're more aggressive with output than you would be if you accounted for the costs of production.

So, a revenue maximising firm charges lower prices and offers more output than a profit maximising firm. So, comparing a counterfactual to a factual where the mode of conduct changes from revenue max to profit max in and of itself would create consumer detriments quite apart from any of the intricacies of the actual impact of competition.

Okay, finally the NECG model. The NECG model is calibrated -- and I told you calibration was going to be important -- is calibrated to the parties' submissions on the factual scenario and the unconfidential counterfactual. I understand there's two counterfactual scenarios about which evidence has been taken, and the NECG model has been calibrated to the unconfidential counterfactual, not to the confidential one.

The marginal cost parameters of the model are calibrated from the market shares in the factual and unconfidential counterfactual that were assembled by NECG from the proffered views of the parties. So, the model is not what is generating the factual and this unconfidential counterfactual from which the calibration is derived; this is the parties' own views of the business, which is setting the scenarios for the calibration from which the marginal cost parameters are derived.

One feature of this approach is that the parameters, the marginal cost parameters are likely to be different in the two cases, the counterfactual and the factual, because they were separately calibrated from different scenarios; and indeed, they are somewhat different. This strikes some as an inconsistency in the modelling approach.

On the other hand the approach does ground the model in the business judgements of the parties in a transparent way. I understand these scenarios have been presented in some detail before, you've had the chance to question them; so these are scenarios that are now leading to the calibration, and this strikes me as a plus to the approach, despite the apparent negative of having different marginal costs.

It seems to me that what this approach does is, it quantifies, in terms of detriments, the impacts of the alliance given those business judgments about the factual and the counterfactual. So, the business people put out the business judgments, transparently, and the economists generate in a quantified way what those implications would be for net detriments or growth detriments before the efficiencies are taken into account.

The downside of this approach, among others, is that any controversy over those judgments about the factual and counterfactual, I know there are plenty of controversies about them, this approach means that those controversies spread to the model itself. If someone thinks those judgments about the scenarios are all wrong, that makes the calibrations also vulnerable to that same view point. So, this is something that needs to be kept in mind.

Nevertheless, the recent NECG sensitivity analysis of their model shows that the results of the model, done as I just described, are robust.

Let me describe my understanding of that and Henry will certainly show you more details; that the model that I've just described yields similar conclusions to a different way of doing the model that avoids both the pros and the cons that I just described.

So, when instead the model is calibrated to the base case, not to the business people's views, the factual and the counterfactual, but calibrated to the base case and the marginal costs are held constant in the simulations of the factual and the counterfactual, and the base case price is used in the calibration; and moreover, the VBA marginal cost is calibrated by a sensitivity analysis that assigns it a 10% higher level than the alliance's marginal costs, a new run of the model is enabled, which avoids calibrating from the business people's view, but instead calibrating it from the base case and this assumption about the marginal costs of the VBA.

When the model is calibrated that way, and it's run for the counterfactual and run for the factual, it gives answers about the overall gross detriment resulting from alliance, and those results are very similar quantitatively to the results that the model outputted when it was calibrated in the other fashion.

And so, I'm feeling like this is a very strong sign of the robustness of the way that NECG went about its work, even though the other calibration is subject to more controversy because it's being grounded in the business people's judgments about the factual and the counterfactual.

So, to conclude, the NECG model is I think to be praised because it uses clear and transparent assumptions, because it turns out to be robust to any controversy over the calibration, and it's consistent with the facts route-by-route and economic theory.

I neglected to point out that another plus of the NECG model is, it's run on a route-by-route basis; no major aggregations into merely two markets, but each route is treated separately and the marginal costs are calibrated separately route-by-route. So that takes network effects into account, because the marginal costs may reflect the way the networks of the airlines have actually performed in giving advantages because of interconnectivity.

The NECG model also incorporates the key elements of competition on the routes that are affected by the proposed alliance. The other carriers are represented in the model, they are not willy-nilly by design left out. They may or may not be important or significant, but it's up to the model to decide, because they're in on a calibrated basis depending on the marginal costs that emerge from their market shares in the base case for the sensitivity analysis.

In contrast, the models of Professors Gill and Hazledine do not capture and analyse elements of the markets that are key to your decision on the alliance. The model leaves out these very important elements of your analysis, and in the ways I've described are predicated on assumptions that don't line up with the facts and the economics, not just willy-nilly, but in ways that systematically turn out to bias the results against the alliance.

CHAIR: Thank you for that presentation, Professor Willig. I've allowed you to present that without interruption, you might have noticed.

PROF WILLIG: No, I never notice.

CHAIR: We did that so that we could simply organise things around the timing, and my proposal at this point is to break for afternoon tea, and when we come back we'll have questions on that part of your presentation. So, thank you for that.

I ask everyone to be back at 4 o'clock, please. I would like to talk to you about how to handle what we thought might be a confidential discussion, I just want to test whether it actually is. Thank you. We'll reconvene at 4 o'clock.

Adjournment taken from 3.45 pm to 4.10 pm

MS REBSTOCK: Can I ask everyone to please be seated. I'd like to reconvene this session. When we finished at the end of the last session Professor Willig had completed his comparison of the different models that have been used in comment before this proceeding, and I've discussed it with my colleagues during the break, and given Professor Willig has taken the time to review the three models, we've taken the view that we would like to ask you questions on it at this stage.

So, I will start, please, with Professor Gillen.

PROF ERGAS: Madam Chair, I'd just like to introduce Jay

Israeloff who has joined us at this point, who's a senior economist at Compass working with Professor Willig and Meg Guerin-Calvert.

CHAIR: Thank you. Welcome. Please start.

PROF GILLEN: I have a number of questions I'd like to ask. The first is, you make the point that using a route analysis more disaggregation may be better, and yet earlier today you made the point that, in some cases it makes sense to aggregate some routes up as long as they're similar in terms of market characteristics, presumably more on the demand side than on the supply side. Is that fair?

PROF WILLIG: A lot of that was fair. One of the difference s that comes into play here. I think I explained this at more length in my report, was that, where the market shares are different route-to-route, and then if one aggregates instead of treating them separately, once one gets a different view of what are the relative competitive strengths of the two carriers, and then when there's an alliance between them the tendency is to overstate the diminution in competition when their shares are averaged out instead of held separately and factually on a route-by-route basis.

PROF GILLEN: I guess I'm not clear. The bias would have to be on the route distribution all in the same direction would it not? I mean, supposing that it was 50/50 and half the routes --

PROF WILLIG: It's true, if the shares are always exactly the same on all of the routes, then nothing is changed by the aggregation. But the example that I use, and it's the extreme case, but just imagine there are two routes and on one route carrier A does everything and carrier B does just a little bit in terms of share, whereas on the other route the roles are reversed; so one carrier is dominant on one route, the other carrier is dominant on the other route.

If one were to, and this is not representative, this is an extreme example to fix the point; if one analysed the two routes separately and imagined an alliance, the alliance wouldn't actually hurt competition very much because frankly there wasn't a lot of competition to begin with. The dominant firm is basically setting the market price and the other firm is going along with it because it's so small.

So, in that case if the routes were analysed separately the model would show very little in the way of detriment from an alliance. If, on the other hand, those same two routes were aggregated in terms of aggregates, the two firms look to be symmetric, like they have equal shares. One's very big on one route, the other on the other, put them together they look equal in the two taken together. Then, when the model thinks these two firms are very evenly matched and there's a lot of competition between them in the counterfactual, then when one proceeds to the factual, all of that competition is lost.

That's an overstatement of the reality of what would be the loss of competition from the alliance. So, that's the point, is that regressing to the mean through over-aggregation, where shares are different in different ways, tends to overstate the competitive impact of the alliance.

PROF GILLEN: Okay, so the degree of the bias would depend very much on the degree to which you're moving away from, kind of, equal shares of the meeting; in other words, a higher distribution means that you get more bias?

PROF WILLIG: The more variance, I would say.

PROF GILLEN: More variance, exactly.

The second point is, and this is on page 8 of your presentation, you make the statement that I have, in the modelling that I was doing, assumed an equal cost between Qantas and Air New Zealand, and that's certainly correct. Then you say, "in reality ANZ has a lower share on the Trans-Tasman routes than Qantas does." If you look at the Draft Determination, table 5, Air New Zealand has 53.7% as Qantas' 38.7, which is exactly the opposite to what you're claiming. These are based on capacity shares on the Tasman.

PROF WILLIG: I have to go back to my notes.

PROF GILLEN: Okay.

PROF WILLIG: And see what the foundation for that view was.

PROF GILLEN: I guess the third question I have, and you made this point rather eloquently yesterday, is that you -- when you're looking at modelling you're really trying to capture the market realities and trying to balance complexity with simplicity of the modelling to capture all the real results. And the idea of kind of revenue maximisation versus profit maximisation, when one speaks with the airlines they're continually concerned with market share, and if you actually looked at their performance they're pretty bad profit maximisers; they haven't done that that well over time.

And this notion that -- and Dr Tretheway addressed this in his presentation, and he and I have actually discussed it -- is that in the short-term where firms have this fixed fleet plan and they may change that over some period of time, whatever that may be, then it's not clear to me that revenue maximisation is such a foul assumption as you seem to suggest.

PROF WILLIG: The images that cross my mind are conversation s that I've had with airline executives, not in this country.

The idea that they don't take costs into account in their pricing, on their route decisions, on their capacity decisions, does not square with my own personal experience in interviewing airline executives for other competition issues generally.

I've been privy to the internal modelling of large airlines elsewhere where they take cost very much into account and where the pricing officials have cost ideas in mind. It's absolutely right that airlines are looking to build share; share is important to them, and I think one of the interesting elements of airlines modelling their own business decisions is their own quality of service indicator, the QSI; where they take the view that a higher share actually makes their flights more attractive if they're building higher share through greater quality, arising from more frequencies, and actually from more on-line service as well, which they take into account in their own quality of service index. So, the airlines are keeping track of their shares because they think that's a good demand side builder. But not in my experience at the expense of neglecting costs; that's just part of their business environment.

PROF GILLEN: Would you think it's fair to say that the issue is -- or the issue may be one of not so much revenue versus profit maximisation, but revenue maximisation with a particular profit constraint and pure profit maximisation?

PROF WILLIG: I take two elements to your question. One, you're asking me, might that be a reasonable model of airline behaviour profit constraint? No, I've seen in my own experience no evidence that that characterises airline behaviour. But the other element is why it's a separate question, why would you expect -- why would the reader of your work expect the relevant objective for the firm to be different as between the counterfactual and the factual? Which is really what drives my conclusion, that a lot of the detriment that the model calculates in many of the cases really arises from that assumption that you bring to the model, of the change in the objectives of the firm when it ceases to be too separate carriers making independent decisions and becomes instead one alliance. Why would they shift from revenue maximisation to profit max?

PROF GILLEN: If you move from the counterfactual to the factual, you're moving from a revenue -- what I'd characterise as a revenue maximising world to one in which you have essentially a cartel, in which case your market share is 100%, so clearly under those circumstances you've already got the entire market, so why wouldn't you try and characterise it as -- it makes sense then to characterise it as profit maximisation.

PROF WILLIG: I think, based on an awful lot of personal experience and disciplinary experience amongst economists, profit max is the way the profession generally models firm behaviour, whether it be two separate firms or the behaviour of the firm post alliance. But, I would submit that your characterisation of the alliance as a cartel; if your modelling reflected that, then in a way you're prejudging the answer, and I think that's in part what makes the way you've chosen to do the model has weakened the impact of the model on a decision that involves an assessment of just what's going to happen to competition under the alliance scenario.

PROF GILLEN: A third question is your argument that the revenue maximisation really does bias the result versus profit maximisation, and is it not more the difference that a revenue maximising firm will produce at higher prices and lower outputs than a competitive or a perfectly competitive profit maximising firm, but clearly is going to be a lower price and a lower output or a higher output than a Cournot competitor.

So, is the difference that you're really saying, in terms of the bias here, is between the initial characterisation as Cournot competition versus perfect competition, rather than between revenue maximisation and profit maximisation?

PROF WILLIG: Absolutely not. If you hold constant in your mind the market setting, you could have a firm be alone in a market or you could have a firm be a Cournot competitor in an oligopoly; in either of those settings, as well as in perfect competition, you know this from your own work; if you were to shrink the marginal costs and do comparative statics on price, you will find that as the marginal cost contracts the price comes down, be it in Cournot, or monopoly, or perfect competition, and corresponding the output of the firm rises.

As you know, revenue max is the same thing as modelling profit max, but with a zero cost assumed. So, that comparative static result applies quite generally and proves the truth of what I said; namely that revenue max endemically leads to a lower price and to higher output than profit max. If you assume revenue max only in the counterfactual and then turn around and assume profit max in the factual, it's like you're assuming that the effective cost that goes into decision making is zero without the alliance and way higher in the alliance scenario. Of course prices go up.

So, you're not asking the competition question with that comparison -- that choice of modelling design makes the result that there seems to be very serious detriments from the alliance.

PROF GILLEN: The final question is, you take issue with the Fifth Freedom traffic, and that really only applies to the Auckland route, and so, given that you have a whole bunch of other destinations in New Zealand, I guess the issue is I guess two-fold; one is that, to what extent are they effective competitors? I don't know of any evidence for that. Number 2 is, given they're only in one particular market whereas we're dealing with a whole bunch of markets here.

PROF WILLIG: It's your modelling choice to aggregate the cross-Tasman routes, and if we just stay with that framework for a moment, in that aggregation I think the record says that the seat capacity flown across all the Tasman and the cross-Tasman routes adds up to about 15 to 20% for the Fifth Freedom carriers, in your market aggregation. So, they are flying 20% or 15 to 20% of the capacity. Now, what competitive effect that has is something for the model to determine, not your decision to leave them out to determine.

On the other hand, if you were to disaggregate and look at the Trans-Tasman routes one at a time on the routes touching Auckland, you'd have a much bigger share than that attributed to the Fifth Freedom carriers in the base case. That wouldn't be all the Trans-Tasman routes, but it will be the important ones that touch Auckland, and you'd get a far different result because their share would be even bigger than 15 to 20% focused on the Auckland routes alone.

PROF GILLEN: In taking that capacity into account, there's this implicit assumption that all the Fifth Freedom carriers are responding in exactly the same way as the incumbent carriers, and I guess I would argue, it's not clear that that's necessarily the case because it is the additional leg that we're talking about. So, their ability to expand capacity in response to changes in fares would -- is different than would it be for someone like Air New Zealand or Qantas, is that not true?

PROF WILLIG: Not in my view. The Cournot philosophy, if you're staying in the Cournot model and you're calibrating, is to calibrate the marginal cost from the market share. So again the calibration would tell you are their marginal costs consistent with their actual factual market share and then let the model run and see what happens to their behaviour under the difference between the counterfactual and the factual.

Quite apart from the aircraft that they might additionally fly in or not -- and I know there's some issues about how they could respond by flying in additional aircraft just for events on that market -- there's the question of them selling more seats on the flights that they're already mounting that lies behind their market share, and in fact I understand that their load factor would accommodate quite a bit more sales of seats on those flights that are already flying.

So, in reality, they do have considerable latitude to expand their market share, maybe even nearly double it without running out of seats on the flights that they are selling right now.

PROF GILLEN: So, in your view in the Cournot model you should formally include all of those Fifth Freedom carriers in the modelling exercise as participants in the market?

PROF WILLIG: I think certainly if you're staying within the Cournot framework, and as I've discussed the Cournot framework is one that all the models seem to adopt, but there's certainly other models available in the economist's toolbox; but if you stay within the Cournot model then you should be attributing the marginal costs to them that's consonant with their market shares on the routes where they have a market share.

You could purposely alter that if you had a factual base for it and try to figure out a more complex cost curve if you thought their capacity was limited by their international flying schedules; it would be more complex.

But one easy way to do that would be to include them, simulate what happens to them in the counterfactual versus the factual, see if moving from the counterfactual to the factual involves them expanding so much that they run out of seats on the flights that they're already mounting, then you could say, oh, I need to constrain their capacity due to these other considerations. There's ways one could handle that without just making a design decision to leave them outside of the modelling framework.

PROF GILLEN: Okay, thank you.

CHAIR: Can I just follow-up with one question, please. You seem to not address the issue about your views on using the Cournot model; you simply note that that was generally agreed amongst the different modellers who undertook the task. But it was noticeable, I think to the Commission, that when you did your original analysis you didn't yourself rely on the modelling done by NECG or anyone else.

So, I'd just like to get a sense of how you -- what your view is about the appropriateness of using the Cournot model in this case, and if you were going to do modelling work, how would you approach it?

PROF WILLIG: It would take me many months, I'm afraid.

CHAIR: I'm not asking you to actually do it, I'm asking you how you would do it.

PROF WILLIG: With unlimited time, data and money. I would just point out that one of the fundamental drawbacks of the Cournot model is that its based on the presumption that each market participant, when it's making its own output decision, takes as beyond its ability to influence the output decisions of its rivals; this is the hallmark of the Cournot model.

So that, if I were an alliance market participant in the factual case, and if I had it in mind to hold output back to attempt to gain market power and exploit it, in the Cournot model I'm not permitted by the construct of the model to think that anybody else would expand because I have decided to hold back my output. I have to take their output as beyond my influence. That's no-one's design decision except Mr Cournot himself a long time ago.

If one's view is that other participants, particularly the entrant, are elastic in their supply, that they respond with their supply to what the larger carriers are doing in the market, and if one believes that that's an important possible way that competition works in the market, then the Cournot model just rules that out by its design.

So, by the design of Mr Cournot, the ability of entrants, or smaller carriers in their expansion, to constrain the bigger carriers is really ruled out by the model.

CHAIR: So, I take it from that answer that that is your view, that you wouldn't accept that as the appropriate model?

PROF WILLIG: I think it's a conservative model for present purposes, where entry is really important. You can model entry endogenously in Cournot, but without the full force that it might actually have under a different modelling approach that might be relevant to the case.

CHAIR: Is there any way to anticipate what effect that would have on the results?

PROF WILLIG: If anything, directionally what it would do is to make it less dangerous for consumers to allow the alliance, because the entrant would be more able to respond more dramatically to any attempts by the alliance to exercise market power.

If I can point out that there's actually --

MS REBSTOCK: Just before you go on, can I just clarify; is that regardless of the particular facts situation and in terms of the extent of the market power and position of the incumbent? Is it always necessarily the case that it would have that result?

PROF WILLIG: The result of making the impact of an alliance more detrimental to consumers?

MS REBSTOCK: Yes.

PROF WILLIG: I don't think I can claim universality for that. I would think, particularly of a market environment where the ability of the smaller firm to expand is an important part of the competitive analysis.

CHAIR: This is exactly what I'm questioning. If the ability to expand is at question, it seems to me that that result does not necessarily hold.

PROF WILLIG: I think that's right, that's not an important feature.

CHAIR: We come back to what is a key issue for us to determine, and I don't think that it is -- it isn't one of these cases where it's necessarily the case; it's actually part of the matrix here of having to decide what we think is going to happen.

PROF WILLIG: I agree with that. And I would say as a result that, if you found that the ability of entrants to expand was indeed an important competitive force here, which within your qualitative analysis would make you feel relatively more comfortable the alliance, then a consequence of that would be, the Cournot modelling would tend to overstate detriment.

CHAIR: Thank you.

PROF WILLIG: Could I add an empirical note. I was remembering there was some empirical work in the literature of economics, I think, with Cliff Winston's name on it, which goes to the question of whether low cost carriers are apt to be responsive in their own pricing and in their output and in their entry decisions to the pricing of incumbents in the market. I recall that the empirical result -- which is not based on Australia and New Zealand, I think it's a US study -- but my recollection is that it shows that the low cost carriers, or Southwest particularly was particularly responsive in its own decision-making to opportunities to undercut a higher market price resulting from some misguided attempt to exercise market power.

CHAIR: Sure. I can understand.

MR CURTIN: Where does that lead you in terms of your conclusion as to the right model to analyse that kind of environment?

PROF WILLIG: I don't think we have a model in this record that gives as full weight as ought to be given to the elasticity of entrants' supply on the view that that is important in fact.

CHAIR: Thank you for that. Dr Pickford, please.

DR PICKFORD: Isn't another problem with the Cournot model in this setting that -- I mean, all else being the same, the lowest cost producer gets the lion's share of the market. The problem we have is, the VBA is the lowest cost producer, so once it's in the market the model suggests it should have the lion's share of the market; whereas that's rather difficult to accept given the state of the incumbents. I just wonder whether you'd have a comment on that?

PROF WILLIG: Yeah, I think there is tradition and good sense behind approaching the modelling in the following way in a Cournot environment. That is, if there's evidence that the physical marginal costs of the low cost carrier are lower than the physical marginal costs of the full service airlines, it should, if that's all there is to it, suggest a greater market share for the low cost carrier than for the full service airline.

But if in addition there are benefits that consumers experience from greater connectivity, from more on-line service, for all the things that the full service airline actually offers, which is why we see full service airlines in the long-run after all, they do do something of value; a relatively practical way to reflect that in the Cournot model is to add on some sort of a hedonic correction for that difference in product quality as perceived by consumers.

So, for example, when I mentioned earlier that -- and NECG should speak for itself -- but I understand that in their sensitivity run they ascribed a 10% higher marginal cost to the low cost carrier, to the value based carrier than the alliance; not based on their view that the physical costs are higher, but based on their view the physical costs are lower, but let's account for the disutility of value based service as compared to the on-line service opportunities that the full service airline makes possible; and in the Cournot model that's a valid way to reflect that difference on the demand side.

MR PETERS: Professor Willig, one of your modelling principles criteria was the avoidance of bias. How does this sit with the fact that factual and counterfactual schedules are both produced by the Applicants who are not disinterested parties, and are you suggesting that the Commission take this as unbiased?

PROF WILLIG: It's an interesting question because it raises the question of whether the business people, in proffering their counterfactual and factual scenarios could actually intuit what they would do to the Cournot model when the Cournot model were calibrated from those scenarios, and perhaps the business people have that degree of intuition or not.

What I did say, and this is really where I wish to stand on this question, is that the counterfactual, the non-confidential counterfactual, and the factual as I understand it are in the record; they've been examined, they're viewed as important parts of the record for other purposes aside from modelling. Yet one might think that the Commission needs to have a quantification of detriments as well as benefits for the purpose of decision-making.

And so, to the extent that the counterfactual and the factual are given credit by the Commission and taken seriously as part of its decision-making, but it still wishes to go to a quantification, then the model calibrated from those scenarios allows that. It allows the quantification of the information built into those scenarios put into the record by the parties.

Now, the Commission may decide not to credit those scenarios because they are inevitably controversial, in which case that quantification will have relatively less value to the Commission because of the way it's actually set up.

MR PETERS: I guess that the -- whether the Applicants -- they probably don't know how a Cournot model runs, that's a fair point, but I think that business people in this industry know that, like Cournot, that an increase in capacity results in a decrease in price. So it probably wouldn't be too difficult to figure that out.

PROF WILLIG: But that may go in the opposite direction actually. I mean, if there's a lot of capacity assumed in the counterfactual, and so a lower price, then -- and if that disappeared in the factual, that would mean more consumer detriment. So, it's not even intuitive to you and me which way it goes, frankly.

CHAIR: I think we better be careful not to insult all the business people in the room, Professor. They might think they're more intuitive than --

PROF WILLIG: About Cournot models? I don't think so.

CHAIR: Not about Cournot models, but they may think they're more intuitive about what the market outcomes might be.

PROF WILLIG: I would hope so.

CHAIR: Any further questions from the Commission? No, okay. Thank you for taking those questions.

We will now turn, I believe, to the session on allocative efficiency. Is that correct?

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MS HARDIN: There's two models that have been available to the Commission for some time which estimate the allocative impacts associated with the alliance, you have the model developed by Professor Gillen and the model developed by NECG, and then there's the model that's been made available more recently by Professor Hazledine which Professor Willig's reviewed.

But just between the models that have been available for some time, the results of the two models vary substantially. The Gillen model estimates $170 million worth of losses for year three of the alliance for domestic New Zealand and the Tasman markets alone, and the NECG model estimates $23 million of losses for year three of the alliance for all of the affected routes.

Both of the models have some limitations, but it's our view that the framework and the assumptions and the implementation problems associated with the Gillen model make it impossible to rely on for assessing the alliance. The limitations of the NECG model have small effects and in most cases make our estimates conservative.

So, on that basis we believe that the Commission should rely on NECG's estimates and not place any weight on the results obtained by Professor Gillen.

We'd prepared a number of slides going through the problems with the Gillen approach, but I think that given the time limits we have I might skip those slides because Professor Willig's already gone through most of those issues, so I might just move straight on to the NECG model.

CHAIR: That's fine, unless there are any points that he's not picked up?

MS HARDIN: I think we've covered most of the points.

CHAIR: All right, thank you.

MS HARDIN: So, if you move to slide 12, that's where the NECG model discussion starts. And, just to reiterate again, the NECG model relies on the Cournot framework and the essence of that approach, that firms use output rather than price as the main strategic variable, and we chose that framework because it's simple, because it has empirical and theoretical support, and also because we believe that it's a conservative approach.

There's a number of issues that we've explored with our model since submitting it to the Commission. We've looked at the framework for calibration -- this is the issue that Professor Willig's just discussed, about what market shares you use to calibrate the marginal costs.

We've looked at issue of product differentiation. We've looked at the issue of price discrimination, the intensity of VBA versus FSA competition, the issue of cost savings and how that should flow through to the price solution, and also there's the impact of the undertakings which we don't include in our model at all.

So we've -- for each of those issues we've worked through and it's our view that they either have a small impact on our results or they make our results conservative.

So, I just start with the framework for calibration.

Under standard merger analysis you compared two states of the world; one with the merger and one without the merger, and marginal costs are estimated for the world without the merger, and then prices and outputs are calculated assuming that the only thing that changes is the merger itself; that we move from N firms to N minus 1 firms. There's no new entry, no exit, and there's no exogenous expansion or contraction of capacity.

And this diagram just depicts the process that we worked through to calculate the solution price under the factual and counterfactual. So, up the top we start with market information to calculate the market shares with no alliance. We use that information together with price elasticity information, the base case price to calculate a price cost margin, and that's used to calculate the marginal cost for each of the players in the market with the no alliance scenario, which is then used to calculate the counterfactual price.

Then the only thing that changes is the alliance, and we calculate the marginal costs again with the alliance, with the only thing changing being that we calculate the marginal costs for Qantas and Air New Zealand as a weighted average of their marginal costs pre-alliance. So, that's the framework that we use.

The main issue is what market shares should be used to calculate the marginal costs without the alliance, and there's three options. We could use the disaggregated factual market shares, we could use the counterfactual market shares, or we could use the base case market shares, and each approach involves some limitations compared with what would actually happen with and without the alliance.

So, the first approach is the approach NECG -- the NECG model takes. We use the disaggregated factual market shares to calculate the marginal costs. So, this approach assumes that the counterfactual shares are equal to the disaggregated factual shares. So, in the factual schedules that we have Air New Zealand has a market share of 25% and Qantas has 45%, then under our modelling approach we'll assume that the counterfactual -- in the counterfactual the airlines operate those market shares separately.

On a number of city pairs this approach underestimates the allocative efficiency loss of the alliance. An extreme example. If we had for example Qantas operating 70% of total capacity in the market and Air New Zealand operating none, then the counterfactual would be assumed to be Qantas operating all -- Qantas operating that 70% alone with Air New Zealand operating none; even if the real counterfactual had Air New Zealand operating 25% of the capacity. So, we would estimate no price impact under that scenario when there actually should be, given that both operate in the counterfactual.

And on some city pairs this approach over-states the allocative efficiency loss, and this will happen where both airlines operate the city pair under the alliance, but only one operates it without. So, it's just the opposite of the example that I ran through.

The second option is to use the counterfactual market shares to calculate the marginal costs. However, on a number of city pairs this approach will overstate the price increase associated with the alliance. So, for example, where the level of VBA entry is higher in the factual than in the counterfactual this approach will understate the level of VBA entry with the alliance and hence overstate the price increase. And, where there's no VBA entry in the counterfactual but there is entry in the factual, then you need some assumption to calculate the marginal costs associated with the VBA for the factual.

The third approach is using the base case market shares to calculate marginal cost and this approach is the one that's usually adopted in standard merger analysis, because it allows a before and after comparison and it's based on actual market share information; you don't have to believe the factual and counterfactual schedules supplied by the airlines.

The problem with it is that it doesn't capture all of the information about what would actually happen in the future with and without the alliance: Where the VBA operates in the factual and the counterfactual but not in the base case, the analysis won't pick it up at all; there will just be no VBA because there was no VBA in the base case. So, if you want to include a VBA in this type of scenario you have to make some assumptions regarding that VBA's marginal cost.

And also, Qantas' increase in capacity under the counterfactual won't be reflected in the analysis at all because again the Qantas addition of capacity under the counterfactual won't appear in the base case at all.

We've run the three different scenarios and we've also included in that base case market shares the assumption, or we've allowed the output of the VBA to be determined endogenously, as Professor Willig was suggesting before, was the appropriate approach.

So, we've got those three different approaches. So, we've got three approaches; the disaggregated factual shares, the counterfactual shares and the base case market shares for calculating the marginal costs. So, we ran our model using those three different scenarios, and under the counterfactual market shares approach, the deadweight loss, the total allocative loss goes up, and when we use the base case market shares approach allocative loss goes down. And we're using the assumption there that the VBA costs are 10% higher than the costs of the alliance.

Another issue that we don't incorporate in our model is product differentiation. It's very complex to add product differentiation in the disaggregated model that we've used. So, what we did to look at the impact of product differentiation was to use the Gillen/Hazledine framework where we have the aggregate markets for domestic New Zealand and the Tasman, and we don't have any differentiation between Qantas and Air New Zealand, and they have equal market shares. We do differentiate the VBA from the FSAs but we don't have any Fifth Freedom airlines operating.

So, under that approach we looked at the allocative efficiency loss inside a product differentiation model, and these results -- what's driving these results is the extent of product differentiation that you assume. So, if we used Professor Gillen's assumptions about product differentiation, we get an allocative efficiency loss for the Tasman and domestic New Zealand of $55 million. If we assume that the VBA imposes the same extent of competition on the FSA as another FSA would, then we get $17 million in allocative loss.

CHAIR: So, that would be assuming they constrain each segment of each market in the same way, basically?

MS HARDIN: In the same way as an FSA, yeah. So it's really dependent on what assumptions you make about that.

On price discrimination, empirical and anti-trust literature generally ignores the impact of yield management. Really, introducing price discrimination into this type of modelling is state-of-the-art. There are some theoretical results that have begun to emerge, but really, they're largely untested. And it's unlikely that economics will ever be able to accurately reflect the complexities associated with yield management.

MR CURTIN: I can't resist saying that at this stage the businessmen have a model that the economists have no intuition about.

MS HARDIN: That's fair, but we would say that the Commission's price discrimination work that you presented in your Draft Determination would seem consistent what we would expect; that when you have more price bands, the allocative efficiency loss would be lower than when you have fewer price bands.

So, under your estimates you had \$32 million of allocative detriments with five price bands, and \$85 million with three price bands. So, that's consistent with what we concluded, that ignoring price discrimination in our model is a conservative assumption.

On the intensity of VBA/FSA competition, we think that our model understates the impact of the VBA on fares. We used historical data for domestic Australia and estimated, using our model, what the prices would be with and without VBA entry, and we compared that to actual outcomes, and we found that our model understated the impact of VBA entry on the three major routes where the VBA entered, from between 2 and 13%.

We also ignored the undertakings in our modelling, so we don't try and impose any price cap or capacity floor, and for that reason again we believe our modelling is conservative. And our total results, which we've presented to you before are $160 million worth of allocative efficiency losses over five years.

So, in summary, we believe that the Gillen model is based on a flawed framework and the assumptions and the results that are obtained from that analysis are just implausible. We've tested a number of variation s to our model which address the issues which might be raised, and the impact of these is either small or makes our approach conservative.

PROF ERGAS: Can I add one point, if I may -- thank you, Alexis -- which comes back to the issue of product differentiation, and that point is this: That to get large detriments in the product differentiation model, in essence what you have to assume is, as Alexis noted, that the VBA is considered so inferior a substitute for the product that is offered by the alliance, that its offerings have very little constraining impact on the prices that will be charged by the alliance.

We believe that there is very little evidence, if any, that is consistent with that assumption, i.e. that is consistent with the assumption that consumers so widely regard the VBA product as inferior; that competition from the VBA does not have a price disciplining impact, a strong price disciplining impact on the FSA carriers. Indeed, we note that in Professor Gillen's report, the Gillen/Morrison/Stuart report surveying information about price elasticities, that at section 5 of that report information is presented which highlights the impact that VBA entry has on FSA prices, and that of course is consistent with the work of Professor Morrison and others in the United States and with the results that Cliff Winston and Steve Morrison have obtained in respect of Australia, and we will be tabling some further sensitivity tests in respect of that modelling.

The point I am making is this: That not only is there no evidence that VBAs do not constrain FSA prices, but rather the evidence is that the disciplining impact of VBAs on FSAs is stronger, significantly stronger than our Cournot modelling suggests. What that implies is that the results of the product differentiation models which are based on the strong assumption for which there is simply no empirical evidence that those results cannot properly be given, in our view, any weight in an economic assessment.

CHAIR: Thank you, Professor Ergas. I just want to check now on, that is your presentation fully on the allocative efficiency; is that right?

PROF ERGAS: If I may, Madam Chair, we also have a presentation that, with your indulgence, we would like to present at this stage which responds to a number of points that have been made by Professor Zhang in reviewing the NECG model. There are in the report of professor Zhang a number of comments that refer to information that is confidential to the parties, and in our review of professor Zhang's comments we have had to at only a couple of points rely on information that is confidential to the Applicants.

As a result, in working through the presentation we will provide a full copy of the slide pack of course to the Commission, but the material that will be displayed on the overhead projector will not include that very limited data that is confidential to the Applicants.

CHAIR: I am appreciative of you doing it that way because I think it's preferable not to go into confidential session. I would note, however, that the handouts that will come to the Commission will also be made available to interested parties who have signed the appropriate undertakings, and I'm sure that the Applicants understand that.

PROF ERGAS: Of course.

CHAIR: So, any external experts who wish to have access to that should contact our staff at the end of this session to get a copy of that.

Can I just -- I just want to -- if you just give me a second, I just want to confirm with my colleagues that they're happy to take all the questions after the next presentation. [**Documents distributed**].

Happy to wait on the questions, depending on how long this next presentation will take; can you give us a sense of...?

MS HARDIN: Ten minutes.

MS REBSTOCK: Ten minutes, okay. I think you all are the most productive economists attending the Conference. I think we can declare victory already.

PROF ERGAS: That's why I selected her to present; she's so quick. I'm a lapsed -- I hope not defrocked -- but lapsed Professor, I was once. So it's a courtesy you extend to me but improperly so since my epaulettes have been removed.

MS HARDIN: Okay, Professor Zhang outlined a number of issues in his review of the NECG model, and we've gone through the major ones of those which I've listed here which we'll talk through today.

Professor Zhang argues that there is an inconsistency between NECG's assumptions regarding the counterfactual that, on the one hand, we claim that there are large increases in capacity under the war of attrition, and on the other hand we claim that there's Cournot competition.

As a result, he suggests that the load factors obtained using our approach might be commercially unviable. Instead Zhang claims that a more reasonable alternative may be to depict the war of attrition with a non-Cournot conduct parameter; either negative or even minus 1, which implies perfect competition.

We need to make the point that our use of the term "war of attrition" is not a cut-throat battle which involves dumping of capacity. Rather, it's a prolonged engagement that's consistent with the increases in capacity to date, and this diagram's for the Tasman -- sorry, I didn't label it -- it just shows that between 94/95 and 01/02 the growth in Qantas capacity on the Tasman was 8%, which compares to what we're using as our counterfactual between the base case in year 3, a growth rate of capacity of 9%. So, it's not inconsistent with what's happened over the historical period. And on that slide we've shown the same for domestic New Zealand.

Also, we want to make the point that the difference between our counterfactual and the capacity that's required for the Commission's natural growth counterfactual is only small, and we don't think that that is likely to make the difference between Cournot competition and Betrand competition. Hence, we think the nature of the competition that is used for our counterfactual should also apply to whatever the Commission determines to be the appropriate counterfactual. Again, we've got another confidential slide there to demonstrate the difference between our counterfactual and your counterfactual; why it's only small.

Also, the airlines' own modelling of the alliance doesn't imply any expectation about the nature of competition changing between the factual and counterfactual; the modelling undertaken to inform the airline's decision about the alliance based on the same schedule information used by NECG. Under those scenarios, Air New Zealand and Qantas' modelling estimates an increase in average of about 2% on the Tasman and domestic New Zealand routes between the factual and counterfactual, which we think is inconsistent with the change in the CV parameter or the conduct parameter.

Also, the load factors obtained in the NECG's model are not as low as Zhang seems to imply. For the Tasman under our counterfactual we get an average load factor of 74%, and for domestic New Zealand we get an average load factor under the counterfactual of 69%. We looked at what would happen to the load factors if we assumed more intense competition than Cournot. So, if we change the CV or conduct parameter to minus 0.5, the load factor would go up to 83% on the Tasman and 81% in domestic New Zealand. If we increase it further to minus 0.8, load factors would go up to 89% on the Tasman and 92% in domestic New Zealand. Under those type of scenarios you'd obviously need more capacity to operate those routes effectively.

Also, we think that if we were to assume the counterfactual to be perfectly competitive or close to perfectly competitive, then there would likely be a more rapid failure of Air New Zealand and that would need to be taken into account. We looked at the implications of more intense competition for Air New Zealand's profitability in our model, and again if you change the conduct parameter to minus 0.5, then Air New Zealand's operating profit would be $160 million a year lower than under the Cournot assumption, and if you change it to minus 0.7, it would fall by $285 million compared to the Cournot assumptions.

The second point that Zhang makes is he points -- well, it's actually a point made by the Commission -- that there's an inverse relationship between factual capacity and welfare, and Zhang implies that there's either an error in our model or that the schedules aren't optimal, or that our cost savings are overestimated, but we don't think that that result is counter-intuitive. If you get more capacity in the factual, it does decrease the deadweight loss, and that works through the capacity elasticity. So, if you have more capacity under the factual you'll have more output under the factual regardless of price, so you'll have a lower deadweight loss.

If you have less capacity in the factual you'll also increase cost savings so -- and the source of those cost savings is a rationalisation of capacities. So, if you do increase capacity under the factual, you will get a reduction in efficiency gains, and overall what's happening is that the reduction in -- overall we have -- if you have a reduction in factual capacity, you will get an increase in welfare because the benefit associated with capacity rationalisation outweighs the increase in the deadweight loss, and that's what's happening and that's why that inverse relationship exists.

Also, I think there's an impression that the cost savings we're claiming are very large. They look large compared to the deadweight loss, but when you consider them relative to the total costs of the airlines' operations on the affected routes, it's the cost savings that we're claiming are only 4% of the total counterfactual cost base.

The third issue that Zhang raises is the calculation of the marginal costs. He notes that we calculate marginal costs using the disaggregated factual market shares with the base case price and he claims that that's inconsistent; we should calculate marginal costs using the base case market shares, and that's one of the three approaches that I presented in the session before, and the impact of using the approach that Zhang recommends is a reduction in total detriment of $10 million in year 3 compared with NECG's approach.

Zhang also raised the issue of density effects. He notes that we deal with cost savings outside of the model, which he agrees is appropriate when the cost savings are largely driven by changes in fixed costs, but he also notes that there might be a reduction in marginal costs under the factual due to density effects, and because we haven't taken those into account, our modelling might be conservative, and I think we agree with that.

The 5th issue is the calculation of the deadweight loss in welfare within our model. Zhang notes that we use the marginal costs of the parties under the factual and counterfactual to calculate the deadweight loss. However, he says that the marginal costs of all airlines should be used to do this calculation, and he notes that when you do this the deadweight loss -- and he reports a deadweight loss for all consumers, not just for New Zealand consumers, so it's for New Zealanders, Australians and other foreigners -- falls from $83.2 million to $80.7 million. That's in Australian dollars. And, he says that if you also apply the marginal cost for all airlines' approach to calculate savings in marginal cost, then you actually get a negative marginal cost saving of $86.7 million, so he's saying that the marginal costs, when you use it for all airlines, goes up under the factual compared to the counterfactual. He sums those two numbers together, and again therefore all producers and all consumers, to get a total deadweight loss of $167.4 million.

The first point is that he doesn't allocate those deadweight loss numbers to New Zealand if you allocate the first component of that, which is the normal deadweight loss component, then the amount allocated to New Zealand is $34.5 million. It's unclear to me how you allocate this negative savings in marginal costs to New Zealand versus to other producers, but we think that it is appropriate to use the marginal cost for all airlines to calculate the deadweight loss, but we also should have kept the marginal cost the same between the factual and counterfactual. We don't think that there's any reason why the alliance would increase the marginal cost of other airlines, and the marginal costs of Qantas and Air New Zealand under the alliance, if anything, are likely to be lower than in the world without the alliance as a result of the density effects noted by Zhang.

We don't claim any savings related to changes in marginal cost. All our cost savings are related to changes in costs that are fixed with respect to passengers, and we hold marginal costs constant in our calculations of price and output.

So, the only adjustment required based on Zhang's criticism is to calculate marginal costs using the weighted average marginal cost for all airlines, and to hold that constant between the factual and counterfactual. When you do that the deadweight loss for New Zealand in year 3 falls from A$35.5 million to A$32.1 million and the total allocative loss falls from NZ$23 million to NZ$19 million.

Zhang also makes the point that cost savings are calculated outside of our Cournot model. He argues that the unit cost estimates we use that are calculated based on the financial accounts of the airlines are completely independent of the marginal costs estimated in the Cournot framework. And, he suggests that this approach might be appropriate for computing changes in fixed costs, but not for changes in marginal cost, and we agree, and our estimate of cost savings is limited to costs that are fixed with respect to passengers; we only claim cost savings associated with the number of departures and the number of block hours. We don't claim any savings associated with marginal costs, and hence don't take account of the fact that marginal costs might actually be lower under the factual than the counterfactual.

The final point that Zhang makes that we wanted to comment on was market segmentation, and again this is based on confidential information, so we've had to take it out, but basically that information shows that the entry of Virgin Blue in domestic Australia did not only reduce yields in the economy cabin but also in the business cabin as well.

And I think we make the point as well that Virgin has said on a number of occasion s that it's targeting the business segment of the market as well, and advertises specifically to business customers.

PROF ERGAS: So overall, the conclusion we would draw from that is that there are a number of points that Professor Zhang raises that we agree with; there are a few that we would dispute. Taking account of his points though, would tend to reduce the detriment as calculated rather than increase it.

If I might add one more point to what my colleague has said, it's really a point of emphasis. It's this: Professor Zhang suggests that as between the factual and the counterfactual, because of the greater capacity that would be offered in the counterfactual according to the schedules that have been proposed by the Applicants, competition might be significantly more intense in the counterfactual to the point of approaching perfect competition. We believe that one useful way of sanity checking that result is to look at what the airlines' own financial modelling, i.e. the modelling that informs the decisions their boards have taken about this transaction, modelling which has been examined as part of the record in this application.

What that modelling shows, do the airlines themselves and their financial advisors, who have great experience of understanding airline markets and forecasting competitive outcomes in airline markets, do they believe that prices would be much lower in the counterfactual than emerges from the work that we have done?

Rather, when you look at the modelling that the airlines and the financial advisors to the airlines have done, what you see is this: That the difference is not the difference between their results and results that we obtain; the difference is not that in their results prices are estimated to be much lower in the counterfactual, in fact that's not the case. Rather, the difference is that the airlines themselves believe that prices in the factual would by-in-large not increase in the way that the Cournot modelling suggests.

In other words, the airlines take the view that the type of price increases that the Cournot model implies are unrealistic, and this comes back to the very important point that Professor Willig made, that there are many many respects in which the Cournot approach that we have used is conservative, and that indeed is one of the reasons why we have used it.

CHAIR: Okay, thank you for that. I will take questions now, and I'll start with Commissioner Curtin, please.

MR CURTIN: I only have one, and it was on just looking at page 5 of the paper titled "Allocative Efficiency" where you're talking about conjectural variations, or the conjectural variations approach, and you note it was adopted by Gillen and Hazledine.

Why do you think that they went that approach? What do you imagine they were trying to capture by taking that approach, and why do you believe it leads to -- I suppose there are two questions; the first one is, why would anyone want to go that route, and the second one relating to your point that there are theoretical problems; what are they and what's wrong with it?

PROF ERGAS: The difficulties that we have with the approach that they have adopted are set out in some detail in the Applicants' submission in response to the Draft Determination, and I wouldn't impose upon you to at this stage an attempt to repeat the arguments that we have put. But, suffice it to say this: We aren't -- we really are not in a position to know why Professors Gillen and Hazledine have adopted that particular approach. That's really a question that needs to be put to them.

However, what can be said is that the approach that they have adopted is, in a way, aimed at trying to capture the notion that you may have differing degrees of intensity of competition in a market with a relatively small number of players; and, they have broadly attempted to do that through the use of this conjectural variation parameter in their modelling.

The use of that approach raises two sets of issues. The first set of issues is really analytical and it goes to whether the assumption s that are being made about the way the participants in the oligopoly game view each other's expectations of behaviour, whether those conjectures can be given some rational explanation. So, the core of the analytical issues is to do with what is commonly referred to as the rationalisability of the expectations that parties hold of each other, and the consistency of the conjectures that each party has with respect to the other's behaviour. There the central question is, are those conjectures, as they are modelled, consistent with rational decision-making? There's a substantial literature on that which we summarise in our written submission and which is highly critical of the approach that Professors Gillen and Hazledine have employed.

There's a second set of problems which goes to the question of even abstracting for the moment from whether the conjectures that are being used are theoretically defensible; are those conjectures capable of being tested with respect to empirical data? And so, you can derive those conjectures from, for example, econometric studies which would model the behaviour in the relevant markets.

Now, a fundamental problem with the use of the approach that the models of Professor Gillen and Professor Hazledine rely on, is that there are very substantial econometric difficulties involved in estimating that parameter, and these difficulties are quite apparent in the empirical work that has been done by Professor Hazledine, and the issues or weaknesses involved in that empirical work are criticised both in our submission and in the submission that has been made by Professor Willig.

And so, given that it is difficult on theoretical grounds to justify the approach they have adopted, and though they argue that the parameter that they use is derived from empirical work, when you look at that work there are fundamental difficulties with it; then we conclude that their use of that particular approach is inappropriate.

That said, it's worth noting the following: While we are very mindful of the difficulties that are involved in attempting to estimate CV parameter along the lines that have been done or attempted by Professor Hazledine, we recognise that there is a literature which aims at testing different market outcomes to see whether or not they are consistent with the Cournot assumption, and indeed an important contributor to that literature is Professor Zhang, and there's a widely cited article that he co-authored with Professor Brander which tests that assumption in the context of aviation markets, and finds that the Cournot assumption works reasonably well. It seems consistent with the data that was used in the Brander and Zhang study.

There's a more recent paper; indeed, one that I think is just about to appear in the journal -- I think it's of transport economics and policy -- that does a slight variant, but again testing for Cournot in an aviation market, and yet again finds that that assumption seems a good approximation to the way aviation markets behave.

We have looked at what the Brander and Zhang method tells you about competition in the markets at issue. It's important to note that there are a number of very serious difficulties involved in applying the Brander and Zhang approach, and I'll just mention two. The first is that you essentially have to limit competition to a duopoly. It's extremely difficult to get any results when you take account of the presence of more than two firms; and secondly, you need a robust way of estimating marginal costs so as to apply the Brander and Zhang test.

What we have found, as we have stated on a number of occasions, is that the Brander and Zhang test, though we do not believe that we have estimates with respect to marginal costs that are so robust that we would put enormous weight on them, if you use reasonable estimates of marginal costs and taking account of the biases inherent in the tests, we believe that the data that is available on the record in these proceedings, not only to us but to the Commission and to third parties, shows that applying those tests would give you the result that these markets have outcomes that look either Cournot or very close to Cournot. That doesn't mean that the -- that you can derive from that evidence that is rock solid, I don't believe that, I think there are limits in all of these tests. But nonetheless it makes the basic point that there is substantial literature in economics that applies tests to look at aviation markets, concludes that those aviation markets have the type of competition we model. The data that has been made available is not inconsistent at least with the use of that assumption.

MR CURTIN: Thank you very much.

PROF GILLEN: I think that there was a debate in the literature, and I don't disagree that the CV approach has its detractors, but I also think that there are some who support it.

I would also argue that -- and I don't disagree with you that the empirical literature does provide strong support for a Cournot solution, but I also would argue that the use of the CV approach that I employed was really trying to get at the issue of degrees of competition, and whether it made some difference in terms of the benefits of judgments and, as I say, I think that there is a literature that detracts from that; as a matter of fact, I think Professor Willig's handbook has some of those in it, but it also has some people in it who are supporters of that particular approach.

So, I guess I would disagree with you that the jury has come in and has decided that this is an approach that should not be used in any type of analysis.

PROF ERGAS: Bobby, would you like to comment on this issue?

PROF WILLIG: I have a long lecture on the subject that nobody wants to hear.

I've used the CV approach in my own work and my students have made me sharply aware of where it's patently valid and where more subtle work shows that it's not valid. I think the CVs are valid for representing in an understandable way the degree of competition that a particular market equilibrium holds.

If one takes a market equilibrium and understands elasticity shares, price cost margins, one can deduce CVs, empirically or judgmentally, and have a way to understand where on the spectrum of degrees of competitive intensity this particular market equilibrium lies, and I find it quite useful for that purpose.

Where there's tremendous dangers, as my students teach me, is in taking such a representation and doing comparative statics with it, holding it constant while the rest of the market environment is changed, because if the market is operating through some other game, theoretic solution, be it Cournot or Betrand or repeated games of one kind or another, which is our best theoretical oligopoly model today, you can represent one equilibrium through CVs, but you cannot validly hold that CV constant while you vary the number of players, or vary a marginal cost; you just can't do validly do comparative statics holding the CV constant. So it's good for some purposes, but dangerous for other purposes.

PROF GILLEN: I have a number of questions, some of clarification, and some of explanation. One of the things that you -- you talk about market shares, and in the modelling that you did, you use capacity shares and not passengers. I was wondering if you could offer some justification for using capacity and what the implications are for load factors in your model?

MS HARDIN: We use the capacity shares to approximate market shares, because we were using the factual schedule, so we're looking at a future state of the world; we don't have passenger share information for that future state of the world, so we use capacity shares to approximate the market shares, and airlines agreed that capacity shares were a good approximation for market shares. In terms of the implication for the load factor?

PROF GILLEN: Yeah.

MS HARDIN: I'm not sure, it will affect the marginal cost calculation; if the capacity shares are different from the market shares, it will affect the marginal cost calculation in the price and output results, and hence the load factor through that affect, but unless you know which way that capacity shares are under or overestimating true market shares, it's hard to say what the impact will be on load factors.

PROF GILLEN: Two observations. One is, I believe, and I could be corrected on this, that APG in one of their presentations made the statement that there's no relationship between capacity shares and market shares, in terms of passenger market shares, and that I think that on one of their slides they said that the S curve effect just doesn't hold.

I'm not sure that I agree with that or not. If you look at some of the data in the United States, for example, and this comes from Aviation Daily, that if you do look at the relationship between capacity shares in a market and share of passengers in that market, it varies all over the place, depending -- and it doesn't depend on whether you're a full service carrier or a low cost carrier, so this is the --

MS HARDIN: I think the APG material you're referring to might be revenue shares compared to capacity shares, if it's the material I've seen? I don't think they compare passenger shares to capacity shares.

PROF GILLEN: I agree with that. It was in their slides, and I think the statement was -- is that, when you're looking at capacity shares we're looking at revenue shares, but there was no relationship between capacity shares and passenger shares. That's what I thought I heard, but I could be corrected on that.

MS HARDIN: I think we can easily look at -- I'm not sure --

PROF ERGAS: We can pursue that with APG, but I think the point that APG makes is that city presence affects revenue share in essence, and that a firm that has substantial city presence at either end of a city pair will gain a yield premium from that city presence, and that that will affect its share of city revenues.

I don't think that there is an underlying statement there about the relationship between the capacity shares and passenger market shares, if that's what's being implied. My belief would be that by-in-large over the longer term those two variables would tend to move together.

I mean, obviously you might assume that for example a value based airline or a low cost carrier might have a higher share of passengers than its share of capacity because it would perhaps operate to a higher load factor.

PROF GILLEN: In fact, it's just the opposite. Southwest has substantially more capacity than passengers.

PROF ERGAS: But in our modelling we don't believe that there's any systematic bias that is introduced by the assumption that broadly in the factual the capacity shares would be reflective of anticipated passenger shares.

MS HARDIN: I think it would be easy enough to test, using historical information, the correlation.

PROF GILLEN: Exactly. You can have an empirical basis for that assumption.

MS HARDIN: Yeah.

PROF GILLEN: The second question: You didn't speak to how you handle Fifth Freedom carriers in your modelling, and in particular differences under the factual and counterfactual since you didn't have capacity shares for them, and in your explanation it implied as if Qantas and Air New Zealand were the only players in the market.

MS HARDIN: No, we have Fifth Freedom carriers in the factual and counterfactual, exactly the same capacity; we just use the base case market shares for them, or capacity for them and actually increase their capacity at the natural rate of growth, natural rate of demand growth. We increase their capacity in the model, so we've got the base case capacity for Fifth Freedom carriers, and we increase that to whatever year we're looking at.

So, in year 3 we just increase it at the natural growth rate, natural rate of demand growth. So, they have more capacity than in the base case, but exactly the same capacity as between the factual and the counterfactual.

PROF GILLEN: Is that what you observe empirically, with the Fifth Freedom carriers?

MS HARDIN: That they increase capacity in that way?

PROF GILLEN: Yeah, at the natural market growth rate, yes.

MS HARDIN: They're not all likely to increase their capacity at that sort of rate; in fact, we have some of them flying at, you know, fractions of aircraft, but we thought that was probably the most sensible approach to try and approximate what their capacity would be in the different years.

I think it makes no difference because we have the same level of Fifth Freedom capacity in both, and we don't have the new Fifth Freedom capacity put on by Emirates on the Tasman. They weren't there at the time we did the analysis. So, we probably have Fifth Freedom capacity than we should.

PROF ERGAS: We also don't assume that there's an additional expansion in Fifth Freedom capacity as a result of price changes in the factual.

So, our broad assumption is that the Fifth Freedom capacity in both the factual and the counterfactual simply increases with the natural rate of growth of market demand, and we do that again -- and I believe that we noted this, perhaps we didn't emphasise it sufficiently in the original submission -- but we certainly noted it, that that was done as a way of ensuring further that our results were conservative.

CHAIR: We need to interrupt the discussion that we're having now, we will continue it at 9 o'clock in the morning.

What I'd like to do now is thank you for the presentation so far, and I will assume you will be available for further questions in the morning on this.

The Applicants have agreed to provide the Commission with the handouts, and I would imagine these will be provided to all parties tonight, the handouts for the remaining sessions.

When we finish the questions on this session in the morning they will then move straight to questions on those handouts; there will not be presentations done on them.

I would like to ask Virgin Blue to be available at 10 o'clock in the hopes that, no later than 10.30 we can start the scheduled session with them.

So, that is the plan for tomorrow and, for anyone who may want to know, the plan tomorrow evening is to go until 6.15 in the evening.

We're starting at 9 in the morning and going till 6.15 in the evening. So, I'd like to thank you all, once again, and I will adjourn the meeting for tonight. Thank you.

Hearing adjourned at 5.43 pm
Resuming Thursday, 21 August 2003 at 9.00 am

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