

21 AUGUST 2003

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3 **CHAIR:** Good morning ladies and gentlemen. I'd like to welcome  
4 you to the fourth day of the Commerce Commission's hearings  
5 into the applications from Qantas and Air New Zealand.

6 I just want to, before we start, indicate that we have  
7 received a further letter from Air New Zealand regarding  
8 slots, ground handling and other such matters, and we would  
9 be making that available to any interested party who would  
10 like to see it.

11 I think, to the extent possible, I'm hoping at some  
12 point these exchanges might settle during these proceedings,  
13 but...

14 **MR P TAYLOR:** Getting very close, Madam Chair.

15 **CHAIR:** I might hold you to that. Okay, and I understand  
16 there's also been a written response to some of the  
17 questions that I put to Dr Ergas yesterday on why we've seen  
18 a delay in entry by low cost carriers in Australia and  
19 New Zealand, and again, I assume that that can be made  
20 available to all interested parties?

21 **MR P TAYLOR:** I think it already has been.

22 **CHAIR:** It has been? Okay, thank you very much.

23 Now, before we proceed I would like to ask the  
24 Applicants to read into the record the title of the  
25 presentations that have been tabled with the Commission,  
26 which we did have the opportunity to look at yesterday. We  
27 will be taking questions this morning on those documents as  
28 well as the presentations that we heard late yesterday.

29 So, Mr Taylor, if you could read into the record the  
30 documents that you tabled with the Commission, please.

31 **MR P TAYLOR:** Thank you, Madam Chair. The documents which have

*Preliminary Matters*

1 now been handed to the Commission, without presentations,  
2 include a slide presentation on productive and dynamic  
3 efficiencies, a slide pack relating to cost savings, a slide  
4 pack relating to balancing of the benefits and detriments, a  
5 slide pack relating to the issues surrounding the freight  
6 market benefits, and a slide pack relating to the travel  
7 distribution market, and a short paper you've already  
8 referred to, Madam Chair, relating to delays in the entry of  
9 low cost carriers.

10 **CHAIR:** Thank you very much.

11 **MR P TAYLOR:** We invite questions on all of those.

12 **CHAIR:** Okay, we will now move on to the questions.

13 Can I say that we do need to start with the Virgin Blue  
14 presentations as close as we can to 10 o'clock; 10.30 at the  
15 latest. If we do not complete this session then I will come  
16 back to it later in the day.

17 If can I ask Dr Pickford, please, to start with the  
18 questions. I might just, for the record, indicate before we  
19 start that my lateness was not due to either of the airlines  
20 involved in this application. [**Pause**].

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1 on the consumer side, then that is enough to the Professor  
2 that it's win/win and in fact tallying up the consumer  
3 benefits, as we've tried to do, is an underestimate of the  
4 total social benefit because it omits what is presumably an  
5 additional benefit to the producer. If that were not a  
6 benefit but a net harm to the producer, it would have been  
7 avoidable by the producer to simply not do that pricing  
8 move. And so, I think the logic is plain that tallying up  
9 the consumer benefit understates the social benefit from  
10 that change.

11 **DR PICKFORD:** In terms of the consumer benefit, your measure is  
12 in terms of the price fall that they experience, but surely  
13 the underlying benefit is the enhanced convenience and the  
14 measure of the price fall may not tally with the actual  
15 convenience that they experience.

16 **PROF WILLIG:** Well, suppose this is the situation; I choose  
17 product A, product B is available; say, product B is  
18 available at a lower price, but I for my personal balance of  
19 cost and product characteristics -- I'm forgetting which is  
20 A and which is B -- I choose the more expensive one because  
21 it's better for me in terms of its characteristics. And now  
22 a change occurs, the price of B is lowered because the  
23 producers have now elected to in view of the alliance.

24 Now, it's a double win for me as a consumer. I can  
25 still enjoy the product that I chose, namely the schedule,  
26 the timing of what used to be inter-line instead of on-line,  
27 but now it's available to me at a superior price. And so, I  
28 get both the timing that I desired and now I get that same  
29 timing available at the better price, and so, an estimate of  
30 the gain to the consumer from that move is the decline in  
31 price.

1           The study that we did assumes that the consumers stay  
2 with their chosen schedule, but get that same schedule at  
3 the lower price that would be theirs if it had been an on-  
4 line opportunity. The moment the alliance forms, that same  
5 itinerary which had previously been inter-line now  
6 automatically becomes on-line because it's within the  
7 offices of the alliance, and this is assuming no  
8 rearrangement of the actual departure times and the  
9 deployment of the aircraft, which would be presumably a  
10 source of further benefit but not something that we're  
11 speculating about in that particular study.

12           So, holding everything constant, lower price because  
13 that's what the data shows is the truth of the market both  
14 here and internationally, and that's an underestimate of the  
15 total social benefit.

16 **DR PICKFORD:** In terms of the price, you measured it in terms of  
17 the change in business fares between inter-line and on-line  
18 and averaged it at 20%.

19           How representative do you think that would be of all  
20 fares? Business Class fare are relatively a small  
21 proportion, I guess, of all fares. If you were to apply the  
22 analysis across the board, would you get as much as a 21%  
23 fall or...?

24 **PROF WILLIG:** It's a worthwhile subject to grapple with. We had  
25 our researchers back home working with the internet prices,  
26 the data source, for a variety of different categories of  
27 fares that were not the unrestricted business fares, and we  
28 basically threw up our hands because we could not discern  
29 via this internet source of data what were comparable  
30 classes of non-business fares, what were the restrictions;  
31 and we tried mightily and gave up on it because we couldn't

1 do it in a reliable way. So this was our best source of  
2 comparable price data.

3 **DR GUERIN-CALVERT:** I think the other part, a question was asked  
4 yesterday as to exactly what we had done by Commissioner  
5 Bates and I went back and checked, and for the reasons that  
6 Bobby indicated, what we had done is on the first half of  
7 the segment chosen an Air New Zealand flight with a  
8 particular -- a real itinerary, and we got the Business  
9 Class fares off of the Air New Zealand website. The second  
10 half of the route, we took a Qantas Business Class fare and  
11 then we compared that to a Qantas on-line, and the reason  
12 why we did that is that there were no Air New Zealand on-  
13 lines to compare it with, and we had taken as well the on-  
14 line fares and the return fares off of the websites.

15 We do have our staff going back and checking, but just  
16 to confirm, we did not use the Virgin Blue fares; they do  
17 fly on some of those itineraries.

18 **MS BATES:** I think they're starting to introduce a bit of  
19 Business Class but I think it's all one class which made me  
20 think you hadn't gone with the Virgin option.

21 **DR GUERIN-CALVERT:** And what we are trying to do, to respond to  
22 your question is, by our staff just going on to the  
23 websites, they were unable to do the -- a very precise  
24 economy calculation. We are endeavouring to try to follow-  
25 up to do a more comprehensive look at that time.

26 The one thing I would mention is that, a number of the  
27 empirical studies that have evaluated the fare reduction do  
28 look across broader fare categories and across average  
29 yields and find this kind of result, so it's in general a  
30 broader result in terms of the empirical studies, including  
31 the Carlton one, as opposed to just looking at business

1 fares. A number of those studies had access to more broadly  
2 available yield data that looked across a wide range, but  
3 we'll endeavour to try to do something specific.

4 **MS BATES QC:** Just to correct a misapprehension you may have had  
5 yesterday because I asked what was the difference between  
6 the \$900 Perth fare and the inter-line; I went and checked  
7 at home with what we'd done, actually the story was that the  
8 inter-line fare was \$20 cheaper but that the waiting time  
9 was significantly reduced by the on-line option.

10 So, the prices were identical and I have to say that  
11 these were fares that students were looking for, so they're  
12 fares at the bottom end. But however, there's a whole range  
13 available, so taking just one end of the spectrum may not  
14 give you the right picture.

15 **DR PICKFORD:** Just one more question on the same theme. The  
16 Business Class fare comparison you make is both without the  
17 alliance, and I suppose the more appropriate comparison  
18 would be business fares, as they are now without the  
19 alliance, and business fares after the alliance has been  
20 introduced, and so there's an issue about whether in fact  
21 those fares will in fact be impacted by any market power  
22 that might arise.

23 **PROF WILLIG:** Well, that's for sure. The way we have proceeded  
24 here is to discuss the conceivable harms to competition and  
25 how to analyse those; that was the subject of our lengthy  
26 presentation in the morning, and then to the side in a  
27 separate category of analyses look for direct evidence  
28 pertinent to New Zealand on the subject of what are the  
29 expected benefits from the formation of an alliance like the  
30 one before you with particular regard both to the  
31 convenience factors that consumers have experienced

1 elsewhere and applying them to the data that pertain here,  
2 and also to the pricing issue which is the expectation that,  
3 for whatever would be the state of competition, it is to be  
4 expected both from local and international experience that,  
5 for that state of competition it is to be expected that on-  
6 line fares are substantially less than the sum total of the  
7 inter-line fares for the same itinerary where there's not a  
8 coherent on-line alliance-like relationship.

9 So yeah, if you're worried about monopoly on the one  
10 hand there are consumer benefits on the other. If the  
11 concern about monopoly was minimal, which was the conclusion  
12 of our presentation about competitive effects, but the  
13 benefits appear to be substantial, then it would seem like a  
14 good policy move to permit the alliance to form.

15 **DR PICKFORD:** Yes, but the point is that if there were market  
16 power effects generated by the alliance then that would  
17 undermine the benefits that you are claiming because it may  
18 be that the on-line fares, once the alliance is introduced,  
19 would be higher than the inter-line fares are now before the  
20 alliance is introduced before you have competition.

21 **PROF WILLIG:** Well, there's no doubt about it that if the  
22 Commission finds serious detriment to competition from the  
23 formation of the alliance, that would be a very substantial  
24 counter-weight to what our studies show are the expected  
25 benefits from the alliance.

26 But if on the other hand there's thought to be a  
27 minimal, or perhaps even no danger to competition but here  
28 is strong evidence of the potentiality of substantial  
29 consumer benefit, then the right decision would seem to me  
30 to be to permit the alliance at this time.

31 **DR PICKFORD:** Thank you.



1 **PROF WILLIG:** I have a number of questions for NECG, some are  
2 just for clarification and others are more substantive.

3 On the handout called "Allocative Efficiency" on page 26  
4 you refer to a price comparison, and I wanted to know what  
5 price you're talking about here. Is that an average price,  
6 is it yield, is it full fare economy?

7 **MS HARDIN:** It's average yield.

8 **PROF GILLEN:** So it is yield, so it would be a weighted average  
9 price, is that correct?

10 **MS HARDIN:** Yes.

11 **PROF GILLEN:** So, the price for example, if we look at Sydney-  
12 Melbourne, the yield is \$160 and the model price after VBA  
13 entry is \$153. Is that also a yield because you used fares  
14 in your model?

15 **MS HARDIN:** The fares in the model are average yields.

16 **PROF GILLEN:** Are weighted average?

17 **MS HARDIN:** Yeah, as well; same information.

18 **PROF GILLEN:** I'd also like to go back to the role of Fifth  
19 Freedom competitors, and I believe yesterday you said that  
20 the Fifth Freedom were, in your model, simply taken at  
21 capacity and then the capacity was allowed to grow at a  
22 certain rate, and that rate was for each year over the  
23 five years.

24 **MS HARDIN:** Yes.

25 **PROF GILLEN:** It appears to me that in a number of your  
26 presentations that the presence of Fifth Freedom carriers is  
27 being treated as a fairly significant competitive force  
28 against the alliance, so in other words, it's tempering the  
29 impact of the alliance on fares. And yet, within the model  
30 it's benign, it's not really playing that role, there is no  
31 reaction, there is no competitive response within the model

1 of the Fifth Freedom carriers, and I wonder if you would  
2 comment on that.

3 **PROF ERGAS:** I'm not sure that's quite correct. The way the  
4 model works is it treats the Fifth Freedom carriers as  
5 suppliers into the market and hence their supply into the  
6 market affects concentration margins and market price. What  
7 is correct is that it's plausible that were you to have the  
8 type of price increases that we estimate in the factual,  
9 that you would get greater expansion of Fifth Freedom  
10 capacity than we model and that that would temper the price  
11 increases that we've projected in factual.

12 In other words, very much along the lines of the  
13 comments Professor Willig made yesterday about the  
14 architecture and limitations of the Cournot approach; we  
15 don't have in our modelling a response where the Fifth  
16 Freedom carriers expand their capacity even though there  
17 might well be profitable opportunities for them to do so.

18 **PROF GILLEN:** So, the notion of them being a competitive  
19 threat is one that is notional as opposed to one that comes  
20 out of the results of the Cournot model?

21 **PROF WILLIG:** Henry, you're saying they are in?

22 **PROF ERGAS:** Exactly, they're in.

23 **PROF WILLIG:** They're in the capacity that's set by the growth  
24 curve, and you're not being more aggressive about the  
25 modelling expansion that they might bring where market  
26 conditions different, but nevertheless they're in the market  
27 with your projected capacity share. And that's certainly  
28 within a Cournot model as a very significant impact to the  
29 extent that the share of capacity you've modelled them as  
30 having is significant. And I take it that it is on those  
31 routes where they're presently operating.

1 **PROF ERGAS:** Yeah, basically on the city pairs where the Fifth  
2 Freedoms are a significant force, then they count in the  
3 model essentially in relation to the market share of  
4 capacity that they bring to the market.

5 **PROF WILLIG:** And by them being in the model, like any Cournot  
6 model, they're affecting the price, they're affecting the  
7 elasticity as perceived by the alliance, and the factual by  
8 the players and the counterfactual, and influencing the  
9 shares and the outputs of all the other players by dint of  
10 their presence. Had you zeroed them out, of course prices  
11 would have been higher and the alliance, or the parties  
12 would have had correspondingly more output and more market  
13 power.

14 **PROF ERGAS:** Yes, and our approach is conservative in two  
15 respects there. The first is that, you might expect, and I  
16 think it would be reasonable to expect, that if prices and  
17 margins were higher, that the Fifth Freedoms would play more  
18 of a role; they would, for example, be more aggressive in  
19 selling seats into the market --

20 **MS BATES QC:** Could I ask you a question please, Professor  
21 Ergas, as we like to call you.

22 **PROF ERGAS:** There are too many genuine professors around for me  
23 to be uncomfortable with that.

24 **PROF WILLIG:** It's the "Ergas" that's really unique.

25 **MS BATES QC:** Now, you said a few moments ago that there would  
26 be price increases in the factual.

27 **PROF ERGAS:** Yes, that's correct, our modelling suggests higher  
28 prices in the factual than in the counterfactual.

29 **MS BATES QC:** That must be assuming that Virgin doesn't come in,  
30 mustn't it?

31 **PROF ERGAS:** No, the --

1 **MS BATES QC:** Well, in the factual, I think as is currently in  
2 the Draft Determination, Virgin doesn't come in.

3 **PROF ERGAS:** Sorry, that's in the Commission's factual as it's  
4 in its Draft Determination.

5 **MS BATES QC:** Does Virgin come in on your assessment?

6 **PROF ERGAS:** Yes, that's correct, it does.

7 **MS BATES QC:** Well, I'm having a problem with this because we  
8 had evidence from both players that say they would match the  
9 Virgin fares, so why is it that you say there will be price  
10 increases?

11 **PROF ERGAS:** The point is really this, that our modelling of  
12 Virgin and its impact is deliberately conservative. So what  
13 we assume in fact, perhaps the simplest way of putting it  
14 is, we assume in our modelling that Virgin is like a smaller  
15 scale version of the full service airlines, and it affects  
16 prices and outputs in much the same way that a full service  
17 airline with a relatively low market share, not low in  
18 absolute terms, but lower relative to the alliance, would  
19 affect prices and outputs.

20 Now, we do that because that's an extremely conservative  
21 way of modelling the world, and we recognise that, and in  
22 the submission we put, we explain that, in our view the  
23 approach we've adopted to modelling the impact of the VBA  
24 likely significantly understates the impact of the VBA. It  
25 does so really because it abstracts from the very important  
26 point that Dr Winston made in his presentation the other  
27 day, that identity matters, as he puts it; that it's not  
28 irrelevant what the nature of the competitor is in that  
29 particular competitors such as low cost carriers have an  
30 especially marked impact on fares. We don't pick that up.

31 **MS BATES QC:** So, can you please just say -- you say it's a

1 conservative way of looking at the world, right?

2 **PROF ERGAS:** Yes, that's correct.

3 **MS BATES QC:** Okay. We've heard from a number of people here  
4 from the Applicants that the barriers to entry by the VBA  
5 are low, that there's nothing -- that Virgin has a very  
6 solid base, that it's poised to enter and it will enter, and  
7 if it does enter it seems to me all the evidence points to  
8 the fact that the fares from the other two would come down  
9 to match, and I just can't see why that wouldn't happen.  
10 And, you know, I'm sorry to sort of badger you a bit on this  
11 point but it is important for us to understand how that  
12 works with your model, and it may be that I shouldn't be  
13 talking because I'm not -- I'm a lawyer not an economist.  
14 It's probably obvious, but I need to understand why that is  
15 so.

16 **PROF ERGAS:** Let me, if I may, address that by making two points  
17 and then perhaps I'll ask if Cliff and then Bobby or Meg  
18 would like to comment.

19 The two points are these: Our modelling framework is a  
20 conservative modelling framework, we've always said that,  
21 it's a modelling framework that tends to overstate  
22 detriments, and it overstates detriments because it  
23 abstracts from the fact that the mass of studies, and  
24 I believe Cliff will bear me out on this, the mass of  
25 studies shows that competition from low cost carriers has a  
26 significant effect, disciplining effect on fares above and  
27 beyond the rather moderate type of effects that our  
28 modelling framework picks up. So that's the first point,  
29 our modelling framework and the assumptions it makes about  
30 how effective the competitive discipline that comes from  
31 value based airlines is, is an extremely conservative one.

1           The second point that is also important is that we have  
2           in our modelling value based entry in both our factual and  
3           the counterfactual, and what our estimates of detriments  
4           pick up is not a comparison of the world in the future with  
5           the world today; it's a comparison of two future worlds, and  
6           in both of those future worlds you have in our modelling  
7           value based airline entry.

8           So, even though the VBA enters and has an impact which  
9           is, we agree, a relatively moderate impact in our modelling,  
10          the extent of that is, in terms of dissipating the  
11          detriments, is somewhat limited by the fact that that entry  
12          occurs in both the factual and the counterfactual world.

13          But that said, I would come back to the core point I'm  
14          making, which is that because of the modelling approach that  
15          we've adopted, abstracting from the role and impact that in  
16          practice VBA entry has, we get fairly conservative results  
17          with respect to price.

18          If I may make one final comment there, I think it is  
19          telling that the financial modelling done for the airlines  
20          suggests that the price -- that you will not see the type of  
21          price increases, the scale of price increases that we  
22          project as between the factual and counterfactual world, so  
23          the airlines themselves, their boards in taking these key  
24          business decisions, don't believe what we believe and what  
25          we model, which is these quite significant price detriments.

26 **MS BATES QC:** Yeah, but you don't actually believe them, do you,  
27          you're just taking a conservative approach?

28 **PROF ERGAS:** Exactly, and I think Dr Winston might want to --

29 **CHAIR:** I'll just ask that you let the Commission direct the  
30          questions to who we think is relevant because, I think, if  
31          the Commissioner has further questions she'll follow it up,

1 otherwise we probably should pursue the questions.

2 **PROF ERGAS:** Fair point. I'm quite happy with that.

3 **MS BATES QC:** So, you chose a conservative model to be a nice  
4 guy?

5 **PROF ERGAS:** Well, we chose a conservative model because we  
6 recognise that economic modelling, as Professor Willig very  
7 rightly, in my view, emphasised yesterday, all applied  
8 modelling of this kind where you're trying to assess what  
9 will happen in the future relies on a number of assumptions,  
10 and what you want to do is be explicit about those  
11 assumptions but also ensure that --

12 **MS BATES QC:** It's a margin of error?

13 **PROF ERGAS:** You're not making assumptions that biases the  
14 results in your favour, and so, what we did was, we said we  
15 believe for many reasons that we don't have time to go into  
16 at the moment, we believe that there is a compelling case  
17 that there will not be a significant competitive detriment.

18 However, let's adopt a modelling approach that is widely  
19 used in respect of this industry which we know is both well  
20 tested and conservative and see whether, in using that  
21 modelling tool, we can still examine sensibly the types of  
22 welfare consequences that this alliance will have.

23 **MS BATES QC:** So you can say even on worse case scenarios,  
24 benefits being probably much greater than the actual  
25 situation, that it all works to a net benefit?

26 **PROF ERGAS:** Exactly.

27 **MS BATES QC:** Yep, I understand. Probably I should leave it to  
28 the economists.

29 **PROF GILLEN:** I would like to revisit the Fifth Freedoms.  
30 What's the assumption on and the load factors in the Fifth  
31 Freedom carriers in your model? Are they constant?

1 **MS HARDIN:** Between the factual and counterfactual?

2 **PROF GILLEN:** Well, yes.

3 **MS HARDIN:** Yes, they just stay constant.

4 **PROF GILLEN:** So there's no competitive response. So, if Virgin  
5 Blue enters and lowers fares as is claimed, then there is no  
6 response on the part of the Fifth Freedom carriers that they  
7 would exit the market?

8 **MS HARDIN:** True, yeah.

9 **PROF GILLEN:** I also would like to -- this is probably a point  
10 of clarification, but in your handouts that looked at the  
11 response to Anming Zhang's criticisms on page 19 of that  
12 handout, where the criticism is, is that your cost savings  
13 are done completely outside of the Cournot model, so it's  
14 abandoned and you use block hour costs, and you make the  
15 argument at the very bottom of the page:

16 "NECG does not claim any savings associated with  
17 marginal cost and hence does not take account the fact that  
18 marginal costs may be lower under the factual."

19 And if you go to your handout called "Cost Savings" and  
20 you look at page 5, you say here that:

21 "Cost savings are calculated as the difference between  
22 the operational and capital costs associated with the  
23 factual versus the counterfactual."

24 That seems to be at odds with one another because in one  
25 case you're saying variable costs are not in, and in the  
26 second case you're saying they are in.

27 **MS HARDIN:** We don't include any cost savings that vary with  
28 respect to passengers. They are variable with respect to  
29 departures and variable with respect to block hours, but not  
30 with respect to passengers.

31 **PROF GILLEN:** So that's the argument as to why you can abandon



1 the costs that you calculated under the Cournot model and  
2 use these other block hour costs?

3 **MS HARDIN:** We don't calculate any cost savings under the  
4 Cournot approach.

5 **PROF GILLEN:** No, I understand that, but there are some costs  
6 that come out of the Cournot approach and they vary  
7 significantly between routes, but you basically ignore that,  
8 you basically take the passengers and the prices in the  
9 Cournot model and you go outside of the Cournot model and do  
10 all of your cost savings calculations?

11 **MS HARDIN:** That's right.

12 **PROF ERGAS:** We do essentially, with respect to fixed costs, the  
13 approach that Professor Zhang recognises is appropriate;  
14 which is that calculating changes in fixed costs outside of  
15 the Cournot model.

16 There's then the question of what happens with respect  
17 to marginal costs. Now, we believe it's implausible that  
18 you would have the alliance and marginal costs would  
19 increase. We believe that under the alliance both the  
20 commercial imperatives of the party and commonsense  
21 associated with the recognition of the fact that there are  
22 economies of density suggests that marginal costs are more  
23 likely to fall. However, we don't claim any cost savings in  
24 respect of marginal costs, and so the fact that they are  
25 more likely to fall than to rise does not flow through into  
26 the benefits that we claim.

27 **PROF GILLEN:** You have a PAX burn, you reduce capacity and  
28 these are your cost savings, and so you're reducing  
29 economies of density and you're now claiming that your  
30 marginal costs don't go up? I mean, if your passengers were  
31 to increase I could see that.

*Applicants (cont)*

1 **PROF ERGAS:** No, no, we -- what happens in the -- under the  
2 alliance is that the combined load of passengers is managed  
3 jointly by the alliance parties, and it's that joint  
4 management of that overall load that, for example, allows  
5 the efficiencies in respect of aircraft selection and in  
6 respect of schedules that we take account of.

7 Now, one aspect of those efficiencies in aircraft  
8 selection and in scheduling would be that you would expect  
9 the airlines to achieve cost efficiencies, and one aspect of  
10 those cost efficiencies would likely be reductions in the  
11 variable per passenger costs. But we don't take any account  
12 of those in terms of the cost savings that we claim.

13 **PROF GILLEN:** Okay.

14 **MR PETERS:** This is a question that we covered in part  
15 yesterday; when it was suggested that the Commission had, in  
16 some sense, accepted the schedules in the factual and the  
17 counterfactual submitted as part of the NECG model. First  
18 I'd like to assure the Applicants that this was not in fact  
19 the case and as outlined in Professor Zhang's report we did  
20 attempt to change the schedules to test the NECG model.

21 NECG in response to the finding in Professor Zhang's  
22 report that a reduction in capacity increases welfare stated  
23 that this is because cost savings are larger in the NECG  
24 model than welfare reductions.

25 Now, I would agree with this insofar as their model cost  
26 savings do indeed dominate welfare changes. But I'd just  
27 like to illustrate this aspect of the NECG model further  
28 with some simple examples, if you would.

29 We've already heard that decrease in capacity in the  
30 factual with respect to the counterfactual increases  
31 welfare. It is also true that increasing capacity in the

1 model even by a small amount reduces welfare as measured in  
2 the model. Indeed there is a negative relationship between  
3 the output and welfare such that total welfare is maximised  
4 in the model when the Applicants have shut down, i.e. Have  
5 no flights in factual.

6 My question is this; how can a competition authority use  
7 a model that in the way I have described seems to run  
8 counter to economic theory and standard analysis?

9 **PROF ERGAS:** Well, I'm not sure that that's a question; it seems  
10 to me to be more of a statement of a point of view. What I  
11 would say about our model is this; is that essentially our  
12 model, which uses a very widely used modelling approach that  
13 has been used by Professor Zhang himself and Professor  
14 Gillen and many others, looks at the change in welfare that  
15 is likely to arise as you move from the factual to the  
16 counterfactual schedule.

17 What you are suggesting is that, instead of the factual  
18 and the counterfactual, what we should look at is a  
19 hypothetical world in which the airlines decide that really  
20 what they want to do is a form of, not even euthanasia, but  
21 hari-kari, and essentially abandon what are profitable  
22 opportunities to serve the market, and shut down their  
23 capacity and exit.

24 Now, clearly, if you take such a completely implausible  
25 view of the world, don't admit any response by competitors,  
26 because that's what you've presumably done; you've exited  
27 that but you haven't adjusted anything else, right. So, if  
28 you ask models questions that perhaps would not sensibly be  
29 described as reasonable questions, much less questions that  
30 were well and fully consistent with the approach that one  
31 would normally take, well, you know, if you ask that sort of

*Applicants (cont)*

1 question the model will tell you what you want to hear. You  
2 assume that capacity shuts down, that no-one else responds,  
3 you then say look, this model generates this result; well,  
4 the model is telling you what you want to hear.

5 The reality is, when you look at the model within these  
6 reasonable ranges, which are the factual relative to the  
7 counterfactual, on the very conservative assumptions that  
8 we've made, what basically happens is that the benefit  
9 associated with capacity rationalisation outweighs the  
10 increase in their weight loss.

11 So, we don't say there is no increase in deadweight  
12 loss. We don't say there is no price effect. We say, when  
13 you look at that world there are changes that occur, but on  
14 a sensible assessment of those changes, within the framework  
15 of the model and recognising the limitations that this model  
16 like all models have, then what you see is that the benefits  
17 outweigh the costs.

18 **CHAIR:** I'd like to follow that up please and I'd like to direct  
19 my questions to Professor Willig. I am not an  
20 econometrician but I read a lot of -- and we hear a lot of  
21 evidence on models, and one thing I'm quite clear on is that  
22 it is an often taken step to do a bit of sensitivity  
23 analysis on key results and ask, does this tell us what we  
24 sensibly might think might happen in the real world.

25 It does seem to me that capacity is an issue at play  
26 here, and in fact in your earlier talk you talked about how  
27 regulators tend to see this issue of capacity and that it  
28 does matter and that normally I think increases in capacity  
29 are a positive thing for consumers.

30 So, I'd just like your view on, leaving aside whether we  
31 ask whether they completely go out of the market. If you

1 get a result generally that shows an effect going in a  
2 particular direction, and you think it's a particularly  
3 relevant factor to take into consideration when you think  
4 about welfare, is this such an outrageous thing to do when  
5 you test the model, in your view?

6 **PROF WILLIG:** In my view it's always a good idea to test your  
7 models in ways that might possibly reflect areas where the  
8 modeller, or the users of the model might be less than  
9 certain about the calibration of the model.

10 For example, when we estimated the benefits we used the  
11 elasticity of 1.3, but there was reasonable doubt about, is  
12 it exactly the accurate number, it's a weighted average  
13 after all, let's take it through its range of plausibility  
14 to see if that really changes the results in an important  
15 way, and we understood in that way moving the parameter  
16 through that range did affect the results and made me feel  
17 more comfortable about the results that we presented to you  
18 because of that sensitivity analysis.

19 But it's important to do sensitivity analysis in the  
20 relevant range, changing the model in ways that are  
21 imaginable but no model is going to stand up, or very few  
22 models stand up, as an econometrician would say, out of  
23 sample; shocking it in ways that are implausible, no model  
24 is going to give a global prediction of all conceivable  
25 circumstances.

26 **CHAIR:** I understand that, but it should tell us reliable things  
27 about key factors, and in your earlier talk you certainly  
28 seemed to think that there is certain things you might  
29 expect to see, in fact want to see happen with capacity.  
30 And I would have thought capacity is not a minor issue for  
31 us in what we might want to look at.

*Applicants (cont)*

1           So, I would like actually for you to respond to the  
2 question that was put before, and with respect I think it  
3 was a question, we're asking your view on the observations  
4 that were made. Is this a reasonable thing to look at in  
5 terms of sensitivity analysis around the use of these  
6 models? I believe Professor Zhang thought it was.

7 **PROF WILLIG:** On capacity, just to tie this back to our  
8 conversation about capacity yesterday; it's not my view that  
9 in all circumstances more capacity is better for the  
10 economy --

11 **CHAIR:** I understand that, but under some circumstances it is.

12 **PROF WILLIG:** Oh, sure.

13 **CHAIR:** And I'm sure you'd agree that no capacity is not  
14 necessarily a good thing.

15 **PROF WILLIG:** No capacity is not going to be very good for a  
16 supplier, that's for sure, but hopefully no capacity is well  
17 out of sample here, and so...

18 **CHAIR:** I understand that point, but we don't have to go to no  
19 capacity to get the result that was spoken of, we just have  
20 to have small changes to demonstrate the result.

21 **PROF WILLIG:** The exact controversy about what Professor Zhang  
22 found with capacity and how the internal models of NECG  
23 reflect changes in capacity with respect to the cost side  
24 and the delivery side is something that we've heard Henry  
25 and Alexis speak to, and while I can't say, like you, you  
26 know, that's for the model builders to explain to us --

27 **CHAIR:** Well, you've undertaken a review of these models and  
28 you've given us your expert opinion on them, so I think you  
29 must be in a good position to comment on this matter.

30 **PROF WILLIG:** Well, I, in fairness, will say to you that I have  
31 not undertaken the sensitivity analysis myself of the NECG

1 model with respect to changes in capacity.

2 **CHAIR:** Well, let's just take it on read what has been put to  
3 you. If you found that result, what would you think?

4 **PROF WILLIG:** So what was precisely the result that was  
5 upsetting that you're asking about, if I may?

6 **MR PETERS:** There is a negative linear relationship between  
7 output and welfare, so by -- basically at any level if you  
8 reduce output then welfare increases.

9 **PROF WILLIG:** And that's through the marginal cost effect?

10 **CHAIR:** No, I don't want you directing questions to someone  
11 else, I'm asking you --

12 **PROF WILLIG:** I'm trying to clarify what the issue is for my  
13 understanding.

14 **CHAIR:** Well, clarify it with the person asking the question,  
15 please.

16 **PROF WILLIG:** And so do you have a view of which side of the  
17 model is producing that result? Surely it's not the  
18 consumer side.

19 **MR PETERS:** Well, I haven't -- didn't develop the model so  
20 really this was just testing to see if it was fit for the  
21 purpose --

22 **CHAIR:** Let's ask this in a hypothetical sense. Say you found  
23 that result and you're familiar with this model since you've  
24 reviewed it, what would you make of a result like that?  
25 Would it puzzle you, would you think it was consistent with  
26 what you would find? How would you view the result?

27 **PROF WILLIG:** My first reaction would be, curiosity and  
28 puzzlement and then my second step would be to probe the  
29 internal workings of the model to see what feature of the  
30 model it is that's actually producing that somewhat puzzling  
31 result.

1 **CHAIR:** And if we couldn't find an acceptable explanation for  
2 it, would it give you concerns about the overall robustness  
3 of the model?

4 **PROF WILLIG:** If the counter-intuitive puzzling finding came  
5 about because of changes that were "out of sample", beyond  
6 the reasonable range of changes to be interested in, it  
7 wouldn't undermine my feelings about the model. But if I  
8 couldn't understand what it is that's causing that result  
9 for relatively small changes, I'd try to keep probing until  
10 I satisfied my curiosity on the subject.

11 **CHAIR:** So you think it's a useful thing for the Commission to  
12 pursue in satisfying itself?

13 **PROF WILLIG:** Absolutely. Sensitivity testing is something that  
14 is always useful in these sort of models.

15 **CHAIR:** Thank you. I'll hand back for further questions on  
16 this.

17 **MR PETERS:** This is a follow-up. In the usual analysis cost  
18 efficiencies are a shift downward of the cost curve i.e.  
19 Producing the same output for less cost. The reduction in  
20 costs due to the reduction in output is not a welfare change  
21 and should not be added to other welfare measures.

22 Is it possible that these costs were included in NECG's  
23 model, these cost savings?

24 **MS HARDIN:** Sorry, costs that are related to higher prices are  
25 taken out of the model in the PAX burn? That's what the PAX  
26 burn is for, to take out any costs that are saved as a  
27 result of less people flying, and that's precisely the  
28 reason that we took out those cost savings.

29 **PROF ERGAS:** The point is that, in our modelling, despite some  
30 of the statements that have been made about the relationship  
31 between the factual and the counterfactual capacity, the gap



*Applicants (cont)*

1 in capacity between the factual and the counterfactual is  
2 not enormous, and so what is essentially happening in our  
3 model is that you are looking at the effect of a relatively  
4 small change in capacity, and in that region of a relatively  
5 small change in capacity the assumption of an approximately  
6 linear pattern of behaviour in the model is not an  
7 unreasonable one.

8 Obviously, if what you were to do was to go outside of  
9 the range of a very small change, then you would need a very  
10 different model from the type of model that we have built.  
11 So, it's not sensible to look at our model and say, a test  
12 of that model is how it behaves if you shock capacity by 80%  
13 or 60%; it just is asking the model to do something that  
14 it's not designed to do and that, to the best of my  
15 knowledge, models of that kind generally don't do.

16 So, what happens in our modelling? Well, in our  
17 modelling you get this relatively small change in capacity  
18 between the factual and the counterfactual, you get a change  
19 in market structure. The change in market structure and the  
20 change in capacity are associated with a change in prices  
21 and outputs. One consequence of that is that you have a  
22 reduction in passenger numbers that occurs as a consequence  
23 of the price increase that we model.

24 That change in passenger numbers, when you look at it,  
25 is again such that you think it's within the reasonable  
26 range of the model. And clearly that change in passenger  
27 numbers implies some savings in costs to the airlines. Of  
28 course, we don't treat the cost savings associated with  
29 price increase induced reductions and outputs as cost  
30 savings to society. We don't do that.

31 What we do look at are the cost savings that basically

*Applicants (cont)*

1       come from the fact that you move from a world where you have  
2       two airlines that for example have a lot of wingtipped  
3       flying with relatively inefficient aircraft selection to, a  
4       world where the two airlines combine their load and, for  
5       example, have better schedules, but also importantly better  
6       aircraft selection, and that in turn allows genuine cost  
7       savings which are the cost savings that we claim.

8       Those cost savings look large, as we said yesterday,  
9       relatively to deadweight loss, but when you actually examine  
10      their quantum, the cost savings that we claim are 4% of the  
11      total counterfactual costs of the parties on the routes  
12      affected by the alliance; so they're very small, and  
13      entirely plausible when you think about combining  
14      operations, having better aircraft selection, reducing the  
15      amount of purely duplicative flying, you could reasonably  
16      expect cost savings which were greater than the 4% that we  
17      claim. But it's only those cost savings that we claim, not  
18      the cost savings associated with the price increase induced  
19      reductions in output.

20 **MR PETERS:** Thank you. A question about -- another question  
21      about the NECG model. Cournot is generally regarded as a  
22      quantity setting framework for analysis. In the NECG model  
23      counterfactual capacities, factual capacities and costs are  
24      an input to the model. The model uses Cournot formula  
25      formulated to determine the price differences between the  
26      counterfactual and the factual. Given this, might the NECG  
27      model be more aptly described as a model that assumes  
28      Cournot pricing rather than a Cournot model?

29 **PROF ERGAS:** If what you mean is that the selection of capacity  
30      occurs outside the model, then that is correct. What we do  
31      is, we determine capacity in the factual and the

*Applicants (cont)*

1 counterfactual on the basis of schedules developed  
2 essentially working with the airlines. The reason we do  
3 that is that, as we've explained, we believe that it's  
4 important to have a city pair by city pair view of how  
5 capacity will evolve in the world with the alliance and the  
6 world without the alliance, and that's important for the  
7 reasons that Professor Willig underlined yesterday.  
8 Determining how capacity will evolve at a city pair level  
9 for a very large number of interdependent city pairs is  
10 obviously an extremely complex task, and the reality is that  
11 even individual airlines, even airlines that are very  
12 sophisticated and well resourced such as the parties, don't  
13 do that by having an analytical model that they solve which  
14 determines their capacity levels. They do that on the basis  
15 of a mixture of analysis, experience, insight, knowledge of  
16 how markets behave.

17 So, if you want to try to capture the reality of how  
18 airlines determine capacity, one of the best ways of doing  
19 it is to rely on the experience of the airlines themselves  
20 and their understanding of those markets. So that's  
21 essentially what we do, and as Professor Willig rightly  
22 noted yesterday, we take those projections of the world and  
23 then they are used to determine important parameters of our  
24 model and in turn affect output and prices. That's the way  
25 we generate the estimates that we derive.

26 If you have a different view of the world, i.e. Of what  
27 would happen with and without the alliance, then the model  
28 provides a framework within which you can input your  
29 differing estimates of how capacity will evolve as in those  
30 alternative states. In our view our factuials and  
31 counterfactuals are plausible ones, they're consistent with,

*Applicants (cont)*

1 we believe, historical experience; we think that the way the  
2 model then translates them into prices is conservative, but  
3 we recognise the fact that this is really a modelling  
4 framework where others who might have differing views of the  
5 factual and counterfactual could use that modelling  
6 framework to test the consequences of their own views.

7 **CHAIR:** I might just interrupt, if I can. We'll come back to  
8 these questions, but I am aware of the time, and we do need  
9 to start the presentation with Virgin Blue at 10.30. So, I  
10 propose to come back to these questions in the early  
11 afternoon.

12 Can I just make one further comment, please. There have  
13 been a number of matters that -- where we've requested  
14 additional information or responses from the Applicants. I  
15 have been keeping a list and I believe our staff have as  
16 well, but at some point I would like us to agree what is on  
17 that list so I can read it into the record. So, if counsel  
18 can do that with us during the breaks I would be grateful.

19 **MR P TAYLOR:** I have the Commission's list and I think we're  
20 almost there.

21 **CHAIR:** Okay great, thank you for that.

22 Can I suggest we break for 10 minutes and we'll start  
23 again at 10.30 with Virgin Blue.

24

25 **Adjournment taken from 10.20 am to 10.40 am**

26

27 **CHAIR:** If I could ask everyone to be seated, please. Just  
28 before we proceed further, I understand that Professor  
29 Willig needs to leave at midday and won't be here for the  
30 further sessions, so I would like to thank him for his  
31 willingness to take questions and for the presentation that

*Applicants (cont)*

1 he has made available to the Commission; it's valuable to  
2 have that sort of expertise in a matter like this and we are  
3 grateful to him. So, I don't know if he's still here but,  
4 if he is, I would like to extend our appreciation.

5 Now, we will start the next session, which is with  
6 Virgin Blue and I would like to start by asking Virgin Blue  
7 to introduce everyone at the table, please, and then I will  
8 ask you to start with your presentation. Thank you.

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**PRESENTATION BY VIRGIN BLUE**

1

2

3 **MR CALLAGHAN:** Thank you Madam Chair. My name is Jonathan  
4 Callaghan, I'm from Gilbert + Tobin in Sydney. Next to me  
5 is David Huttner; David's the Head of Communications and  
6 Strategy at Virgin Blue. David's role encompasses all the  
7 commercial operations of Virgin Blue, including development  
8 of its international strategy, which obviously encompasses  
9 the Trans-Tasman and New Zealand. Next to David is Tanya  
10 Thomson from Simpson Grierson. Simpson Grierson are Virgin  
11 Blue's New Zealand legal advisors.

12 I plan to give a very brief outline of Virgin Blue's  
13 position on the proposed alliance, and David plans to read a  
14 brief statement onto the record outlining the commercial  
15 issues from Virgin Blue's perspective of the proposed  
16 alliance.

17 We do not propose to speak very long, we see our role  
18 here today as primarily answering the questions that the  
19 Commission might have, and while we see that the Commission  
20 must address a raft of legal and economic issues, many of  
21 which we have already made submissions on, we believe that  
22 we are best able to assist the Commission today in its  
23 assessment as to whether Virgin Blue can be an effective  
24 competitive constraint on the proposed alliance.

25 The Applicants in their case for authorisation rely  
26 heavily on the ability of Virgin Blue to provide an  
27 effective competitive constraint on the proposed alliance.  
28 They argue that the world with the alliance is one which is  
29 more attractive for entry by Virgin Blue by virtue of the  
30 increase in prices and a decrease in capacity. They also  
31 argue that there are no barriers to entry and expansion in

*Virgin Blue*

1 this market and, accordingly, Virgin Blue will be an  
2 effective competitive constraint.

3 Virgin Blue's position is fairly simple; we just believe  
4 that this is a simplification and overstates the ability of  
5 Virgin Blue to be an effective competitive constraint to the  
6 proposed alliance within a reasonable timeframe.

7 Virgin Blue believes that there are opportunities in  
8 this market, it recognised that a long time ago, and has for  
9 quite some time always said it will enter this market and  
10 enter the market soon. There are, however, barriers to its  
11 entry and expansion within this market; these are  
12 principally, as has been identified in the submissions,  
13 barriers associated with the strategic or predatory conduct  
14 of the proposed alliance, and also access to key facilities.

15 Virgin Blue believes that, given these barriers, it is  
16 difficult for the Commission to be satisfied that Virgin  
17 Blue can offer an effective competitive constraint to the  
18 proposed alliance. However, it also believes that these  
19 barriers can be addressed either by the imposition of  
20 conditions or reaching commercial resolution on these issues  
21 prior to the authorisation taking effect and, in a nutshell,  
22 that's Virgin Blue's position, at which point I'm going to  
23 pass over to David who's going to read his statement.

24 **MR HUTTNER:** Thank you, I have just a brief opening statement.  
25 Madam Chair, Commissioners. First of all, we'd like to  
26 thank the Commission for inviting us here today to  
27 participate in the hearings. Throughout this process we  
28 have found that the Commission has shown a willingness to  
29 listen to our views, but has also had, shall we say, an  
30 inquisitive desire to ask well thought out questions in  
31 order to get a better understanding of the background and

*Virgin Blue*

1 environment under which this discussion is taking place. It  
2 is appreciated.

3 While we are more than willing to answer any questions  
4 you may have to the best of our abilities, there are a few  
5 points we'd like to mention in regard to events leading to  
6 today.

7 It was suggested by Mr Geoff Dixon, the CEO of Qantas,  
8 that Virgin Blue may have overplayed its hand in this  
9 process. Those are easy words to say if you are the one  
10 holding all the cards.

11 There are many possible futures that could arise, but we  
12 cannot foresee any scenario where Qantas doesn't come out as  
13 a winner. The reality is that we are playing the best hand  
14 we have and we are a few cards short if we want to be able  
15 to be the same force for competition that we are in  
16 Australia, and furthermore, if it is desirable for us to act  
17 as the competitive constraint that this alliance requires.

18 Today we have only identified those things that will  
19 make this role possible. Virgin Blue has maintained a  
20 consistent position since our initial submission. We have  
21 said we will enter the Trans-Tasman and domestic New Zealand  
22 routes in some form or another with or without alliance. We  
23 are not opposed to the alliance outright, we have simply  
24 said that certain key issues should be addressed if it is  
25 allowed to proceed.

26 We have clearly stated our confidence that we are the  
27 best suited party to provide sustainable competition in the  
28 interests of the travelling public.

29 We have said it is critical that we have access to  
30 facilities at comparable times and under comparable  
31 commercial conditions.



*Virgin Blue*

1           We have said that it was critical that anti-competitive  
2 behaviour be addressed. Originally we pointed out that the  
3 easiest way to resolve this problem would be from the  
4 divestiture of Freedom Air with a constraint on the  
5 reintroduction of a so-called "Freedom Air 2".

6           Since then a number of changes have taken place  
7 including Qantas' introduction of JetConnect, an equally  
8 potent weapon that can be just as easily trained on Air New  
9 Zealand as upon ourselves. The introduction of JetConnect  
10 devalues the Freedom Air divestiture as it is effectively  
11 Freedom Air 2. While this situation is not ideal, it is a  
12 defacto reality and, therefore, we are focused on Qantas and  
13 Air New Zealand's rather surprising offer of capacity  
14 constraints instead.

15           While attractive in principle because they address a key  
16 weapon to stifle new entrant competition, the drafting of  
17 these needs to be tightened up as the loopholes they wrote  
18 in are presently big enough to fly one of their aircraft  
19 through.

20           Virgin Blue has also tried to avoid getting involved in  
21 academic debates about what may happen next. While we have  
22 the highest respect for the various industry experts who  
23 have commented on what may occur five years down the track,  
24 I have yet to personally read a paper written five years ago  
25 that accurately predicted what would happen in the global  
26 aviation industry today, and I have a hard time believing  
27 that anybody else could make such a prediction confidently,  
28 whether they are lecturing university students or running an  
29 airline.

30           We believe in our model and, if we can overcome certain  
31 obstacles, we believe we will succeed in becoming the choice

*Virgin Blue*

1 of the majority of travellers in the region over time. We  
2 cannot say whether this will be against one competitor or  
3 two, nor can we say whether or not Air New Zealand will fail  
4 in the brutal manner that Ray Webster, Geoff Dixon and Ralph  
5 Norris described. Unfortunately, Nostradamus doesn't exist  
6 in the airline business.

7 One thing that we can say is that, if the future is as  
8 dire as Air New Zealand management have made it out to be,  
9 then we have been surprised by their reluctance until now to  
10 engage us in order to address our concerns and remove some  
11 of the hurdles we face. Even if they believe that our  
12 expectations are too high, they pale in comparison to the  
13 view that competition authorities in two countries should  
14 just take it on trust that there will be no substantial  
15 impediments to new entry and approve a dominance over South  
16 Pacific Aviation without them really addressing the key  
17 concerns of other parties.

18 In the past few days Air New Zealand appears to have  
19 backed away from its hard line stance by opening  
20 communications on one of the key issues that needs to be  
21 addressed, access to airport facilities. We are trying to  
22 determine whether this is a serious attempt to address our  
23 concerns or simply a ruse to persuade the Commission to  
24 forget that Air New Zealand has stonewalled all attempts by  
25 Virgin Blue to engage Air New Zealand to address these  
26 matters in a sensible manner over the last nine months.

27 Virgin Blue intends to advise the Commission of the  
28 progress of these matters by the end of this month and to  
29 indicate by then whether we believe these new offers are  
30 legitimate and allow us to provide effective competition.  
31 Certainly, no approval should be granted until Air New

*Virgin Blue*

1       Zealand is able to resolve these matters in full and without  
2       any reservations.

3             If these late efforts by the Applicants are not sincere  
4       and at some stage in the future Air New Zealand finds itself  
5       in the doomsday scenario it has described, then the senior  
6       management of Air New Zealand will only have themselves to  
7       blame for the outcome as it is our view they could have done  
8       more, and done it much sooner, to convince all concerned  
9       that they were interested in a level playing field and not  
10      simply stitching up a dominant position in the market.

11            Like Qantas and Air New Zealand, Virgin Blue is not  
12      playing its hand to lose, but we also have no desire to sit  
13      in a game where the dealer has stacked the deck.

14            We make one simple promise now, one that we can back  
15      with the experience of millions of Australians instead of a  
16      dubious economic study: If we get the right conditions, the  
17      real winners will be the air travellers, cargo shippers and  
18      tourism industries of Australia, New Zealand and Fiji.

19            Thank you for considering our views, and I welcome your  
20      questions.

21      **CHAIR:** I'd like to go back to the comment that was made that  
22      one of the key strategic barriers, or one of the key  
23      barriers to entry and expansion might be thought of as a  
24      possible strategic response of the Applicants, and I would  
25      like you to help us out a bit more with that. In doing so,  
26      we've had a lot of talk about why what might happen here  
27      might be quite similar to what happened in Australia in  
28      terms of Virgin Blue's ability to enter and expand, and we  
29      are very interested in hearing what your experience was in  
30      Australia; and I suppose, to put it bluntly, we have had a  
31      lot of talk in the hearings about to what extent was Virgin

*Virgin Blue*

1 Blue assisted by the Ansett failure and what was your  
2 position at that point in time.

3 What was it, from the point of entry up until when  
4 Ansett failed, and how important was that in your ability  
5 then to expand to the position you have today?

6 **MR HUTTNER:** Virgin Blue went through a period -- and it is the  
7 subject of another case outstanding for which Qantas is  
8 being sued by the Commission in Australia -- where we felt  
9 that we had some severe concerns about our ability to  
10 survive due to the unconstrained use of capacity as a  
11 weapon. It's hard to compare the situation in Australia  
12 with New Zealand. We're a different airline since then, the  
13 environment is different, and so, I don't know if we will be  
14 able to draw direct comparisons.

15 What I can say is that we believe that we can become the  
16 same force for competition here in New Zealand as we are in  
17 Australia. It is true that the Ansett collapse probably  
18 allowed us to become the number two airline probably a lot  
19 quicker than we expected, but if you look at our original  
20 business plan -- which has been discussed in the media  
21 although we haven't actually published it -- it's fair to  
22 say that we've always said, and long before the collapse of  
23 Ansett, we always believed we would become the number two  
24 airline in Australia. It just happened a bit quicker than  
25 we thought it would.

26 **CHAIR:** Can I just follow that up. When you say you're a  
27 different airline, it would be fair to say that you accept  
28 the proposition that, as you enter New Zealand, it's not  
29 really the entry of the sort when you entered Australia? In  
30 other words, it's an extension of what you're doing in  
31 Australia, you have that base to work from, you're not

1 nearly as exposed as you were in the earlier time?

2 **MR HUTTNER:** Certainly, I would agree with that in the sense  
3 that we are not exposed, but that being said, we probably  
4 weren't exposed even last year. But, for example, we  
5 couldn't fully become everything we are now without access  
6 to certain facilities. So for example at Sydney Airport, as  
7 was well reported a while ago, we had only access to what  
8 was commonly referred to as the "tin shed", and when we  
9 moved into the former Ansett terminal, it has allowed us to  
10 grow our corporate market, it has allowed us to actually  
11 compete on a somewhat level playing field.

12 That being said, that's not the only, you know,  
13 structural barrier, but certainly it was a major one that we  
14 were able to overcome. I think that would be an example --  
15 I think, if you take the case of New Zealand, we believe we  
16 have much more resources behind us but, you know, there are  
17 certain issues that are difficult to do. You can't look at  
18 the market as a whole; you can't in a sense that Australia  
19 and New Zealand are this greater thing and that we have  
20 certain economies of scale and certain operational  
21 efficiencies which we didn't have a few years ago, but you  
22 also have to look at each market on a route-by-route basis.

23 You can have tremendous competition in Auckland, but it  
24 doesn't do much good for the people here in Wellington, or  
25 in Christchurch, or in Dunedin. So, the reality is that,  
26 there is a greater market and there's also very very  
27 individual markets, and both issue need to be addressed.

28 **CHAIR:** How do you weigh up the opportunities of entering  
29 New Zealand, both the Tasman but also then expanding into  
30 the domestic routes? How do you weight up those options  
31 with options to further expand in Australia?

1 **MR HUTTNER:** Economically and operationally in the short-run?  
2 It would be a lot easier to put on another Sydney-Melbourne  
3 plane. International flying has complications, but  
4 eventually we want to continue to grow our airline and it  
5 would be desirable to open up the most opportunity as  
6 possible, be it in Fiji, New Zealand, wherever.

7 We would like to grow because we don't believe -- we  
8 don't really look at flying to New Zealand from Sydney as  
9 being much different than flying to Perth from Sydney. Yes,  
10 there are operational issues and legal and customs and  
11 immigration, you know, aside from old sporting rivalries;  
12 the reality is, is that there's a lot of issues but none of  
13 them from a pure commercial sense -- you know, we see it as  
14 a natural growth plan.

15 **CHAIR:** Can I take it from that, that once you cross the Tasman,  
16 you've basically overcome the major hurdle; that's the hard  
17 bit, it's not the hard bit to then expand the domestic  
18 routes?

19 **MR HUTTNER:** No, actually I wouldn't assume that's the case. If  
20 you cross the Tasman, we have at least on one end of the  
21 equation a very solid distribution in marketing and brand  
22 position in place. While, we are known in New Zealand, and  
23 we have some travel agents in New Zealand who do work with  
24 us, the reality is, is that, if you go -- you never start an  
25 airline business -- you try to avoid going spoke-to-spoke if  
26 you can, you try to always go from a place where you have a  
27 market presence to some place you don't and then take the  
28 next step. So, we might fly in the future to one of the  
29 Island destinations in the Pacific via New Zealand, but we  
30 probably wouldn't do it all on day one because you'd be  
31 doing spoke-to-spoke.

1 **CHAIR:** But let me try a different angle on that. Once you've  
2 made the commitment to cross the Tasman, to get the full  
3 benefits of it, you really do then need to extend your  
4 network into domestic New Zealand?

5 **MR HUTTNER:** It is our desire, and we believe it would be  
6 economically beneficial to fly domestically, yes.

7 **CHAIR:** If I understand some of the statements that Virgin Blue  
8 has made, it sounds to me like you're committed now to  
9 crossing the Tasman and entering the domestic routes no  
10 matter what happens in these proceedings?

11 **MR HUTTNER:** It would be safe to say that we would like to and  
12 we have committed to fly across the Tasman where we believe  
13 it's commercially viable without -- where we believe our  
14 product would be competitive, where we believe that we can  
15 offer a service that is worth offering basically, where we  
16 can get our share of the market or, you know, a significant  
17 share of the market to make it economically sustainable.

18 So for example, if you take -- we could even fly  
19 domestically tomorrow, let's say, from Wellington to  
20 Christchurch, or to Dunedin, but we have some issues about  
21 flying tomorrow from Wellington to Auckland.

22 Now, coming back to individual markets versus national  
23 markets; if we wanted to sign a corporate account, shall we  
24 say, with a company such as WestpacTrust who is, I believe,  
25 based here, or any company based here, what we'd have an  
26 issue with is that, it would be very hard for us to approach  
27 them without most of their offerings on the table.

28 I'm not saying we'll be able to ever fly a 737 to Nelson  
29 because the airport can't sustain a 737, but it's fair to  
30 say that your network will be limited -- if your network  
31 doesn't have the main components such as we had in Australia

1 with the problems with Sydney, if one of those hubs, if you  
2 want to call it that, or if one of those key points of  
3 presence is limited, you're in a difficult situation.

4 **CHAIR:** And there's been a lot of talk about whether it's  
5 limited or not, and most of the airport companies are  
6 strongly suggesting that it isn't, and I'd just like your  
7 view on whether that's correct and, if it isn't, then in  
8 what sense is it not correct and at which points in the --  
9 it's mainly, it seems to me, to sound like it's about the  
10 airport facilities.

11 **MR HUTTNER:** Certainly, there's two major issues that we're  
12 concerned about; there's the use of capacity as a weapon and  
13 airport facilities, and whether you call it slots, counters,  
14 there's a whole lot of elements to airports, it's almost  
15 like a chain of events once you go through the airport, that  
16 any one of them could become a constraining factor.

17 It's fair to say that, you know, we're aware of the  
18 communication in Auckland; right now, today, if we want to  
19 do this, or in the next few months, there are no obvious  
20 domestic facilities available at Auckland Airport unless we  
21 reach a commercially viable outcome with the Applicants.  
22 Now, it's possible that in six months or a year we'd have to  
23 have further talks with Auckland Airport, and we could rush  
24 to construct a comparable facility.

25 One of our concerns will be -- and we aren't privy to  
26 this information but we've made estimates -- that if we were  
27 to build such a facility tomorrow at Auckland, we will  
28 already be somewhat commercially disadvantaged because Air  
29 New Zealand and Qantas probably have got a much lower  
30 operating cost base than we would have if we had to build a  
31 facility in conjunction with Auckland Airport, or



1 underwritten by or guaranteed by in some sort of way with  
2 Auckland Airport and domestically.

3 **MR CALLAGHAN:** There's also the issue of delay.

4 **MR HUTTNER:** There is a delay factor. There is an issue of the  
5 time to market and so on and the planning process involved  
6 in that.

7 On international there's been a lot of discussion about  
8 slots. So far we have been fortunate in getting something  
9 close to the slots we need, and we hope that that will  
10 continue. We will go through the proper process, and the  
11 slot allocation authorities and committees have been more  
12 than helpful and they've done their best to facilitate us.

13 All we're saying -- and we're trying to hammer out in  
14 recent correspondence with Air New Zealand -- is that in the  
15 event that they cannot provide a slot because assets are  
16 physically constrained at a commercially viable time of day,  
17 not that they're physically constrained all the time, then  
18 at some point we would hope that Air New Zealand and Qantas  
19 would be able to give a concession to make that work.

20 Now remember, it's not just the facility at Auckland; if  
21 you get the slot at Auckland, let's say, at 6.30 in the  
22 morning you have to make sure you have the comparable slot  
23 at Sydney three hours or whatever it is later. So,  
24 otherwise, your slot at Auckland is pretty much useless.  
25 So, it's a very co-ordinated and detailed process.

26 Airports by nature want to say they can do everything,  
27 and they can for a price because they can always build more  
28 facilities, they are monopolies but, you know, they're  
29 monopolies we work with because they are partners in the  
30 business and it's a tenant/landlord relationship.

31 Some certainly we're confident we can find solutions

*Virgin Blue*

1 with the airports over time. The question would be to us,  
2 on domestic facilities for example, Air New Zealand and  
3 Qantas have two terminals today. Now, if you believe  
4 everything that's in these reports, they're gonna have all  
5 these efficiencies and, therefore, instead of having two  
6 planes flying wingtip to wingtip at 7 o'clock, and in  
7 another two at 9 o'clock they might have one at 7, one at 8,  
8 one at 9 and one at 10. Therefore, they should be able to  
9 use their existing assets more efficiently and, therefore,  
10 there should be a benefit return to Air New Zealand, and  
11 Qantas has been identified, and there should be a benefit  
12 return in terms of unutilised assets or under-utilised  
13 assets.

14 That's why we have suggested that there should be no  
15 issue in giving us, or leasing to us in comparable terms,  
16 certain gates for our own dedicated use, where we don't have  
17 to submit to them our schedule to see if they can fit us in.  
18 We don't want to give them our schedule, it's none of their  
19 damn business, and we don't want to actually have -- we want  
20 to actually -- just give us a gate, give us the desk to  
21 check people in, don't -- get out of our way. And that's  
22 the -- if we can have that, we'll run our own operation  
23 efficiently and we'll be competitive.

24 **CHAIR:** I just want to pick up on a little bit of the tone with  
25 which this discussion seems to be evolving, and I made the  
26 observation earlier in the week that it's probably not the  
27 Commission's job to save Air New Zealand or Qantas, or nor  
28 is it necessarily our job to use whatever jurisdiction or  
29 power we have to help any particular carrier, including  
30 yourself, and you could get the sense really that you're  
31 gonna enter New Zealand, you're gonna be here, you're gonna

1 compete for the whole of the market, you're gonna probably  
2 be quite aggressive about it regardless of what happens  
3 here.

4 And really what you're coming to us with now is an  
5 attempt to get us to tilt the field further in your favour,  
6 even though it's not required, in order for you to enter  
7 into this market. And that concerns me, because it's very  
8 clear to me that it is not our job to look after any  
9 particular industry player. The issue here is the benefit  
10 to New Zealand, and if we're going to get that benefit  
11 anyway, this Commission has no business interfering in  
12 commercial negotiations between the different players.

13 I put that fairly strongly because I want your response  
14 to it.

15 **MR HUTTNER:** No, I agree with you. We do not ask, nor would we  
16 expect, the Commission to engineer any outcome. What we're  
17 saying is, the Applicants have asked for a rather large  
18 favour. They've asked for someone to overlook what appears  
19 to be, at first glance, a rather anti-competitive deal,  
20 and --

21 **CHAIR:** Well, I think that has to be established yet, and we're  
22 still hearing submissions on it.

23 **MR HUTTNER:** Okay. In our view, sorry --

24 **CHAIR:** What I'm putting to you is, you've strongly suggested to  
25 me that you don't actually face a problem entering, which  
26 raises the possible question --

27 **MR HUTTNER:** No, I don't think I said that, I'm sorry. If I  
28 could: I'm saying that we can eventually build our own  
29 facilities, it will take time, and in the meantime we would  
30 be facing a competitor which will have overwhelming market  
31 dominance.

*Virgin Blue*

1           Now, someone suggested we were better off shall we say  
2 after Qantas and Ansett merged, and in some ways we were,  
3 and certainly we had opportunities that weren't available to  
4 us before. But we also notice in Qantas' behaviour since  
5 then, they're only fighting on one flank now. They only  
6 have to worry about a competitor from one side, which they  
7 didn't before, and as long as there's fair and unfettered  
8 competition out there, then everyone fights their own  
9 battle.

10 **CHAIR:** I don't think though, and I may be wrong, but I'm having  
11 trouble actually seeing where the exact evidence is that  
12 there's not -- that there really is a problem with you  
13 accessing the main airports.

14 **MR HUTTNER:** If we want to fly tomorrow from Wellington to  
15 Auckland, we have no idea how we can possibly do it.

16 **CHAIR:** That may very well be the case, that you couldn't do it  
17 tomorrow, but it's not clear to me and it's not clear that  
18 you've established that, with further commercial  
19 negotiations, you can't make an agreement in the timeframe  
20 you need in order to enter these markets, and it's that sort  
21 of evidence that the Commission needs from you.

22 **MR HUTTNER:** All I can say is, we can only enter an agreement if  
23 Air New Zealand -- and this is where the interplay of all  
24 the parties involved -- feels compelled to reach an  
25 agreement. For 9 months we have tried to address this  
26 matter commercially because we don't believe it is really  
27 the Commission's role to engineer anything.

28           Until the last few days, that discussion has not really  
29 come forward. Now --

30 **CHAIR:** I hear you saying that, but I want to ask you again,  
31 will that prevent you or delay you from crossing the Tasman

1 and then entering the key domestic routes?

2 **MR HUTTNER:** It will significantly delay us and on certain  
3 routes, without any concessions, it may be difficult for us  
4 to get a commercially optimal product to compete against a  
5 commercially optimal product.

6 **CHAIR:** But it will allow you a product -- it might not be  
7 optimal from your vantage point, but will it be a product  
8 that still allows you to enter and have at least some  
9 ability to compete with the Applicants?

10 **MR HUTTNER:** We could enter tomorrow on a specific city pair  
11 but, as I said, each market is different. Here to Sydney is  
12 different than here to Auckland. So, the fact that you've  
13 entered one market really has nothing to do with the other  
14 market in that sense, because you still need the facilities  
15 in each particular airport at commercially competitive  
16 rates, and that is -- the other thing is that, it's great if  
17 you can enter the market, but if your facilities end up  
18 costing two or three times as much as the other guy's,  
19 you're inherently disadvantaged, and if these people are,  
20 shall we say "hoarding" existing facilities, when in fact  
21 they're supposed to be claiming that they're getting  
22 efficiencies, one has to question the thing.

23 I mean, we would like to expand. We would like to not  
24 just be a bit player in the market, and at this present  
25 time, while we will certainly get some slots at Auckland in  
26 peak times, and while we'll probably be able to negotiate a  
27 deal with Auckland Airport over time to get some sort of  
28 suitable facility, we're always gonna be in second place in  
29 a sense of access. And, you're right, we could do something  
30 probably on most routes, you know, but ultimately it's hard  
31 to imagine that we could do it effectively, and our case in

*Virgin Blue*

1 Sydney should serve as evidence of the fact that, if we have  
2 adequate facilities on comparable standards we can compete  
3 much more effectively than in the alternate case.

4 **CHAIR:** I want to follow-up one other thing and then I'll let my  
5 colleagues ask some questions. On the point about capacity  
6 constraints, I've indicated in earlier sessions that, when I  
7 hear this, I just -- there's a part of me that has a hard  
8 time getting there, thinking that this is a good thing to  
9 limit capacity.

10 And I just wonder, given what you said about it being --  
11 you're a different company now, you're entering New Zealand  
12 on a much stronger footing, and if the issue around the --  
13 let's just assume now that all the issues around access to  
14 facilities was relieved, is there really any argument for  
15 capacity constraints? I mean, isn't most of the ability for  
16 there to be a strategic response gone at that point?

17 **MR CALLAGHAN:** I think the key issue there, from Virgin Blue's  
18 perspective, it's about a time to market, it's about a time  
19 of expansion, and we believe that we can be an effective  
20 competitive constraint on the alliance, but that won't occur  
21 overnight and that will take some time. We are saying that,  
22 with these capacity constraints in place, the Commission can  
23 be more satisfied -- certainly Virgin Blue's more confident  
24 that it can be a more effective competitive constraint  
25 quicker. It is more a question of timing, and timing of  
26 reaching that scale to be an effective competitor.

27 **CHAIR:** So, what is your projections in terms of the timing?  
28 How do you see your growth path in New Zealand?

29 **MR HUTTNER:** Well, we're not -- to be quite honest, we put  
30 forward to the Commission, because we were asked, you know,  
31 one particular scenario. The reality is, and this is what

*Virgin Blue*

1 we've been saying before about the other submissions, is  
2 that the airline market is extremely fluid. What we think -  
3 - we have said we would like to fly into New Zealand in some  
4 limited form before the end of the year, but we won't be a  
5 national airline by the end of this year. We can become a  
6 national airline similar to what we are in Australia sooner,  
7 rather than later, given this situation being addressed.

8 We also are worried about -- all we're saying is that,  
9 Air New Zealand and Qantas volunteered and acknowledged --  
10 the use of capacity as a weapon was acknowledged by their  
11 undertaking there, but they wrote the undertaking in such a  
12 way that if, let's say, Polynesian Airlines flies one flight  
13 a week between Wellington and Melbourne, that it  
14 disqualifies that route under the undertaking they have  
15 given.

16 All we're saying is, they have made the undertaking,  
17 they've recognised that this is an issue, they've recognised  
18 that there are severe questions about this in Australia. We  
19 don't really like market engineered solutions, but we also  
20 are aware that, if there's a free market out there, there  
21 probably wouldn't have been the Government intervention in  
22 Air New Zealand there was last year. That's the reality,  
23 it's not a criticism or any sort of complaint; it just is  
24 what it is.

25 So, unfortunately, given the fact that you have  
26 companies with huge resources who can throw 767s right on  
27 top of your schedule, or 747s on top of your schedule in  
28 some cases, you know, we have to say we would like to enter  
29 into it quickly without the risk of, shall we say, activity  
30 that one would question the economic viability other than to  
31 achieve a damaging outcome to one's competitor.

1 **CHAIR:** Okay, thank you for that. [**Pause**].

2 **MS BATES QC:** The first thing I want to ask you this is, and  
3 that is; do you think you are better placed to deal with a  
4 strategic or competitive response with or without the  
5 alliance?

6 **MR HUTTNER:** We have said pretty consistently I think, and we've  
7 said it to both the Commission here and the Commission in  
8 Australia, that we actually believe that with the  
9 undertakings we've mentioned already today, we believe that  
10 we're actually better off if the alliance goes forward,  
11 we've said that on the record to both parties. But we've  
12 said that with the caveat because, if the alliance goes  
13 forward and we're expected to fight with one hand tied  
14 behind our back, at least for a certain period of time, a  
15 start-up period of time, it is a challenge for us.

16 **MS BATES QC:** Let's put it this way: Is your response  
17 predicated on the basis of the conditions that you want,  
18 without aircrafts flying through them, or is it predicated  
19 on the basis of the conditions as written?

20 **MR HUTTNER:** No, it's based on what we want. I think it's fair  
21 to say that it's based on what we want.

22 In the event that it was passed without some of the  
23 issues addressed that we've asked to be addressed, once  
24 again, we believe we'll be forced -- if we want to grow at  
25 the end of this market, which we do, that we'll be at a  
26 significant disadvantage for some time to come.

27 What I'll see, for example, if you take the Sydney  
28 scenario as was given, I think it was one of the investment  
29 banks, Macquarie maybe, issued a report recently that said  
30 our share of market at Sydney lagged behind Melbourne or  
31 Brisbane, and that's because that lag that occurred because



*Virgin Blue*

1 of the facilities issue at Sydney Airport a year ago still  
2 carries on today. Because, you always have to go up a  
3 curve, and if that curve starts at a later point in a  
4 timeline, that curve will continue indefinitely. So, we are  
5 still behind in Sydney relative to our position in Melbourne  
6 or Brisbane because of an event that happened a year ago.

7 **MS BATES QC:** Okay. Let me just explore this --

8 **MR HUTTNER:** Go on.

9 **MS BATES QC:** -- a little bit further, because it's pretty  
10 important to us.

11 **MR HUTTNER:** Okay.

12 **MS BATES QC:** So you support the alliance if you get what you  
13 want, is basically what I hear you saying.

14 **MR HUTTNER:** What we need, but yes.

15 **MS BATES QC:** Well, need or want, but..

16 **MR HUTTNER:** Okay, fair enough.

17 **MS BATES QC:** Now, I don't necessarily say that you can fly the  
18 aircraft through the applicant's proposed conditions, but  
19 just to say those are the conditions that you are stuck  
20 with; will you enter or not?

21 **MR HUTTNER:** We have said, and we will continue to say that we  
22 plan on entering, but our ability to grow and become an  
23 effective constraint and to cover all city pairs possible,  
24 as early as possible, is severely hampered. And we believe  
25 we're not just talking about a few more months here, we  
26 believe that it will be a significant constraint and in the  
27 meanwhile, while we're trying to build, while we're trying  
28 to go with one hand tied behind our back, the two parties  
29 have then integrated their operations to be a much more  
30 competitive response, focused directly on one flank, and  
31 that flank would be us.

1 **MS BATES QC:** So --

2 **MR HUTTNER:** It also limits their ability -- sorry.

3 **MS BATES QC:** So, absent the conditions that you need or want,  
4 you think the alliance would be a stronger competitor than  
5 the two separate ones, do you?

6 **MR HUTTNER:** Yes. We believe that the combined resources, Air  
7 New Zealand's tremendous presence domestically, Qantas'  
8 financial resources, the fact that they only have to face a  
9 competitor on one flank; if this is truly a free market, and  
10 there will be truly no future interventions or subsidies of  
11 any sort, then we'd rather fight it out if that was the  
12 choice.

13 **MS BATES QC:** So, we've been told you have a large war chest; is  
14 that right?

15 **MR HUTTNER:** We have a war chest, not nearly as large as  
16 Qantas'. We hope to get there.

17 **MS BATES QC:** You hope to get there. So, what you're saying is,  
18 entry will be reduced in scale and scope and slower?

19 **MR HUTTNER:** One thing I should say about the war chest: We  
20 will be reducing -- we will be limited -- it's not reduced,  
21 it's like, we're holding back. We will go forward at as  
22 reasonable speed as we can commercially.

23 While we have a war chest, and we've had one since day  
24 one to prepare for, shall we say, anti-competitive behaviour  
25 and so forth, we've never had to tap into it. This company  
26 started with \$10 million in capital. Now, we had access to  
27 the resources of the Virgin Group, but we've never had to  
28 tap into the war chest, nor have we had to operate at a loss  
29 for any significant period of time. The one route that  
30 operated a loss for a continued basis, we pulled off of  
31 because --

1 **MS BATES QC:** Which route was that?

2 **MR HUTTNER:** Mount Isa to Brisbane, and we felt that because of  
3 issues related to competition -- lack of effective  
4 competition constraints, we felt that there was no way we  
5 could ever beat what Qantas was willing to bankroll on that  
6 route. So, although we believed, to the best of our  
7 knowledge, that they were losing more money on the route  
8 than we were at the time, their ability to bleed longer at  
9 that time was far greater than our own and, therefore, we  
10 withdraw from the Mount Isa-Brisbane route.

11 **MS BATES QC:** But at the moment you're prepared to enter --  
12 absent the alliance, based on the conditions you want or  
13 with an alliance based on the conditions as written, you're  
14 prepared to enter; you say it will be a slower entry, a  
15 smaller entry?

16 **MR HUTTNER:** We started off, for example --

17 **MS BATES QC:** Sorry, I'm not trying to put words into your  
18 mouth. You answer.

19 **MR HUTTNER:** Yes, certainly, it's true, but we want -- we  
20 started off -- you know, we want some certainty in our  
21 expansion plans to go forward at the highest possible speed,  
22 at the greatest -- we want to grow like any company does, we  
23 want to grow effectively and profitably. Market share  
24 without profit is pretty useless.

25 We want to -- we believe -- like, for example, we  
26 started in Brisbane; we didn't start with Sydney-Melbourne.  
27 Impulse started on Sydney-Melbourne without all the proper  
28 pieces in place. Impulse got massacred. They had far more  
29 start-up capital than we did. Now, they made a few mistakes  
30 as well, let's be frank here, but they -- it's fair to say  
31 that, if we would start for example tomorrow, we might not

*Virgin Blue*

1 fly Auckland-Sydney because Auckland-Sydney has a lot of  
2 competition, right now it's pretty aggressive.

3 But ultimately, to address the corporate customers,  
4 which is a third of our market in Australia, we need to  
5 offer a product that meets their needs which would include  
6 Auckland-Sydney but we also need to do everything else as  
7 well. It's a bit of a puzzle that all fits together, and if  
8 we are to be successful -- we will enter no matter what, as  
9 you say, we agree with your statement, but we would like to  
10 grow faster and effectively.

11 **MS BATES QC:** Now, what we're interested in, I suppose, or what  
12 I'm interested in is, at what point do you become a  
13 competitive restraint? At what point, how big a market  
14 share do you have to get to become an effective competitor?  
15 Because what we've heard, I put this to you, is that you  
16 only need to get 5% share of the market and, you know, that  
17 will have a -- the effect of a very very significant fare  
18 reduction on the part of everyone else, and that's what  
19 we're hearing, so I want to hear your view as to at what  
20 point you think you become an effective restraint.

21 **MR HUTTNER:** If 5% was really an effective constraint, you  
22 wouldn't see Qantas and Air New Zealand being able to  
23 command the premium prices on morning departures out of  
24 Auckland. Right now, the Fifth Freedom carriers might have  
25 5% of the market on Auckland-Sydney or Auckland-Brisbane,  
26 but all of their flights, because of the nature of  
27 international flow of planes, all come in from Australia in  
28 the morning, go out in the afternoon or evening; but if you  
29 try to leave Auckland at 6 or 7 in the morning, it's a bit  
30 harder to find cheaper seats than those that overlap with  
31 the flights that the Fifth Freedom carriers are operating,

1 because there's less competition.

2 So, certainly they have some impact, but if you want to  
3 be a true level impact I think we need much more than 5%,  
4 and that's why in Australia, while we've got about 30%, we  
5 are now starting to sign a large number of corporate  
6 customers; we now have over half of Australia's top 50  
7 corporations dealing with us, that doesn't mean we get the  
8 majority of their business, but we certainly get some, and  
9 we're now at a stage where we can balance out the market  
10 with 30% in a way that we couldn't do with 5%.

11 **MS BATES QC:** Okay, but it's somewhere between 5% and 30% that  
12 it becomes effective?

13 **MR HUTTNER:** It's closer to 30% before you become an effective  
14 constraint for all segments of the market, whether it be  
15 cargo shippers, business flyers, a variety of people, not  
16 just -- you see, everyone's focused on this lead-in fare  
17 with that one flight a day, and the lead-in fare that Tasman  
18 Express put out last week, or the Emirates does, that's all  
19 well and good, but that fare is not offering a product that  
20 meets the needs of all customers; it's one flight a day, buy  
21 it 21 days in advance, no changes, no this, no that.

22 Virgin Blue would like to have frequency, it would like  
23 to offer flexibility. These are things that are not being  
24 offered out there today, even with the competitive markets,  
25 as they might be called, in Auckland, and Sydney to a point;  
26 it's more there than elsewhere.

27 **MS BATES QC:** So you don't accept there's a 20% reduction by Air  
28 New Zealand across the board?

29 **MR HUTTNER:** If I need to go tomorrow morning because my mom is  
30 ill, or because -- what was that the TV commercial? My  
31 child -- or the wife's pregnant or have a new baby and you

*Virgin Blue*

1 want to see your grandchild all of a sudden -- which, I may  
2 have to get home very quickly --

3 **MS BATES QC:** Really?

4 **MR HUTTNER:** Not a grandchild, thank you. No, but just a child,  
5 but I'm on a leave pass, as I think some people know here,  
6 and my wife is expecting me home this afternoon, that's why  
7 I'm cutting short today. It's fair to say that, if I had to  
8 jump on a plane, and I wasn't travelling with the generosity  
9 of the staff agreement, you know, I don't think I'd be  
10 paying those lead-in fares that you see that are advertised  
11 in the papers. And that's a lot of the market and that's  
12 where Virgin Blue's been successful.

13 If you look at today on Sydney-Perth, Qantas has put on  
14 so much capacity with their new A330s; you buy a month in  
15 advance, often times their fares are very competitive with  
16 ours. But we actually have to hold back seats because, if  
17 not, for the last minute flyers, where they're traditionally  
18 belted by a full service airline, we would have no seats  
19 left because we sold them all at a reasonable profitable but  
20 lower fare way out in advance. People will snap up -- we  
21 have simply lower capacity right now to do that; we're  
22 trying to expand as quickly as possible.

23 But we actually hold some seats back, Qantas actually  
24 take some of the football team that are booked three months  
25 in advance, and we have to let some of that business go  
26 because, if not, we can't get that business, where we're  
27 literally a third or a half the price of what Qantas is  
28 offering for a walk-up customer at the last minute.

29 **MS BATES QC:** Yes, I have experienced that, I know what you  
30 mean.

31 **MR HUTTNER:** I think most people have at some stage.

1 **MS BATES QC:** Is connectivity an issue for you at all?

2 **MR HUTTNER:** We run every route we can based on its own route  
3 economics. Connectivity would be described as cream. In  
4 other words, we don't run network based revenues. If the  
5 route doesn't make money, and we don't foresee it will make  
6 money, we will pull the route, as is demonstrated by  
7 Brisbane-Mount Isa.

8 If, on the other hand, we believe that the route will  
9 break even, but if we had some connections we would actually  
10 be highly profitable, that's fine, but the route better  
11 break even on its own point-to-point merits. You won't see  
12 us running milk runs and all that. We would like to have  
13 some connectivity, and certainly we will look at that  
14 because you'd have to say, certain city pairs won't sustain  
15 on their own direct service; others will.

16 We've put jets -- Adelaide-Brisbane was a great example  
17 where we thought the market was massively underserved, and  
18 we put jets without going through a hub. There are others  
19 as well where we've done what is called "hub busting". We  
20 fly Adelaide-Broome now, which is something nobody ever did  
21 before, and we're pretty full on Adelaide-Broome. Gold  
22 Coast to Adelaide as well. Adelaide's a great example of a  
23 city that's been held back by lack of direct flights.

24 It's fair to say that connectivity -- now also  
25 connectivity, regional carriers, we believe although we  
26 don't really run regional airlines and it's not our goal to  
27 probably get in the regional airline business, it's not our  
28 competency, we would like to offer connectivity, formal and  
29 informal, as we do with Rex for example in Australia, to  
30 some of the regional carriers because otherwise, if you are  
31 sitting in Nelson, you're pretty much stuck as far as your

1 options go.

2 So, if there's a regional carrier such as Origin Pacific  
3 or whatever, we would be happy to work with them, although  
4 you might not see us do it in the same way as the  
5 traditional full service airline, as they call it, structure  
6 which is this through-check from Nelson to North Hampton in  
7 the UK with, you know, three connections and global  
8 recognition on your lounge card and the whole thing; it's  
9 not us, but it doesn't mean we don't offer a service, and a  
10 lot of people connect on us. They do.

11 **MS BATES QC:** One last question, and I don't know if you were  
12 here when Mr Webster spoke, but he didn't see your model as  
13 being a pure VBA model, and I think he -- I don't know if  
14 that's right or not -- but I do notice that in Australia you  
15 are providing some services to your business, I think  
16 probably aimed at your business passengers, would that be  
17 right? Like, lounges, facilities and even the occasional  
18 hot meal.

19 **MR HUTTNER:** Uh-huh. For a price.

20 **MS BATES QC:** So you charge for those?

21 **MR HUTTNER:** Yeah. Let's talk through this whole VBA, FSA  
22 discussion. There is a difference between VBAs and FSAs, as  
23 they call it, but it's more a question of philosophy and  
24 management style than it is, like, there is a definition  
25 that it's black or white, that there's a VBA and FSA out  
26 there, it's a bit of shades of grey. Although there's  
27 definitely a few shades between us -- there's less shades  
28 between us and easyJet than there is between us and Air New  
29 Zealand and Qantas.

30 We are a separate product but we have lounges, as you  
31 pointed out. We actually use lounges on a pay per use



*Virgin Blue*

1 basis. Our Brisbane lounge just got past break even now.  
2 In other words, it's self-sustaining as a profit centre and,  
3 therefore, we don't make -- people who just want -- if you  
4 want a \$69 fare and you are happy to pay an extra \$5 to  
5 enter the lounge because you're a business traveller, we're  
6 not gonna make you pay a penny more to support your lounge  
7 or your frequent flyer programme or anything else.

8 **MS BATES QC:** I said it was the last one, this is the last one,  
9 but the operating costs, there's a difference, but you've  
10 set yours much lower than Qantas?

11 **MR HUTTNER:** Ours are much lower than Qantas, but I think it's  
12 also safe to say that we looked at easyJet when we started  
13 this airline; I used to be in the European operation of  
14 Virgin Group. You know, Mr Webster runs an excellent show,  
15 but we didn't think -- every market has its nuances and we  
16 didn't think the easyJet operation would succeed.

17 That being said, as was highlighted by Air New Zealand,  
18 we did have meetings with them last year at some point and  
19 it became clear early on that what their view of what an  
20 airline should be was quite different than ours, and basic  
21 management philosophies of how you approach the customer are  
22 very different; that's why I think the discussions didn't go  
23 very far.

24 **MS BATES QC:** Okay, thank you very much.

25 **MR CURTIN:** Thanks for all of that. Our job, as you know, is to  
26 try and guess how the alliance airlines might behave. I  
27 hear everything you say, that you'd like to have a 30%  
28 market share so you can compete for the corporate accounts  
29 and have the whole kit they'd look for. I accept that.

30 But there's also a line of argument that says, you don't  
31 have to be here at all in a way as long as you're lurking as

*Virgin Blue*

1 a credible threat in the background, and you could argue  
2 that the Express service and that lead-in Tasman fare are a  
3 response to you lurking there --

4 **MR HUTTNER:** Oh, I would say that's completely wrong.

5 **MR CURTIN:** Perhaps you'd care to expand on that. I'll have one  
6 detailed question in a minute.

7 **MR HUTTNER:** Look, it's funny, when we started in Australia,  
8 Qantas only put really really low fares out on the routes  
9 that we were flying. Then all the other routes appeared to  
10 cross-subsidise those routes. And then, all of a sudden, I  
11 think they caught on to that issue as we caught up with the  
12 ACCC, and then all of a sudden what you started seeing was  
13 low fares on all the routes, even the ones we didn't fly,  
14 but somehow the availability of seats at those low fares  
15 were much greater on the routes we did fly; they just never  
16 could seem to get those discount fares for Christmas on the  
17 routes we didn't fly.

18 Therefore, one, certainly they're trying -- and last  
19 week's PR show was certainly a way to get a leg up on trying  
20 to position themselves as a low fare airline. We're happy  
21 to compete with that because we know we can demonstrate to  
22 the consumer that our flexibility, like we talked about  
23 before, will differentiate our product even if the fare's  
24 are similar because you won't always get the -- there's a  
25 management of expectation; if you put a fare in the paper  
26 and you call up tomorrow and you can't get it, you're upset.  
27 And, therefore, we can do that.

28 The second issue is of course is that, if we fly on one  
29 route; let's say tomorrow we fly Wellington-Sydney. If we  
30 fly in one route, what we've seen is that the price and the  
31 availability tends to drop literally about the day we start,

*Virgin Blue*

1 and we've had -- this has been usually a standard line in  
2 almost all of our route launches; they notice how the fares  
3 were yesterday before we arrived here, and they're much  
4 higher than they are today.

5 That means that -- and Qantas recognises, and Air New  
6 Zealand probably recognises too, that the public's memory is  
7 rather short-term. You know, if I go to the market right  
8 now, I'll pay \$25 or more a kilo for a bag of cherries. But  
9 tomorrow, if they have a special for \$9.95, I won't -- you  
10 know, I'm not going to say, oh, those bastards, they charged  
11 me \$25 last week and now it's \$9.95. You're going to take  
12 home the bag of cherries at \$9.95, it's a good deal, you go  
13 home and you'll enjoy the bag of cherries. I know this  
14 because I experienced it over the weekend.

15 And so, you know, it's a little bit about, the public's  
16 memory for the fact that -- we try to build up on the  
17 public's resentment saying, remember what happened to you  
18 for the last few years, and to a certain point you get a  
19 certain sympathy for that, but at the end of the day the  
20 consumer looks in the paper, that person calls on the phone,  
21 and they take the lowest price out there that they can get,  
22 a lot of consumers do, at the most convenient time etc  
23 depending on what their value proposition is for whether  
24 it's schedule versus fare.

25 It's fair to say that we could be -- when we come into  
26 the market, although these actions are taken beforehand, the  
27 reality's still different once we're actually there.

28 **MR CURTIN:** And, just one small point. In your opening  
29 statement you had a passing reference to operating in the  
30 freight market. We haven't had much on the record, if  
31 anything, about the freight market so far, but I would quite

1 like to understand what you do in Australia and what you  
2 think the impact has been on the freight markets in  
3 Australia and perhaps, if you can, what you're planning to  
4 do here.

5 **MR HUTTNER:** An airplane, by nature, is a little metal tube that  
6 carries a wide variety of services. It can be visiting  
7 friends and relatives, it can be tourism, and it can be  
8 business flyers and down below it can be freight, and that  
9 freight can be express cargo or fruit or whatever.

10 We provide a freight service -- and freight service is a  
11 little bit like connecting traffic, it's not something  
12 that's part of our core business but we use it to get cream,  
13 and we actually run it profitably, and we become an  
14 effective constraint on the other guy's pricing because,  
15 although we only carry what's called "loose" cargo, we don't  
16 have the big palletised containers that you see on all the  
17 747s and all that. We ultimately force their price down in  
18 the same way we would if we do with -- Economy Class  
19 actually does impact upon Business Class in way. You could  
20 say that there are some customers who will fly Business  
21 Class when it's only \$100 more than the walk-up fare, but  
22 they won't fly business class if it's \$500 more than a walk-  
23 up fare.

24 So, we perform an effective constraint, in some ways, on  
25 freight as we do with other things even though we don't  
26 address all needs of the freight market in the same way that  
27 we do with passengers, even though we might not address  
28 every single segment of the passenger market.

29 **MR CURTIN:** Would you have any feel, in that sort of loose goods  
30 area you were talking about, would you have any feel for the  
31 impact you had on freight rates in Australia as a rough

1 percentage?

2 **MR HUTTNER:** Honestly, I don't have the answer to that question.  
3 If it was critical I could find it, I believe we have, but  
4 it's a bit theoretical because, you know -- I mean, in a  
5 sense that, I think we could probably provide a lot of  
6 anecdotal evidence if we probably did some research into it,  
7 but we've been told by shippers that, when you came into the  
8 market, into our city pair, you know, we weren't belted any  
9 more.

10 Tasmania is a great example of where we have a  
11 tremendous relationship with a lot of produce shippers, and  
12 all I can say is that, for the Premier's office, Premier  
13 Bacon's office at various meeting and others we have  
14 received a lot of favourable comment. Could I demonstrate  
15 that in a numerical sense? Might be difficult, but we could  
16 try.

17 **MR CURTIN:** Thanks for that.

18 **MR PJM TAYLOR:** Thank you. As a cherry grower, I applaud your  
19 choice of fruit.

20 **MR HUTTNER:** How much do they cost right now?

21 **MR PJM TAYLOR:** Could I take you back to your comments about the  
22 Mount Isa route, and you pulled that off, I think you said,  
23 because you couldn't see a chance of making it profitable.

24 Why do you think it was that Qantas chose that  
25 particular route, which at least to an uninformed New  
26 Zealander would seem a relatively minor route, to sort of  
27 take you on and make an example perhaps?

28 **MR HUTTNER:** Because at the time they probably -- their senior  
29 management probably didn't want to see us have a dot on the  
30 map that they didn't have. Nowadays we have a couple of  
31 exclusive routes, or routes that we actually dominate, but

1 back then that would have been very unprecedented.

2 **MR PJM TAYLOR:** They didn't have a route there when you started?

3 **MR HUTTNER:** Yeah, what happened was, Qantas pulled off the  
4 route, or their predecessors pulled off the route in 1989 in  
5 during the pilot strike. Ansett became a monopoly provider  
6 on the route.

7 We had spotted Mount Isa when we did our research and we  
8 said, well, if Ansett ever -- you know, if we can ever  
9 convince the large corporation town and the Queensland  
10 Government and a few other parties, those Mount Isa minds  
11 and the Queensland Government to buy in, we could probably  
12 put in a better service than Ansett had, but we kind of let  
13 it sit on the back-burner for a while.

14 And then, when Ansett collapsed, we quickly identified -  
15 - and we actually spoke to the Queensland Government, said  
16 we're in a pinch here we're in a pinch there, and we had a  
17 certain amount of loyalty towards Queensland because  
18 Queensland has always been supportive of us. And we said,  
19 look, we'll do our best, and we scrambled to get aircraft.  
20 We announced literally the day after Ansett collapsed that  
21 we'd start scheduled services to Mount Isa. A couple of  
22 days later Qantas actually flew in with the first service,  
23 but it was an ad hoc service, it was like not an announced  
24 scheduled service, but they announced after we had announced  
25 that they'd be running scheduled services. They put on two  
26 flights a day, their load factors were worse than ours. As  
27 far as we could tell, we did a lot of research and we kind  
28 of heard what was going on, and we know -- we have some  
29 pretty strong suggestions as to what they were earning on  
30 the route, and we know what the BA146 which is a much more  
31 expensive aircraft per seat kilometre than our was; they

1 were running on two flights a day.

2 And we felt that at the time -- and they also made a  
3 play for the Mount Isa Mines contract, and once that was  
4 closed, and we weren't at that time making great progress  
5 with the Queensland Government business, we saw no future.  
6 We weren't gonna keep up there for the network. We said, we  
7 can't make money, but we did make the first go and we  
8 thought it strange that, while Qantas had allowed for over a  
9 dozen years for Ansett to have a monopoly on this route,  
10 that somehow it was inappropriate for us to have one.

11 Since we pulled off we have received letters, we've  
12 received -- there's editorials in the paper saying, you  
13 know, that the major customers in town screwed up and backed  
14 the wrong horse, that they've been -- the feeling of the  
15 community has been in numerous letters and editorials in the  
16 press that they've been ripped off since and, most recently,  
17 Qantas after trumping us with two services a day moved back  
18 to one service a day.

19 In other words, without effective competition, now that  
20 they owned the market, they figured, ahh, we'll go back to  
21 one service a day now with a 717. It's unfortunate for the  
22 people at Mount Isa, and it's fair to say that when we go to  
23 see other communities we say, well, you know, competition is  
24 only as good if you support the competition. We usually  
25 give a very clear presentation that, when Optus came in in  
26 Australia everyone noticed how Telstra all of a sudden  
27 lowered their rates.

28 Well, it doesn't mean much if you don't occasionally use  
29 Optus for your phone services and you only back Telstra  
30 because they've lowered their rates now, and I think we've  
31 taken that same approach with a lot of the regional

1 communities where we service with jets, large jets, where  
2 they've never even seen jets before; Coffs Harbour didn't  
3 have jets for years. Launceston, McKay, Rockhampton didn't  
4 have large jets. These are actually communities that  
5 benefitted from our business model more than they benefitted  
6 from the traditional airline model.

7 **MS BATES QC:** Wouldn't you move in now, now that you've got a  
8 chance at Mount Isa, with everybody being so dissatisfied  
9 and whatever; wouldn't you now move in and say, right now,  
10 we'll get that Government contract and knock Qantas out of  
11 the picture?

12 **MR HUTTNER:** I wouldn't say we haven't looked at it since.  
13 Qantas can keep on doing what the new pricing strategy, the  
14 new pricing strategy is, I think they're welcome to do that  
15 because some day we may pull a rabbit out of a hat. But,  
16 you know, I don't think that day is today and we'll see what  
17 happens. And I think that in some way we provide some form  
18 of competitive constraint, but I'd say it's pretty minor at  
19 this stage, and it's fair to say that at the time we  
20 determined that Qantas, although we had resources, we knew  
21 we could allocate those resources better.

22 After the Ansett collapse, Mount Isa was literally the  
23 only city in the country that had over-capacity. I mean, it  
24 was rather odd at best, and it's fair to say, we just didn't  
25 want to bleed as long as the other guys were prepared to  
26 bleed. We might.

27 **MS BATES QC:** I suppose my point is, you may not wish to let  
28 that situation go on for you?

29 **MR HUTTNER:** It's fair to say that it's possible in the future  
30 we may try to take another go at it and we probably -- but  
31 it will be a tough go. It's probably a natural monopoly for



1 jet services because of simply the size of the market.

2 **MS BATES QC:** Thank you.

3 **MR PJM TAYLOR:** In addition to your cost advantage, what else do  
4 you see are your comparative advantages?

5 **MR HUTTNER:** For certain market segments we run a superior  
6 product. Because of our simplified way of doing business,  
7 we can be more on time, we don't have to worry about  
8 multiple fleet types, having the wrong crew available; when  
9 you have an A330 available but you only have a 767 crew on  
10 the ground, how do we swap those two because something  
11 happens because one plane goes tech.

12 **MR PJM TAYLOR:** These all feed into a lower cost base.

13 **MR HUTTNER:** These all feed into a lower cost base. There's a  
14 million advantages there, but that actually also improves  
15 service. We believe in many ways we have a superior service  
16 to our competitors. We believe we have better on-time  
17 performance and we are in a process now of challenging them  
18 to put their numbers on the table with us, and we're  
19 hopefully meeting with the Department of Transport in the  
20 next couple of weeks to do that. We believe on-time  
21 performance is a key component for the business flyer, as is  
22 frequently, and we're now building the level of frequency to  
23 compete in that market now that we have the adequate  
24 facilities.

25 So, we also believe we have excellent service, and we  
26 don't define service by a meal on a plastic tray or in a  
27 box. We define service as people who smile at you at 6am in  
28 the morning, which is a tough thing to get from any  
29 industry.

30 **MS BATES QC:** Doesn't help when you're hungry.

31 **MR HUTTNER:** And it's fair to say that, for those people who

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1 don't want to pack their breakfast, we are more than happy  
2 to sell them a delicious snack but the reality is, look,  
3 whether we sell it to them or give it away and wrap it up in  
4 the price of the ticket; airline coffee is always gonna be  
5 airline coffee, and I think it's -- we try to serve the best  
6 coffee we can on board if you want to pay for it, and that's  
7 what Virgin Blue is about. We'll give you the meal, we'll  
8 give you the coffee, we'll give you the lounge. We'll let  
9 you book by telephone instead of the internet as long as you  
10 you're willing to pay for it. We have a reservation centre  
11 as a profit centre, while every other airline looks at it as  
12 a cost centre. It's a very different philosophy but we'll  
13 try to make all the services available if they pay for it  
14 themselves.

15 We've been reluctant on frequent flyer because, although  
16 we recognise there's been an attraction to frequent flyer  
17 programmes, we're still trying to find a model that creates  
18 a self-sustainable cost/benefit, where we don't have to  
19 cross-subsidise with other customers who are not hampered  
20 with the process.

21 **MS BATES QC:** On how many routes do you supply these add-ons?

22 **MR HUTTNER:** On every route, although hot meals are only on  
23 routes of three hours. On other routes that are shorter  
24 it's just regular -- like, fresh sandwiches and so on.

25 **MS BATES QC:** Yeah, I seem to recollect that. Thanks.

26 **MR PJM TAYLOR:** I'd just like your view on the proposition that  
27 the low fares of the Fifth Freedoms into Auckland act as a  
28 constraint on the pricing out of Wellington and out of  
29 Christchurch into East Coast Australia.

30 **MR HUTTNER:** How?

31 **MR PJM TAYLOR:** Well, it's been said that they do act as a

1 constraint --

2 **MR HUTTNER:** Sorry, I missed that one; I wish I heard it.

3 **MR PJM TAYLOR:** Sorry, I misunderstood what your question aside  
4 was.

5 **MR HUTTNER:** No, no, that is my question. That's an interesting  
6 proposition based on my knowledge of the industry, I'm not  
7 quite sure how that works. Look, if we were in Hamilton,  
8 one could say that Hamilton might have a constraint on  
9 Auckland because there are some people, at a certain price,  
10 would drive an hour and a half down the road, or Palmerston  
11 North might on Wellington. But, to suggest that Wellington  
12 has a constraint on Auckland; it would be a pretty hard ask  
13 for most customers except for the odd backpacker who wanders  
14 around New Zealand for a few months and then can wander  
15 around Australia for a few months and doesn't really care at  
16 what point he crosses the Tasman.

17 **MR PJM TAYLOR:** The argument is, ill will with the customer base  
18 in the whole of New Zealand was part of the argument that  
19 was raised with us.

20 **MR HUTTNER:** Markets are based on city pairs primarily. While  
21 you have some overall global markets such as a major  
22 corporation. If you are sitting here in Wellington, what  
23 the hell do you care what the price is from Auckland to  
24 Sydney? All you care about is the price from Wellington to  
25 Sydney.

26 **CHAIR:** I guess the other point is to get capacity shifted to  
27 those other routes if it was profitable to do so.

28 **MR HUTTNER:** Well, what happens with a traditional airline  
29 model, they'll try to force people over the hub to get  
30 certain efficiencies. We don't believe in that model and we  
31 don't believe -- that model means that, if any leg of that

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1 hub is pulled out, it affects the economic viability of the  
2 airline overall. We're not big believers in hub traffic.  
3 We do some hubbing, where we can get those extra city pairs  
4 we wouldn't offer a direct service. But hubbing is not a  
5 core strategy of ours.

6 We believe that people should be offered the most direct  
7 convenient services, and running a hub operation is not part  
8 of our core philosophy, but it certainly is traditional to a  
9 full service airline, as they're so-called, and many of the  
10 airlines in the world do that, and many of the airlines in  
11 the world that do that are in significant financial  
12 difficulties today.

13 Many of the airlines that follow our model are doing  
14 better, but that is not to say that one is inherently right  
15 in every situation or inherently wrong in every situation.

16 **CHAIR:** Can I just ask you if you've looked at what your  
17 strategy, if there is one, might be vis-a-vis the provincial  
18 routes in New Zealand?

19 **MR HUTTNER:** Uh-huh. Two strategies. One is the provincial  
20 routes where we can land a 737 and we believe there is  
21 potential, given the right price structure, to actually  
22 stimulate the market.

23 A couple of years ago on The Holmes Show Richard  
24 Branson -- when we were originally looking at New Zealand  
25 before Ansett collapsed, and we had to delay our plans  
26 significantly -- Richard Branson mentioned Auckland-Dunedin  
27 as a great example of a route where direct services without  
28 the hubbing effect could actually be conveniently offered.

29 Ironically, under previous management of Air New  
30 Zealand, a week later Air New Zealand all of a sudden  
31 announced for the first time I guess in 10 years Auckland-

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1 Dunedin direct jet services. We fly, as I say, Coffs  
2 Harbour which hadn't had jet services in years. We fly  
3 Launceston which had -- the biggest thing was a BA146 and  
4 now there's an empty hangar down there because Qantas has  
5 decided to compete with us with the BA146 now that we're  
6 there, and they just built a brand new hangar which is  
7 basically unutilised. Rockhampton, McKay and there's a few  
8 others.

9 It's fair to say that, where physically possible, we  
10 will always look at putting 737 services into city pairs  
11 that may not have had them before. Freedom Air was  
12 certainly an example of that, you know, I don't know if  
13 Hamilton or Dunedin or Palmerston North -- you know, I think  
14 Kiwi came on first then Freedom Air followed, but it's fair  
15 to say that's an example of that sort of strategy. But it's  
16 also safe to say that there are a number of markets in this  
17 country that don't have airports that we can operate into.

18 That's where we, hopefully, will work on a relationship  
19 with some of the regional carriers, if possible, and we will  
20 also draw people to do something that they wouldn't have  
21 done before which is that, there are some people, if you  
22 have a family of four or whatever that can say, I can save  
23 \$50 a head by driving up the road to Palmerston North as  
24 opposed to flying out of Wellington, I might do that, and  
25 there are certain scenarios where you'll try to pull that  
26 traffic into another airport that might be somewhat  
27 convenient. The same can be said; would someone drive from  
28 another point in the South Island to Christchurch, because  
29 you can offer a lower fare from Christchurch? That is  
30 possible, but it won't -- you know, we recognise there's  
31 certain markets we can't address and that's why, where

1 possible, we'll try to at least offer the service.

2 But a lot of people don't need to book the through  
3 ticket. We find in Australia that a lot of people fly on  
4 our competitors out of the regional monopoly areas, and then  
5 they uncheck their bags and they walk across the terminal  
6 and they check in on our flights for the long sector, and we  
7 see that on the bag tags; it's anecdotal.

8 But we noticed that the day that a company called Flight  
9 West stopped operating, which is an Ansett affiliate at the  
10 time, that all of a sudden we got these calls from little  
11 places like Birdsville and Longreach, which is the home of  
12 Qantas, the original home of Qantas, and people from  
13 Longreach would call and say, "We've got a ticket on your  
14 airline", "Well, we don't fly to Longreach", "Oh, yeah, but  
15 we're supposed to fly on Flight West and then connect with  
16 you; can you help us out". So, we know people do this.

17 **CHAIR:** Can I just ask you, when will you know whether you've  
18 made a successful entry into New Zealand? What sort of  
19 timeframe do you think?

20 **MR HUTTNER:** It depends on how you define it. We'll hopefully  
21 have a successful entry from day one. I mean, from what we  
22 do. Once again, we don't look at New Zealand as a single  
23 thing; it's many markets, and every market we enter we hope  
24 to have a successful entry. Some entries take a year or  
25 two, some markets pick up in three to six months, but we've  
26 had a successful airline over the course of three years,  
27 with a few mistakes on the way, and it's fair to say that we  
28 hope to have a successful entry into each market we enter as  
29 quickly as possible, but sometimes routes take a year or two  
30 to develop properly.

31 **CHAIR:** So, a year or two?

1 **MR HUTTNER:** For some routes that we can actually be a full  
2 competitive constraint for the segment of the market known  
3 as a large corporation.

4 **CHAIR:** I ask that question because there's -- the Applicants  
5 themselves have noted that one of the things the Commission  
6 could do is put a time limit on this authorisation, should  
7 we be minded to authorisation, and it's certainly one thing  
8 that can be considered if we thought we could actually  
9 unpick the arrangement once it was put into place, and I  
10 just wondered if you have any views on that?

11 **MR HUTTNER:** Pardon me for a second. [**Pause while conversing**  
12 **with Mr Callaghan**]. This is not something we've considered.  
13 I'd be happy -- we'd be happy to review that question as a  
14 group. It's not really -- it's hard to say whether -- maybe  
15 that's why Air New Zealand was so attached to Freedom Air at  
16 the time, because they see it as a get out of jail card in  
17 this whole thing; I have no idea.

18 But it's hard to say what type of time limit would be  
19 appropriate or if that really matters; I couldn't give you a  
20 comment at this time. I'd be happy to follow-up and give  
21 you a response back if you need it.

22 **CHAIR:** Thank you. I'd just like now to ask our staff and our  
23 external advisors if they have questions.

24 **PROF GILLEN:** I have a couple of questions. First is, has  
25 there been -- is there any route that you entered into in  
26 Australia in which Qantas, rather than increasing capacity,  
27 had actually decreased capacity as you grew the market?

28 **MR HUTTNER:** Recently -- more recently I think there's been  
29 acceptance by Qantas that we, shall we say, exist and we  
30 ain't going away. So I think what we've seen -- and if you  
31 can come back to what's referred to as the Southwest -- the

*Virgin Blue*

1 American Airlines case which you may be familiar with. The  
2 use of capacity as a weapon towards a player that is fully  
3 entrenched in the market is very different than it is  
4 towards a player that is limited or has constraints, be it  
5 by limited resources in terms of facilities or in terms of  
6 capital available.

7 But no, it's fair to say that at this point in time I  
8 think Qantas has acted more rationally, and probably on some  
9 routes there have been capacity adjustments up and down  
10 depending on a route-by-route basis. Adelaide-Gold Coast is  
11 an example where we can make a route work that Qantas tried  
12 only after we arrived in Australia, hinted that we were  
13 gonna do it -- I think they actually flew it a little before  
14 we did -- but they pulled back on it because our economic  
15 model would sustain an Adelaide-Gold Coast or an Auckland-  
16 Dunedin probably better than a full service airline model.

17 **PROF GILLEN:** Okay, thank you. A second question is, have you  
18 noticed over time any changes, if any, in people coming in  
19 on non-Qantas International Airlines, Singapore, Thai or  
20 whatever, and then inter-lining with you to a second  
21 destination within Australia?

22 **MR HUTTNER:** We get a limited sector, of segment of that market.  
23 We're getting a bit more from very very price conscious --  
24 let's say Chinese tour groups; of course, they stopped for a  
25 while during the SARS situation, but Chinese tour groups are  
26 extremely price conscious, are more apt to do that than,  
27 let's say, a European tour group who might book the alliance  
28 convenience for example.

29 Americans, who are on this -- as Americans do, and I can  
30 say this with authority from my family, they do this two  
31 week tour of Australia and New Zealand and say they've seen



*Virgin Blue*

1 it all. It's fair to say that that type of group probably  
2 wouldn't take our products readily. We have had a very  
3 limited operation with United; it serves a particular  
4 purpose for particular segments of the market, but we're not  
5 even addressing all of United's needs in any way; they  
6 have -- a lot of traffic ends up on Qantas.

7 Inter-line, once again, if we can do it without  
8 affecting our core business model it's fine. We do get some  
9 stop-over based traffic which means, they fly in, they stop  
10 at the arrival point for a couple of days and then they fly  
11 domestically on us, like, almost like a bus transfer with  
12 wings, and then they stop again and then they fly out, but  
13 that's different than true inter-line connecting traffic  
14 which we really don't have much of.

15 **PROF GILLEN:** The third question is, if you look at countries in  
16 which you have value based airlines, the upper limit seems  
17 to be 26, 30% in terms of market share. Do you think that  
18 there's an upper limit and, if so, why and what is it?

19 **MR HUTTNER:** I'm not sure that's the case. Some markets liked  
20 Edmonton-Calgary, I think, it's the majority player if I'm  
21 correct, or Winnipeg-Calgary.

22 **PROF GILLEN:** I agree on those markets; I'm thinking in terms  
23 of the national market. Western is about 28% of the  
24 Canadian market, right?

25 **MR HUTTNER:** Yeah, on a national basis -- no, we've indicated we  
26 believe -- at some point in the future in Australia we  
27 believe we could become the majority player; we're not going  
28 to say it's going to happen right now, we believe it's going  
29 to be a few years down the track but we believe we can  
30 become the choice of the majority of Australian domestic  
31 travellers. That being said inter-line, as you noted, is a

*Virgin Blue*

1 segment of the market that we'll probably never fully  
2 properly address, nor would people who don't care what the  
3 cost is, just fly on business class purely out of who they  
4 think they are or what their position is, and no matter what  
5 the price is they'll pay it because they're not paying for  
6 it. There are certain segments like that that won't  
7 probably fly with us. Now, some of them fly with us on the  
8 weekend with their families, but it's fair to say that there  
9 are segments, but we believe we could contest as much as 50%  
10 of the market, comparing Australia is probably better  
11 compared to Canada than it would be to the US, because 30%  
12 market share in the US would be pretty amazing considering  
13 the multiplicity of carriers versus in Canada where it's  
14 basically a very similar situation to Australia.

15 **PROF GILLEN:** Thank you. My final question is, your cost  
16 advantage over New Zealand Express or JetConnect is going to  
17 be much smaller, which then means that your load factors or  
18 break even load factors are going to be higher. How does  
19 that influence the kind of strategic entry into the Tasman  
20 or New Zealand domestic versus what you experienced in  
21 domestic Australia?

22 **MR HUTTNER:** It's fair to say that New Zealand Express, Freedom  
23 Air, JetConnect, are certainly a more viable threat to us  
24 than Qantas or Air New Zealand mainline has been in the  
25 past. We don't doubt that, as was -- that's why we were not  
26 in favour of Qantas' takeover of Impulse, because it gave  
27 them a weapon, and it has been used. Impulse has been  
28 redeployed, as I mentioned on Tasmania, which was a BA146  
29 route with an empty new hangar because they decided, oh-oh,  
30 better fill the 717s on at Launceston, and same thing at  
31 Rocky. They threw that at us at Launceston.

*Virgin Blue*

1           Like I said before, we're all big boys and girls, and  
2 we're all happy to compete in the market as long as we don't  
3 get the impression that people are doing something that is  
4 completely obviously economically irrational simply to  
5 gazump us, and I think it's fair to say, when you first  
6 enter a market -- and this comes back maybe to time limits  
7 we'd have to discuss further -- but when you're first in the  
8 market it's that initial period when you are the most  
9 vulnerable to someone just making it pretty painful for you.

10 **PROF GILLEN:**       Okay, thank you.

11 **DR PICKFORD:**   A day or two ago a study by Professor Forsyth was  
12 mentioned in which he looked at an index of different  
13 classes of fare in Australia, I think from 1999 to 2001, and  
14 he found that over that period discount fares had fallen  
15 quite sharply but Economy Class fares had risen quite  
16 sharply.

17           Does this accord with your experience?

18 **MR HUTTNER:**   Most of the studies, in our view, are useless  
19 because they have no access to the fare buckets and the  
20 allocation of fare buckets. This is why price constraints  
21 is a bit of a farce, because it's not what the lowest  
22 advertised price is, it's how many seats are available. And  
23 for one, no airline would disclose this information probably  
24 willingly, and it's at the core of how we do business, the  
25 yield management systems; it is for Qantas, it is for any  
26 airline in the world.

27           So, look, we go out and we've offered \$1 fares, but as  
28 has Ryanair and easyJet have offered £1 fares, but the  
29 reality is, I don't think anyone really believes we're  
30 making much profit on the \$1 fare. We do that to fill an  
31 extra seat and to, you know, make a statement about who we

1 are as an airline, that we would do something as "crazy" as  
2 that.

3 We will continue to do those things because our view is  
4 that, whatever incremental income you get on the last seat  
5 is better than no income at all as long as you don't  
6 cannibalise your existing structure too much. So, that's  
7 the basis of a low airline model in many ways.

8 Certainly, that has affected the price points that you  
9 will see advertised in the paper, but as you said, the full  
10 "wide class", the full economy fare hasn't moved much. And  
11 even now in Australia, it's funny, you've got Qantas  
12 offering something that's virtually tantamount to a full, I  
13 think it's K-SOX(?) or BI -SOX(?), I can't remember which  
14 one is which, that is virtually a full fare but is a lower  
15 full fare because they were having trouble selling their  
16 full fare against us because people just didn't pay for the  
17 value proposition.

18 But, that being said, they keep the full fare in there,  
19 which keeps all these people doing the studies as a  
20 benchmark point because their Government contracts, for  
21 example, are based on a 20% off full fare. But a full fare  
22 in these days is a little bit like the rack rate you see on  
23 the back of the door at the hotel or whatever. If you  
24 really paid that rate it's either the Bledisloe Cup weekend,  
25 or you've been ripped off and your travel agent didn't do a  
26 good job. Nobody really pays rack rate most of the time at  
27 hotels and that's why you'll see in Australia that a lot  
28 less people are paying that top bracket than they used to.

29 **DR PICKFORD:** So, given those comments, you wouldn't be able to  
30 really have a view on how Qantas has -- how its pricing  
31 policies have changed across the board since you entered the

1 market?

2 **MR HUTTNER:** I think it's pricing policies have gone closer  
3 towards ours, not completely, but they've certainly been  
4 forced to move our direction; they did it reluctantly, it  
5 took 2 years.

6 We understand that some of the ideas that have been  
7 introduced just recently were actually proposed at Qantas a  
8 couple of years ago, but at the time they were saying, no,  
9 we don't have to do this to compete with these guys, and now  
10 they do.

11 So, we have seen a fare structure introduced by Qantas  
12 that recently that in many ways resembles our own; not  
13 exactly, but much closer than it used to be before and,  
14 therefore, we think -- we've said that we've had a  
15 competitive effect on Qantas, so people -- the same thing;  
16 even if you are buying Telstra, Optus has impacted your  
17 pricing, and in the same way we believe we've changed how  
18 Qantas approaches its pricing and marketing position.

19 **DR PICKFORD:** And to the same extent to business fares as well?

20 **MR HUTTNER:** As noted before, yes. We believe that, when the  
21 value proposition between, let's say, a full wide economy  
22 fare or a walk-up fare in economy and Business Class is only  
23 10%, a lot of people make the trade-off that they won't make  
24 when the difference is 30 or 40\$, especially when they can  
25 pay \$5 more and use our lounge as well.

26 So, would you rather -- for example, you can buy the  
27 extra leg room seats on our plane, the seats by the front  
28 row. Anybody can sit in 1A on our plane for an extra --  
29 sorry, I can't think of the number right now, I think it's  
30 \$35 or whatever it is, so for that we'll make sure you get  
31 one of those front row seats or the seats with the extra leg

1 room by the emergency exit row; we'll sell you a lounge  
2 entrance for \$5. So, if the two most important things to  
3 you about business class is the use of the lounge before you  
4 fly -- or three things; purchase of a hot meal -- the hot  
5 meal and extra leg room, well, probably for under \$60 or \$70  
6 we've addressed most of your concerns for something that  
7 would have actually cost you \$300 or \$400 before.

8 **MS BATES QC:** Yes, but you've got limited ability to do that,  
9 haven't you really, if you've only got one row of seats with  
10 extra leg room?

11 **MR HUTTNER:** There's only nine seats on the aircraft that  
12 qualify under that programme, but we'd rather offer those  
13 nine seats and make a little extra income, better satisfy a  
14 certain niche of customers, than to actually introduce a  
15 Business Class, which we don't think we could sustain on  
16 most routes on a network wide basis every day.

17 **DR PICKFORD:** I'm not sure whether you will be able to answer  
18 this question or not, but you have 10 new aircraft I  
19 understand arriving over the next year. Are there any plans  
20 as to how you're going to deploy them, on which routes?

21 **MR HUTTNER:** We've got lots of plans. Yes, certainly, look,  
22 we've got -- for those 10 aircraft we have devised what I  
23 would describe as about 20 lines of flying, and we'll deploy  
24 them. For example, the aircraft that arrived this month,  
25 which we announced in March or April, that those aircraft  
26 will be flying on extra Perth morning originator services  
27 because before we didn't have a plane that started from  
28 Perth in the morning and we were losing out to some of our  
29 major corporate customers in Perth, Bankwest, West Farmers,  
30 a few others. Now that we have a morning originating  
31 product, we believe we will better address their needs.

*Virgin Blue*

1           Certainly, we've got a pretty good idea where we'd like  
2           to put the aircraft, and we've applied for slots and we've  
3           applied -- you know, and that's because we're considering  
4           where possible, we can get those slots is a possibility.  
5           The reality is, the application process, as everyone knows,  
6           is rather transparent. You can't do much in secret like you  
7           do domestically in Australia so, you know, we've looked at a  
8           lot of things. Whether we act upon -- for example, it's  
9           been put out there that we're likely to announce all our  
10          flights will start at the end of October; well, that's the  
11          airline schedule change season.

12          It's a traditional time to file for slots; one should  
13          not take from that that is the actual start date, and I  
14          think there's been a certain misunderstanding in the media  
15          by some people who don't follow this stuff closely that  
16          because we applied for slots on a date doesn't mean we've  
17          announced a start date.

18 **DR PICKFORD:** And you've applied for access to Fiji and Vanuatu  
19          as well as New Zealand. What are the relative interests, in  
20          terms of flying to each of those three countries, from your  
21          perspective?

22 **MR HUTTNER:** Umm, weather. No, in fairness, it's fair to say  
23          that each market is evaluated on its own. Now, obviously we  
24          -- ultimately you have to make a comparison, but I don't  
25          think for a moment that anyone's saying that Fiji we'd put  
26          head-to-head against Wellington and try and compare them,  
27          you know, it's apples and pears -- or cherries.

28          It's fair to say that we would like to look at both  
29          markets, and we probably will fly eventually to all its  
30          markets unless we can counter some physical constraint, be  
31          it airport operating or range or operational issues. We

*Virgin Blue*

1 would like -- we have applied for Fiji and Vanuatu because,  
2 depending on how things play out, we might decide at this  
3 point in time that's the best next move for us, or we might  
4 put the airplane flying another Sydney-Melbourne flight up  
5 down all day long if we think that's the best move for us,  
6 but we don't have to file that one so publicly.

7 **DR PICKFORD:** Some people have said that the 10 extra aircraft,  
8 you simply can't use them on your present routes or even to  
9 Fiji, so that must mean you are going to fly the Tasman  
10 using them. Is that correct?

11 **MR HUTTNER:** Some people said we'd never get past 10% in the  
12 market; some people said we'd never get past 20% in the  
13 market. There's a lot of experts out there. So far we've  
14 found very few of them have predicted it right, so I think,  
15 if you think we're done growing in Australia, or Qantas  
16 think we're done growing in Australia, they're going to be a  
17 little bit disappointed.

18 **DR PICKFORD:** Just one more question. When you look at the  
19 recent history of aviation in this part of the world, you  
20 see it littered with the wrecks of airlines that have come  
21 and gone. I mean, there's been the two Compass experiments  
22 in Australia, Impulse, Ansett Australia; here we've had Kiwi  
23 Airlines, Ansett New Zealand, Tasman Pacific. You're the  
24 latest in line in a way, and I don't want to cast aspersions  
25 on you, but I mean, airlines are, because of their cost  
26 structure, they can lose money very quickly, they get into a  
27 slide. So, what is it about you that makes us believe that  
28 you're gonna be here for the long haul?

29 **MR HUTTNER:** We believe we're doing things the right way and the  
30 way of the future, in the way that people -- we believe  
31 we've built an airline based on what we believe the consumer



*Virgin Blue*

1 wants as opposed to what an airline thinks the consumer  
2 wants or has decided what the consumer wants. And we  
3 believe the fact that -- and there are stories of airline  
4 failures all over the world, some of them are low fare  
5 airlines too. I mean, a low fare airlines is not a  
6 guaranteed of success; there have been many low fare  
7 airlines that have failed.

8 But if you get it right you see companies that are  
9 lowering fares and making profits and employing more people  
10 and creating more tourism and more growth and impacting  
11 lives in a better way for thousands and millions of people  
12 in places like Carcassonne, France and in Bologna, Italy,  
13 and you can go on and on, and you know in Saskatoon,  
14 Amarillo Texas, and I can also think of numerous others, and  
15 in Dunedin.

16 So, it's fair to say that the low fare model has  
17 demonstrated for up to 30 years for Southwest, and less with  
18 for some other airlines, but at least 10 years for Ryanair,  
19 to be resilient. And the difference between us probably and  
20 a full service airline is, I think we're more resilient when  
21 times are tough. Because, although -- let's imagine the  
22 economy doesn't go well tomorrow for whatever reason and  
23 people don't have as much disposable income to use to fly  
24 around; while we would lose a certain amount of  
25 discretionary traffic, we also see an increase in corporate  
26 traffic when companies are forced to do business but cut  
27 their budgets.

28 So, we can sustain certain cyclicalities better than the  
29 big airlines, and I think we did that during the SARS  
30 campaign -- not the "campaign", what do you call it --  
31 epidemic; epidemic, excuse me. SARS epidemic, thank you,

*Virgin Blue*

1 please strike that. SARS epidemic during -- you know, there  
2 a lot of campaigns -- I was thinking about campaigns about  
3 flying domestically in Australia post Bali. Got two issues  
4 mixed up there, sounds really silly. You know, post Bali  
5 there was a campaign to look at people flying domestically.

6 It's fair to say that we did well out of that too  
7 because external shocks -- we are less exposed to those  
8 external shocks than other airlines are, because we don't  
9 fly the traffic that will disappear the moment a war breaks  
10 out in Iraq or some terrorist blows up a bomb in a hotel in  
11 some foreign country.

12 **MR AINSWORTH:** What's the maximum distance that you can consider  
13 flying? And here I'm thinking of Auckland to the West Coast  
14 of the United States.

15 **MR HUTTNER:** Highly unlikely. We'd probably run out of fuel  
16 long before it reached Hawaii. It's fair to say that -- I  
17 guess technically you could probably do it if you stopped at  
18 a few places along the way, we haven't really investigated  
19 it, but it's fair to say that likely expansion plans for our  
20 airline is probably Auckland plus five to six hours, or  
21 Christchurch is five to six hours, but I think Auckland  
22 would be the furthest point northeast, because that's the  
23 range of our aircraft, and it's core to our model to  
24 maintain a single aircraft type.

25 So us as Virgin Blue, or whatever we call ourselves,  
26 there's been a lot of speculation about that, it's fair to  
27 say that we -- you know, we certainly believe we could offer  
28 competition in Samoa, Rarotonga or Fiji, depending on some  
29 of the bilaterals with certain countries and how that all  
30 works out, over time we will hopefully be able to do all of  
31 them because of the new treaties that are being passed, but

*Virgin Blue*

1 we're not going to solve the Los Angeles issue, if that's  
2 where this is going. Maybe another carrier, be it Virgin  
3 Atlantic or somebody else might; the market will drive that  
4 one, but we wouldn't be the solution to that problem  
5 ourselves.

6 **MS WHITESIDE:** I've just got a couple of questions. Could you  
7 please, maybe not now, but if you could provide to us --  
8 now, we've got information about what slots you've supplied  
9 for and what you've been granted at this stage into  
10 Auckland, Wellington and Christchurch Airports. I was  
11 wondering if you were able to provide us with details of  
12 your intentions at this stage of what your intended flights  
13 over the Tasman are; what, you know, routes, arrival and  
14 departure times and so on, and when you're likely to be  
15 doing that.

16 **MR HUTTNER:** Well, it's fair to say, and I can tell you  
17 something right now that probably won't come as a huge shock  
18 to Qantas and Air New Zealand; we've only applied for a  
19 number of slots that we believe we could reasonably utilise  
20 if we focus our full attentions on New Zealand in the coming  
21 months, given the aircraft deliveries as pointed out.

22 If we choose to deploy as many aircraft in the next  
23 season; the season being from October to the end of March  
24 I believe. If we choose to deploy those aircraft to  
25 New Zealand and make it the focus of our expansion plans,  
26 both international and domestic.

27 So, for example, you'll see that we did not apply for  
28 midday slots at Auckland, we applied for morning out,  
29 evening back slots. At Christchurch we did apply for midday  
30 slots. It's fair to say that there are three peaks at  
31 Auckland; there's one major peak at Christchurch, Wellington

1 doesn't have that issue as much. We would eventually want  
2 to apply for slots during the three peaks to probably the  
3 three major East Coast Airports in Australia, and we might  
4 do another city pair somewhere else where we deem it  
5 economically viable; Gold Coast, Adelaide, Cairns. I don't  
6 know, I mean, we could speculate about this, and Newcastle  
7 didn't go terribly well for the other guys, we'll see what  
8 happens.

9 And I'm not sure whether our situation with Government  
10 traffic out of Canberra, Wellington-Canberra's going to be a  
11 winner either, but it's fair to say that we will -- we are  
12 likely to apply for all those. It would be unfair and undue  
13 for us to burden the Slot Committee -- who actually have  
14 been very very helpful to us, might I add -- who have been  
15 very helpful to us in trying to get us the slots that we  
16 want, and we recognise that, although Air New Zealand and  
17 Qantas I believe, or Air New Zealand sits on the slot  
18 committees, that in no way they've been unhelpful, they've  
19 been quite the opposite, they've been quite helpful in their  
20 roles as Slot Committee Chair and so on.

21 We believe that -- we would eventually like to get all  
22 those, but it would be silly for us to tie up those  
23 resources today. What exact slot timings we'll get depends  
24 on a whole host of factors. So, to put in an arbitrary  
25 schedule about the future; one, depends on commercial  
26 factors, which we can't predict, and what we discover and  
27 what we do on connecting flights in Australia, for example,  
28 and where the aircraft are positioned, but it also depends  
29 on maybe what's available at Sydney.

30 So, for example, we might -- this is where we have to  
31 work out some of the details of what Air New Zealand's

*Virgin Blue*

1 latest proposal to us is -- they might say, we can get you a  
2 slot here at 6.30 in the morning at Auckland or at noon  
3 time, but if we don't have the slot pair at Sydney, it's  
4 pretty useless. So, although it is, shall we say, perceived  
5 of as an Auckland problem or a Christchurch problem, in  
6 reality it's a problem you can't just simply narrow down;  
7 it's a very complex process and to say this is exactly what  
8 we want, and we can't do anything else, that's not  
9 realistic.

10 But we're looking to hopefully in our discussions with  
11 Air New Zealand, which will hopefully take place in the next  
12 week, we hope to simply say that -- and with Qantas -- is  
13 that we would like to have -- we would like to be able to  
14 apply for slots through the normal process and, hopefully,  
15 in three out of four, nine out of 10, who knows, cases we  
16 will get the slots we need through that process. But in the  
17 event that we are simply unable to get the slots at the time  
18 we need, then we would -- and you folks are sitting on two  
19 of them, even though you are supposedly getting efficiencies  
20 that means you can spread your schedules out more, but you  
21 haven't spread your schedule out at that particular time of  
22 the day, that's where we're looking for an undertaking on a  
23 concession in that area.

24 **MS WHITESIDE:** But you've pretty well got the slots that you  
25 have asked for at this stage in the New Zealand airports?

26 **MR HUTTNER:** Yes, and that's what I'm saying is, we might get  
27 all the slots that we ask for in the future as we grow.  
28 Right now we haven't applied for midday slots from Auckland  
29 because we don't -- it would be silly -- look, we could  
30 apply for every slot we could potentially fly in the next 2,  
31 years but that would be unfair to the slot authorities, it

1 would be unfair to the airport to tie up that capacity. You  
2 know, we can't really ask for all that today. All we can do  
3 is what has certainty today.

4 **MS WHITESIDE:** That's what I'm asking for, because you've said  
5 you're going to fly into New Zealand before the end of the  
6 year. We're now well through August. You must have  
7 something reasonably firm at this point, and we'd just  
8 basically like to have what you have; it gives us a bit more  
9 certainty.

10 **MR HUTTNER:** No, we have applied for slots at Christchurch,  
11 Wellington and at Sydney; like I said, you have the slots  
12 applications, they've come back and forth a few times. I  
13 think the Christchurch one got confirmed about 15 minutes  
14 off what we originally explained, but close enough I believe  
15 that it's not going to cause any major hindrance to us, if  
16 I'm correct, but I'd have to double-check that.

17 What you see now is what we foresee being likely in the  
18 next few months given the current competitive environment as  
19 it exists today.

20 Virgin Blue has been known to shift things around on  
21 very very short notice, we're extremely flexible as an  
22 airline, and we might decide in a month to do something new  
23 and different and we'll apply for the slots if they're  
24 available at that time. We will go through the normal slot  
25 application process and we're hopeful, and we have no reason  
26 to doubt that they won't do their utmost to get us the slots  
27 in the normal process. We would just only be concerned  
28 that, if that process is unable to provide that, that we  
29 have an alternative mechanism to obtain it, especially when  
30 our competitors would be perceived as not returning some of  
31 the economic benefits of their alliance to the greater

1 community at large of other airlines.

2 **MS WHITESIDE:** Right. Now, you've taken these steps to  
3 facilitate flights across the Tasman, clearly. Have you  
4 taken any steps towards domestic New Zealand flights, or is  
5 that further back?

6 **MR HUTTNER:** You don't have a slot application process for  
7 domestic; it is a different issue. It's an issue of  
8 facilities. Certainly, we have had discussions with the  
9 major airports about how they could accommodate us both for  
10 domestic and international services; those discussions have  
11 advanced and we've certainly been able to see what we can  
12 do, and we will continue to have those discussions with the  
13 major airports.

14 As was indicated, you know, Auckland believes in the  
15 long-term they can provide a solution to us, and we don't  
16 know exactly how long that term is because we haven't really  
17 spec'd it out, and that's not Auckland Airport's fault. In  
18 many ways -- we actually haven't been able to advance the  
19 process as quickly as we would have liked because of this  
20 situation pending. We would like to, you know -- based on  
21 how things play out, we will try to advance that process and  
22 grow the domestic based on facilities available.

23 So facilities in a way become your constraint, your  
24 bottleneck, not slots in the traditional sense. But even  
25 slots are different than they are in Australia. In  
26 Australia a slot is based on the aircraft frequency and  
27 landing our runway per hour. Well, in New Zealand, in  
28 Auckland for example, slots are often based more on facility  
29 constraints such as throughput at immigration, and gates  
30 and -- well, not so much gates because they can bus you, but  
31 busing is suboptimal regardless of what anybody says, and

1 it's also based on, such as check-in desks.

2 **MS WHITESIDE:** You've said that you have applied for rights to  
3 fly to Vanuatu and Fiji. That's out of Australia, is it?

4 **MR HUTTNER:** Initially, but I think it's fair to say we'll be  
5 looking in the future at some stage of flights -- once  
6 again, it's that spoke-to-spoke question -- you know, once  
7 we build a presence here we would certainly look at flying  
8 to some of the Island destinations from New Zealand where  
9 the appropriate treaties allow.

10 **MS WHITESIDE:** Okay, I just want to revisit something that was  
11 mentioned earlier, just to check it out. Now, the Applicant  
12 said that Virgin Blue was making good head-way at the time  
13 that Ansett collapsed. Could you just comment on that  
14 please?

15 **MR HUTTNER:** A lot of this, I'm sure, will come out in the  
16 coming months, and certainly during the Adelaide-Brisbane  
17 case and so on.

18 We've made tremendous headway since day one. I think  
19 it's fair to say that we've been more than satisfied with  
20 our progress. That being said, there were moments when we  
21 were far from confident about our future, and there were  
22 times when we didn't feel -- it became clear to us that the  
23 Regulator in Australia, while they had the best intentions,  
24 wasn't able to provide the level of protection against anti-  
25 competitive practices that we originally thought we were  
26 gonna get. And that's not a criticism, just a fact of the  
27 way the Trade Practices Act is set up in Australia.

28 It's fair to say that, you know, the world did change a  
29 bit when Ansett collapsed, but we were already making  
30 progress before Ansett collapsed. So, in general we've been  
31 very very happy with the progress and success we've made,



1 but there have been moments that we felt very very tenuous.  
2 I mean, there were -- it hasn't been all good news for the  
3 last three and a half years, there have been days when we've  
4 wondered what the hell we were up to.

5 **MS WHITESIDE:** But were you tenuous at that time?

6 **MR HUTTNER:** At the time of?

7 **MS WHITESIDE:** The Ansett collapse?

8 **MR HUTTNER:** No, a few months before we were. A few months  
9 before we actually looked at a potential -- we weren't aware  
10 at the time of the specific nature of the market, we were  
11 relatively new, we didn't have a feeling for the  
12 seasonalities, and we didn't forward-sell enough to cover  
13 ourselves in April and May of that year, and we woke up in  
14 April and May not realising that we were just in a seasonal  
15 downturn; with Impulse being handed off to Qantas on what we  
16 perceived as almost being a silver platter.

17 And we at the same time saw our numbers not looking  
18 pretty, and that's when we did have talks -- well publicised  
19 talks with Ansett Air New Zealand; publicised at a later  
20 date obviously but, you know, there were talks, because we  
21 had a concern at that stage in the few months before Ansett  
22 collapsed about our future. It probably became more  
23 apparent about June/July, probably July of that year when we  
24 got back into the upswing of traffic that accompanies the  
25 school holidays, and we started to see some of the cracks  
26 starting to show at Ansett, that we actually thought, you  
27 know, it was a temporary downturn, it wasn't a permanent  
28 structural problem for us. But it was -- there were some  
29 scary moments a few months before, and there were days when  
30 we all got a lot of questions from our families and others  
31 like, what the hell are we up to.

*Virgin Blue*

1 **MS WHITESIDE:** There's just one final issue I want to follow up  
2 on. The Applicants have said that Virgin Blue has  
3 stimulated the market in Australia by 20%. Can you comment  
4 on that, and whether that is likely to happen here too?

5 **MR HUTTNER:** The Department of Transport Regional Services  
6 Statistics show that on a before and after scenario without  
7 taking out externalities of, let's say the Ansett collapse,  
8 for example -- this is before -- if you take a before and  
9 answer prior to the Ansett collapse or after the market  
10 stabilised post Ansett collapse. On the markets we entered  
11 price stimulation, and the lowering of the price does  
12 stimulate the market, and as much as we've been skeptical  
13 about some of the claims in the NECG report and other claims  
14 made by the Applicants, some of them we agree with.

15 The low fare model does stimulate traffic. It's been  
16 proven around the world, it's why we believe we're  
17 profitable because, if we were just battling for market  
18 share with the other guys, why would we even start in the  
19 first place? We've actually created new traffic, both  
20 people who couldn't afford to fly, people who didn't fly  
21 very often, who had driven before. I mean, Australians tend  
22 to go on these endlessly long driving trips with their  
23 families; which as I've said before to the Commission,  
24 within my family would have led to domestic violence, but  
25 it's fair to say that people do that quite normally, they  
26 sit in the car for 12, 14 hours, and it was a stunner to us  
27 when we first arrived in the country and started to do our  
28 research, but it's also stimulated companies and  
29 organisations, Government agencies even, the ones that do  
30 work with us, to stretch their budgets further to get one  
31 more sales call in, or get to one more Conference, or be

*Virgin Blue*

1 able to spend their limited travel budget, or cut back on  
2 their travel budget if need be, so we do stimulate the  
3 market.

4 **MS WHITESIDE:** What sort of percentage do you think?

5 **MR HUTTNER:** I think the 20% number's not unreasonable. Some  
6 markets have been more. I mean, we have one market that's  
7 110%, which was Adelaide-Brisbane, but that wasn't a true  
8 number because you can't look at the origin and destination  
9 statistics as they're published because it doesn't disclose  
10 the hub traffic that you cannot see.

11 **DR PICKFORD:** Did you also take share from the other side, or is  
12 it purely market stimulation?

13 **MR HUTTNER:** Oh, we certainly took some customers from the other  
14 side, and we continue to do so with a certain amount of pride.  
15 It's fair to say though, that they have also grown their  
16 market because as they were forced to compete with us, all  
17 of a sudden they became a bit more of a low fare airline  
18 than they ever were before we arrived, and I think -- you  
19 talk about some of the recent moves by Air New Zealand,  
20 they'll probably experience the same thing.

21 They'll create some market stimulus that will be on a  
22 date before Virgin Blue ever enters this market and, you  
23 know, we don't know how much -- if they've lowered their  
24 cost structure as much as they've lowered their yield  
25 structure, we're not privy to that information, but we  
26 certainly believe that we've benefitted them, but we've also  
27 drawn away from them as well. Well, we've benefitted on the  
28 load factors anyway. I don't know if they're making a  
29 profit or not.

30 **MS WHITESIDE:** Just one other thing we realised we hadn't asked  
31 you. Do you think the fact that you haven't had a loyalty

1 or frequent flyer programme up to this date has been an  
2 issue for you for obtaining business passengers?

3 **MR HUTTNER:** Yes. Everything's an issue for you for a  
4 particular individual who fits into a particular scenario.  
5 A middle manager in a large corporation who doesn't have any  
6 relationship to his or her travel purchase, but sees the  
7 people upstairs in the top floor all flying around Business  
8 Class, and he or she's in Economy and, you know, got home  
9 late last night and missed their kid's, you know, piano  
10 recital whatever, put their kids to bed last night. That  
11 person says at the end of the year, those bastards owe me  
12 after all I've done, those miles are mine, and who cares  
13 what it cost the company because I work my butt off for them  
14 and that's mine.

15 So, that's a segment of the market, an example of an  
16 individual who is attracted to frequent flyers in a way  
17 that's not economically rational except for the person's  
18 personal economics, which is economically rational; whether  
19 they can get those frequent flyer points when their kids are  
20 on the school holidays is another question, but it's fair to  
21 say that we do miss a certain type of individual, just like  
22 we did before we had lounges or before we had a certain  
23 level of frequency.

24 As we add as many of those elements as we can as  
25 possible without damaging our core product, such as the  
26 user-pays lounges and so on, we will hopefully get a greater  
27 and greater share of the market, but there will always --  
28 unless we introduce a frequent flyer programme, there will  
29 be a niche of the market that we will not fully address for  
30 their business needs, like I said, even though on the  
31 weekend they may fly us with their families. If they can't

1 get their frequent flyer point tickets.

2 **DR PICKFORD:** There's been some discussion at the Conference  
3 about the relative costs of Virgin Blue compared to  
4 JetConnect, New Zealand Express plus the two core products  
5 of the main carriers. Do you have any views on the cost  
6 relativities here?

7 **MR HUTTNER:** No. Honestly, we don't know what their costs are;  
8 we know what ours are and we wouldn't want to tell anybody  
9 here. Nothing personal, but if you want us to disclose that  
10 in confidence, we could probably tell you a little bit more,  
11 but it's fair to say we believe we're low cost. But it's  
12 fair to say that New Zealand is a lower operating cost base,  
13 and certainly we are exploring -- one of the ways we're  
14 looking at domestic New Zealand services is to explore  
15 possibly setting up our own operation here in New Zealand as  
16 a standalone within the Virgin Blue organisation. That is  
17 something we have looked at and we are looking at.

18 We've not reached a final decision, and you might find  
19 Virgin Blue's planes flying across the Tasman will be  
20 carrying a New Zealand flag not much different than Qantas  
21 has done. If we believe we can operate out of a lower cost  
22 base here, we will do it, just like Qantas will or anybody  
23 else, and that's not irrational, that's just the way we do  
24 business.

25 That's not just the cost of the actual flight, but also  
26 the cost of having two operations split up; there are a lot  
27 of indirect costs, so we have to look at the whole thing.  
28 The difference is, I think, our pricing of our seats are  
29 more cost-based while compared to traditional airlines. In  
30 other words, we will -- we determine what margin we're happy  
31 with above our cost; our prices are not as often determined

*Virgin Blue*

1 by a reaction to saying "we will always be 10% below  
2 Qantas". On some scenarios we might be above Qantas at a  
3 particular day at a particular time and so on because of the  
4 capacity they're offering now. But overall we believe we  
5 come out ahead -- you know, I don't know if it's three out  
6 of four, or five out of six, but our pricing is not driven  
7 as a relative percentage of our competitors; it's driven by  
8 cost, and the more we can lower the cost, the more we lower  
9 the price, and we make our profit not by margin but by  
10 volume.

11 **DR PICKFORD:** Just one final question. The Applicants have  
12 argued that they themselves have not been able to replicate  
13 the low cost model; that's to say, say adapt their current  
14 approach simply because of legacy factors. I just wondered  
15 if you had any views on that?

16 **MR HUTTNER:** What's that silly poster, you know, those little  
17 motivation posters you see? Like, risk is when you -- you  
18 can only see the farthest oceans if you lose sight of the  
19 shore, you know, one of those silly little office posters  
20 you see around.

21 It's fair to say, it's hard for traditional airlines to  
22 make the leap to what we are today; maybe impossible. I  
23 have yet to see an airline do it successfully.

24 Is it cultural, is it physical, is it ingrained in the  
25 labour force, is it ingrained in the management? Gosh, who  
26 knows. But most of the big airlines that try to run low  
27 cost carriers as real independent, true standouts haven't  
28 been successful.

29 That being said, Freedom Air runs at arms-length from  
30 Air New Zealand, but I think if Freedom Air could really  
31 choose unobstructed its own future and which routes it would

*Virgin Blue*

1 fly and how big it would grow without basing it on other  
2 issues, be it union agreements or management decisions about  
3 cannibalisation of the mother product, you'd probably see a  
4 different Freedom Air.

5 So, that's an example of a big airline having a hard  
6 time making the jump to what may be a more profitable  
7 structure, and when they did Tasman Express we were  
8 surprised that they didn't consider doing just Freedom Air  
9 instead. But they did Tasman Express, that was their choice  
10 for whatever reasons; they weren't able to let go of,  
11 they've decided those things that full service airline  
12 model, as has been described, were too critical to their  
13 existence so they kind of went halfway. Will halfway be a  
14 successful strategy? Couldn't tell you.

15 **MS BATES QC:** I just want to round off. I'll just tell you the  
16 impression you've left me with, and that is that the only  
17 real possible barrier to you entering the New Zealand market  
18 is the issue of slots, and I'm wondering if you have any  
19 more evidence other than what you've put up, and I don't see  
20 that you've put up any real evidence of actual problems.  
21 You've put up some of the potential problems.

22 You haven't told us what the situation actually is in  
23 the -- say, the three major cities in the East Coast of  
24 Australia, and I thought by now you would have known if  
25 you've got a real problem on your hands with them.

26 **MR HUTTNER:** I'm sorry, can you clarify?

27 **MS BATES QC:** We have to decide whether there's a real barrier  
28 for you entering the New Zealand market. You've told us  
29 that the slots are critical.

30 **MR HUTTNER:** Not the slots, facilities, but -- I think slots --  
31 you've got to be careful, slots is kind of a catch-all term

1 for access to facilities, yes.

2 **MS BATES QC:** Let's talk about access to facilities. Is there  
3 any hard evidence that you've got, other than what you've  
4 given us, that this is a real problem for you?

5 **MR HUTTNER:** At this point, on international terminals, it is  
6 not a problem yet. It's a problem based on experience that  
7 we have foreseen. We've been in this business long enough  
8 to know that, although those things may be available today,  
9 we can't all of a sudden become 30% of the market today, but  
10 to get there we need some sort of mechanism to be able to  
11 ensure that, if they're not available and the incumbents,  
12 who have been allowed, if they're to be allowed this  
13 alliance have, you know, the ability to keep everything; you  
14 know, we're gonna go home and we're gonna take our ball with  
15 us, then we need to know that somehow, in six months or a  
16 year, that we won't hit the wall in terms of growth.

17 **MS BATES QC:** So, it's a potential?

18 **MR HUTTNER:** It's a potentially huge issue on international. On  
19 domestic in Auckland it is a barrier to growth because, even  
20 if we can reach a deal tomorrow with Auckland Airport, it  
21 would take quite some time to build the terminal facilities,  
22 and it is questionable whether we would be able to get the  
23 terminal at a similar cost structure to what the other guys  
24 are paying.

25 And in fact we don't understand -- if anyone should  
26 build a new terminal, it should be them and they should  
27 should see that one of the existing terminals now --  
28 because, if they're gonna get all of these efficiencies,  
29 well then why do they need everything? And if they're not  
30 going to get the efficiencies because they really are gonna  
31 keep all that capacity in the market, then they don't want



*Virgin Blue*

1 us to question some of their suppositions in their  
2 submission.

3 So, they've got a big terminal and a little terminal.  
4 We don't want the big terminal but we'd like to have, you  
5 know, first right to the little terminal, or some other  
6 similar situation, because we'll take their old junkie  
7 terminal and they can build a new terminal.

8 You know, we've worked out of a tin shed before, we've  
9 worked out of a marquee before, we're not terribly fussed.  
10 Now there's obviously international issues and domestic  
11 issues now with post September 11 security that make some of  
12 the solutions we've found before a little more difficult  
13 today; Check baggage matching, AAA baggage match, there's  
14 all sorts of nice new toys that make these things very very  
15 hard, and we fully support all these improvements, but it  
16 doesn't mean that the solutions that existed before are as  
17 viable today.

18 Airports are being reconfigured due to increased  
19 security measures, but if there's a big terminal and little  
20 terminal available today, and there's potential for a third  
21 terminal, our point of view is, if they want all of this  
22 why -- and they're gonna get all these efficiencies, why  
23 can't they free up some space to allow us to come in sooner  
24 than we could in the ultimate scenario and, therefore, not  
25 give them a huge headstart as a consolidated body.

26 **CHAIR:** Thank you very much. Are there any further comments  
27 that you'd like to make before we finish?

28 **MR CALLAGHAN:** I'd just like to make one final comment, and that  
29 is, there's been a lot of talk here about, you know, when it  
30 is that Virgin Blue imposes that effective competitive  
31 constraint on the proposed alliance. And, as David said,

*Virgin Blue*

1       you know, don't know where it is, it's up there around the  
2       20% mark, but Virgin Blue's position is that we will make  
3       that mark a lot quicker if the conditions are in place.

4               So, in other words, the effective competitive constraint  
5       will come along a lot quicker if those conditions are there,  
6       because what we are talking about here are barriers through  
7       expansion and barriers to expanding its network and offering  
8       further services throughout the domestic and Trans-Tasman  
9       market.

10   **CHAIR:**   Okay.

11   **MR HUTTNER:**   Thank you.

12   **CHAIR:**   Thank you very much for that.  I do want to thank Virgin  
13       Blue; throughout the process leading up to today and today  
14       you've been very willing to answer questions and assist the  
15       Commission.  We do appreciate that.

16               I would like to say that, with or without the alliance  
17       going ahead, it seems to be the one thing that is clear  
18       coming out of these hearings, is that Virgin Blue's  
19       impending entry into New Zealand will undoubtedly bring  
20       considerable benefits to this country.  So, whatever the  
21       outcome of this exercise, we look forward to seeing how that  
22       goes.

23               On that basis, I'd like to have a brief moment to just  
24       update interested parties on the afternoon's proceedings.  
25       We will break now for lunch until 1.30.  At 1.30 we will  
26       take the final questions to the Applicants, and I plan to  
27       finish that at 2 o'clock, and then at 2 o'clock we will be  
28       having a session with Infratil.

29               So, until 1.30 this session is adjourned.  Thank you very  
30       much.

31

1                   **Adjournment taken from 12.41 pm to 1.35 pm**

2

3 **CHAIR:** Can I ask everyone to be seated, please. I'm going to  
4 reconvene the Conference at this time. We are going to  
5 proceed now with the final questions from the Commission for  
6 the Applicants, and it is my intention at 2 o'clock to end  
7 this session and begin the session with Infratil. So, if I  
8 could please ask David, please, to start.

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**PRESENTATION BY APPLICANTS (cont)**

13

14 **MR PETERS:** I'd like to start with the last question that I put  
15 to NECG again. I'm not sure that the answer given went to  
16 the heart of this concern, but I'll rephrase it, hopefully,  
17 to make it a little clearer.

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Cournot is generally regarded as a quantity setting  
framework for analysis; i.e. Factual capacities should  
usually be an output of a Cournot model and price changes  
determined against this endogenous factual output.

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However, in the NECG model counterfactual capacities,  
factual capacities and costs are all inputs to the model and  
the model uses Cournot formulae to determine the price  
differences between the counterfactual and the factual.

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Given this, might the NECG be more aptly described as a  
model that assumes Cournot pricing rather than a Cournot  
model? This is specifically a question about the workings  
of the model itself, not about how the schedules were put  
together.

31

**MS HARDIN:** I think there's a difference between the marginal

1 costs that are calculated for the purposes of the price and  
2 output solution, and the costs that we use for calculating  
3 the cost savings, and the costs that are used to calculate  
4 the price and output effects are calculated endogenously in  
5 the model; marginal costs, estimated based on market shares.  
6 But the cost savings come from comparing two schedules and  
7 those schedules -- the difference between them is a  
8 rationalisation in capacity reflecting the fact that the  
9 airlines working together can carry passengers more  
10 efficiently than when they're operating separately.

11 **PROF ERGAS:** I think, if your question is, in our model is  
12 capacity determined endogenously in some kind of initial  
13 game between the players that is captured inside the model;  
14 the answer is that in our model there isn't such an initial  
15 game. Our model starts from the capacities that are  
16 determined by the players in the factual and counterfactual,  
17 then uses those capacities to determine market shares and  
18 derives from market shares and price data the marginal  
19 costs; the marginal costs, and the market shares, the  
20 elasticities are then used to complete the solution process.

21 **MR PETERS:** So, the model could more aptly be described as a  
22 model that assumes Cournot pricing?

23 **PROF ERGAS:** It's a Cournot model in which the inputs include  
24 the capacity market shares that are provided by the players,  
25 as against solving for them endogenously. What exactly you  
26 call it is, I think, a matter of taste. The important thing  
27 is to understand what's happening in it.

28 **MS HARDIN:** But the price in input is determined endogenously in  
29 the model.

30 **MR PETERS:** The output -- but the capacity factual and  
31 counterfactual are inputs to the model, are they not?

1 **MS HARDIN:** Yeah, but only for calculating the market shares  
2 which is used to calculate the marginal costs.

3 **MR PETERS:** I wonder if Professor Willig might have any  
4 comments on this?

5 **PROF WILLIG:** The way I described the procedure that I think  
6 Dr Ergas was alluding to yesterday, was that the NECG model,  
7 not the sensitivity check model, but the original submission  
8 was calibrated based on the capacity shares that emerge from  
9 the counterfactual and the factual; evidence from the  
10 parties assembled by the economists for determining these  
11 capacity market shares in the counterfactual and factual.

12 My understanding is that the model was calibrated from  
13 those scenarios, corresponding marginal costs emerged from  
14 that calibration, and then the model is run as an ordinary  
15 Cournot model on the basis of that calibration, with outputs  
16 per player determined endogenously within the Cournot model  
17 based on the calibration. That also determines the price  
18 endogenously, as you alluded to, but it also endogenously  
19 determines the output levels of the various participants in  
20 the market.

21 So, I think you're both right. The calibration of the  
22 original model was based on the capacity shares provided by  
23 the parties, but once that calibration has been accomplished  
24 then the model runs endogenously for both quantities and  
25 prices.

26 In contrast, the sensitivity check runs that I alluded  
27 to yesterday are calibrated, not on the basis of the inputs  
28 from the parties, but rather from the data pertaining to the  
29 base case, reality as it were, not speculation or business  
30 judgment about the counterfactual and the factual, but  
31 current data; the model is calibrated on that basis and then

1 run again with prices and outputs figured endogenously by  
2 the Cournot model. Is that...?

3 **PROF ERGAS:** Yes, that's correct.

4 **MR PETERS:** This leads to another question, although it has been  
5 stated that capacity shares are a pretty good basis on which  
6 to take output shares, i.e. Passengers. There does, within  
7 the model, appear to be some disconnect between those, and  
8 if you'll allow me, I have another question on that. It's  
9 really -- and just to hark back to something that Dr Winston  
10 said on day one, that in a Cournot model price and capacity  
11 are generally regarded as inextricably linked. Dr Winston  
12 used this description for airline markets.

13 However, in the NECG model there seems to be a  
14 disconnect between these variables because there seems to be  
15 this disconnect between capacity and passengers. Now, this  
16 is in the -- detailed in the Zhang paper and I won't go into  
17 details because that does cover some confidential material.  
18 But in particular, on the Sydney-Queenstown route there  
19 appears to be a substantial increase in capacity in the  
20 factual, and yet there is quite a significant price increase  
21 in the factual over the counterfactual. This appears to be  
22 because passengers are not riding on that capacity. Can you  
23 please comment on this?

24 **MS HARDIN:** I think I'll have to have a look at what's happening  
25 on Sydney-Queenstown. That is one of the city pairs where  
26 there is a big change in capacity. If I can just have a  
27 chance to have a look at what's happening exactly, and then  
28 try and explain the outcome, is that okay?

29 **MR PETERS:** There are also some other routes where that is the  
30 case. Auckland-Wellington, Auckland-Christchurch seem to  
31 fall into that category as well.

*Applicants (cont)*

1 **PROF ERGAS:** I suspect those are the routes where there is a  
2 difference between the capacity shares allocated to each  
3 party in the factual and the capacity shares in the  
4 counterfactual, and so then the calibration that is used,  
5 whether you use the factual, the counterfactual or the base  
6 case, will have some effect on how the results play  
7 themselves out. And that was the point that we discussed at  
8 some length yesterday in the presentation.

9       When you look at the different options, so you do a  
10 sensitivity test and you say, well, what would happen if, so  
11 as to avoid those results we used for example a base case  
12 calibration, which is what Professor Zhang has suggested and  
13 I believe Professor Willig believes to be appropriate, then  
14 in that case the deadweight and the detriment diminishes  
15 relative to the approach that we've adopted.

16 **MR PETERS:** I think these results that I'm getting here are not  
17 with any changes that we've made, these are just coming  
18 directly out of the model.

19 **MS HARDIN:** Yeah, and they'll happen on city pairs where there's  
20 a big difference between the factual and counterfactual  
21 capacity, but I'll have a look at those particular ones and  
22 maybe can walk you through what's happening.

23 **MR PETERS:** Thank you. Another question about Cournot. On  
24 slide 14 of the presentation on allocative efficiency it is  
25 noted that in the NECG model what differentiates, the two  
26 states is the move from N to N-1 firms. Was any allowance  
27 made for, on a given, route the size of that Nth firm, and  
28 so the competitive impact from the reduction of N-1 firms?

29       An example might be good here. For instance, a route  
30 where the Applicants in the counterfactual have 30% and 50%  
31 respectively might be of greater concern and detriment than

1 if they had respective shares of 30% and 5%. So, what was  
2 done in the model to allow for that?

3 **MS HARDIN:** The model picks that up through the marginal cost  
4 calculation; that's exactly what it reflects. So, the more  
5 even the market shares then, post merger, the higher the  
6 detriment will be.

7 **PROF ERGAS:** I think it's also important to note that what we  
8 are saying here, and the point of that slide is that, that  
9 is not the only change that occurs between the different  
10 states of the world, in our model. It's the only change  
11 that is, as it were, captured in the Ferrall-Shapiro type  
12 models, where you simply move from N to N-1 firms.

13 In our model between the world with and the world  
14 without, there are several things happening, including the  
15 entry of a player who's not in the market in the base case,  
16 and that's why those complex issues of calibration arise,  
17 because it's not simply a move from N to N-1, and you then  
18 need to address those issues of calibration by doing the  
19 kinds of sensitivity tests that we've run.

20 **MR PETERS:** Thank you for that. In your submission on the Draft  
21 Determination you maintain the view that reliance on the  
22 Cournot approach on both the factual and counterfactual is  
23 appropriate.

24 Doesn't Cournot pricing depend on the existence of a  
25 stable Nash equilibrium, and yet in our counterfactual there  
26 is a war of attrition; can this be an equilibrium? Please,  
27 can you comment on how this affects your Cournot pricing  
28 assumptions?

29 **PROF ERGAS:** The approach that we've adopted is that of saying  
30 that we are going to compare two states of the world as if  
31 those two states of the world were in some underlying sense



*Applicants (cont)*

1 sustainable, and the way we've derived those two states of  
2 the world is intended to capture an equilibrium concept, and  
3 in particular, in devising the counterfactual, what we did  
4 was we elicited from the parties their own view of what the  
5 other player would do and what their best response to it  
6 would be, and the counterfactual that we model is, as it  
7 were, the equilibrium in those best responses. So, it  
8 corresponds relatively closely to the idea of the  
9 intersection point or stable point; the intersection point  
10 of two best response functions.

11 Now, in doing that we have always said that we believe  
12 that our counterfactual is in important respects one that  
13 overlooks some of the risks that the world without the  
14 alliance poses to Air New Zealand and that, if you had a  
15 more complete view of the world, the view of the world that  
16 we believe would be more realistic, you would take account  
17 of the fact that, in that world without the alliance, Air  
18 New Zealand encounters some very serious risks and it's  
19 quite likely that it would not be able to continue to  
20 operate on anything like the scale that we model in the  
21 counterfactual.

22 So, in that sense our counterfactual which assumes that  
23 Air New Zealand would be able to operate on that scale, is  
24 again in our view at least a highly conservative one. So,  
25 whilst we believe that the reality is one of a competitive  
26 contest that poses grave threats to the survival -- at least  
27 on the scale that we model it -- of one of the players, our  
28 modelling does not capture that risk, nor the reduction in  
29 competitive detriment that that implies relative to the  
30 factual.

31 **MR PETERS:** I guess that my question was really about the fact

1 that there is change from period to period, and that this  
2 doesn't sit well with the concept of an equilibrium on which  
3 this pricing approach is based.

4 And I guess that this leads into my next question, that  
5 in a -- in multi-period oligopoly interaction models with  
6 Cournot participants such as we seem to have in the NECG  
7 model, is it generally true that the single period Cournot  
8 price markup will prevail in all periods.

9 **PROF ERGAS:** I suspect that the answer to that is that, in any  
10 view of the world that attempted to capture the full  
11 complexity of aviation markets, you would get shocks and  
12 you'd get periods of destabilisation, perhaps in competitive  
13 relations; you would get a succession of events that is  
14 extremely difficult to capture in any tractable model of the  
15 kind that is needed to inform the types of assessments that  
16 we're making here.

17 That said, I'm not sure that our model, which admittedly  
18 simplifies away all of those aspects and has, as it were,  
19 behaviour which is changing over time in line, for example,  
20 with anticipation today of market growth and of other  
21 changes in the environment; I'm not sure that our modelling  
22 of that is in any sense biased, other than being biased in  
23 the direction of perhaps being relatively conservative.

24 So, whilst I agree with you that the real world is an  
25 extremely complex place, that multi-period oligopoly games  
26 are extremely complicated, and you can get all kinds of  
27 results in them, if you have to inform a policy decision  
28 what you need to do is try to devise a model that is going  
29 to be relatively transparent, relatively robust and is not  
30 going to be biased in the direction of the view that you are  
31 testing.

*Applicants (cont)*

1 **MR PETERS:** I follow what you're saying, but the -- really what  
2 I was trying to get at is the effect of these things on the  
3 assumption of Cournot pricing.

4 **PROF ERGAS:** Well, I suspect that the answer to that is that, in  
5 the real world you are unlikely to observe the persistence  
6 of highly stable Cournot behaviour period after period, and  
7 I'm sure that, you know, that there will be periods where  
8 you will observe different types of behaviour in the market,  
9 and maybe you'll get learning and all kinds of other  
10 phenomena associated with the interaction between players  
11 and the changes in the environment and random shocks and so  
12 on. It's not possible to capture all of those in a model  
13 that will still be simple enough to be readily tested and  
14 robust enough to handle the types of issues that we want to  
15 address.

16 We accept fully that our model is a simplified and in  
17 some respects simple model. It's not a map on a scale of 1  
18 to 1. If you've already tried to use a map on a scale of 1  
19 to 1 you'll have discovered that it's just not very useful,  
20 but you have to abstract from that, and the question is, in  
21 abstracting from the scale of 1 to 1, have you introduced  
22 systematic bias? We believe that, to the extent to which we  
23 have introduced bias, it's consistently in the direction of  
24 being conservative.

25 **MR PETERS:** Thank you. I have just one more question. What  
26 you've said about possible shocks in the market leads me  
27 into this last question. The NECG model uses as inputs  
28 counterfactual schedules provided separately and  
29 confidentially, I believe, by the respective  
30 Applicants/NECG. In period 1 each Applicant makes some  
31 assumption about how the other would behave, what possible

1 shocks there might be, and they set their schedules  
2 accordingly.

3 Now, this assumption about the other player might be  
4 incorrect, and presumably some probability weighting could  
5 be ascribed to the assumption. In period 2 there are  
6 assumptions made about how the other player will act in  
7 period 2, and again there could be some probability ascribed  
8 to this period 2 assumption. This is drawing partly on what  
9 was said in the -- by Qantas regarding how their  
10 counterfactuals were developed.

11 But, however, the period 2 assumption is based on the  
12 outcome of period 1 which is dependent on its own  
13 assumptions. The compounding probabilities in subsequent  
14 periods would seem to make the outcomes modelled in other  
15 periods most uncertain. Can we rely as much on these -- the  
16 outcomes of these later periods as we do on the earlier  
17 periods? Could you please comment?

18 **MS HARDIN:** The airlines gave us each a set of confidential  
19 schedules for the counterfactual with their own estimates of  
20 the flights that they would run and also the estimates of  
21 what the other party would run, so we had, for each of Air  
22 New Zealand and Qantas, their views on what they would do  
23 and what the other party would do and we compared those for  
24 each of the three years, and they were extremely close in  
25 terms of guessing what the other party would do in each of  
26 those periods.

27 There are a couple of instances where they deviated, but  
28 overall for each of the 3 years they're extremely close.

29 **PROF ERGAS:** That's -- it's in that sense that I said that, when  
30 we developed the counterfactuals we did look very carefully  
31 to ensure that those counterfactuals were, as it were,

*Applicants (cont)*

1 consistent with the expectations of the parties. So, in  
2 that sense they are the intersections of their best  
3 responses.

4 Of course, what's true is that our and the parties'  
5 assumptions about what the world will be like in each of  
6 those years are sure to be wrong and there will be many  
7 changes that we simply cannot foresee and even the parties  
8 who are much more expert at this than we are cannot foresee.  
9 But what it comes back to, is there anything in that  
10 uncertainty that is associated with bias? And the answer,  
11 in our view, is that while there is uncertainty, there is a  
12 range around the outcomes. The points that we have selected  
13 are not biased points within that range. To the extent to  
14 which there is bias in our model, it is bias in the  
15 direction of a conservative result.

16 **MR PETERS:** Thank you.

17 **PROF GILLEN:** I have a couple of questions. One is going back  
18 to the way that quality differences were treated in the  
19 modelling that I did and that Professor Hazledine did, is  
20 you created a substitution elasticity and in the modelling  
21 that NECG did, I think you just changed the cost function,  
22 you added a 10% penalty I think to the cost, and in your  
23 view, does this introduce a real -- a bias, in the sense  
24 that when you shift the demand function it becomes -- price  
25 elasticity is lower at every price -- I'm sorry, higher at  
26 every price.

27 What you're doing is shifting the cost function down, so  
28 you're moving up and down the existing demand function, and  
29 so it's not clear that the impact on price elasticities --  
30 matter of fact they wouldn't necessarily be the same at all.

31 **PROF ERGAS:** There are a range of ways of doing this, and we've

*Applicants (cont)*

1 always noted that really the fundamental question, or the  
2 more difficult question is, how do you capture the kind of  
3 interaction that VBAs have with FSA pricing; we're not sure  
4 that anyone knows how to capture that in this kind of model  
5 horribly well at this stage.

6 So, what we've actually done is, we've tried two  
7 approaches. We've tried one approach which is the approach  
8 that you just describe, and I agree there's some issues  
9 about that which you would need to work through. I haven't  
10 worked through that particular issue that you raise, but I'm  
11 not sure it would create either a systematic bias or a large  
12 bias.

13 The second approach is to explicitly introduce product  
14 differentiation, and as we said in our presentation  
15 yesterday, we have done that. And when you do that with  
16 what we think are plausible estimates, you don't come out  
17 with detriments or deadweights that are much bigger than the  
18 deadweights that we model. So, I agree that there is an  
19 issue about how you best do that. I would think that, to  
20 the extent to which VBAs do provide the kind of strong  
21 competition that certainly the presentation from Virgin Blue  
22 today suggested, and that Cliff Winston and Steve Morrison's  
23 work suggests, then our modelling, to the extent to which  
24 they do provide that very strong competition, our modelling  
25 will be extremely conservative.

26 **PROF GILLEN:** When you look at issues of productive efficiency  
27 which is -- you have a whole handout on that, I'm looking  
28 particularly at page 5, and the question alludes to some of  
29 the issues discussed on page 5. And the idea of achieving  
30 the kinds of efficiencies under the alliance versus under  
31 the counterfactual, it seems to me, is the notion of co-

*Applicants (cont)*

1 ordination; when you form strategic relationships the  
2 ability to achieve cost savings is highly contingent on  
3 whether you can kind of work together, whether you can get  
4 systems working together or not.

5 And correct, me if I'm wrong, but I believe that under  
6 the alliance it includes almost 100% of Air New Zealand but  
7 only a 20 or 25% of Qantas, and I may be wrong in those  
8 percentages, in terms of their business. So, it seems to me  
9 that when you're trying to have a -- kind of co-ordinate,  
10 and you have this asymmetry between the two firms in terms  
11 of the proportions of the businesses involved, does this  
12 change the extent to which you can distribute likelihood of  
13 achieving those kinds of cost savings?

14 **PROF ERGAS:** To my mind that's a fair point in the sense that we  
15 don't know what the two parties could achieve if they were  
16 to affect a complete merger. Obviously what they're  
17 proposing to affect actually falls somewhat short of that  
18 complete merger. That said, it does cover a very  
19 significant part of their operations, individually and  
20 jointly, and we would expect that, with reference to that  
21 part of their operations that is covered by the alliance,  
22 that is, as I said, a very significant part of their  
23 operations, that they will have every incentive to seek  
24 productivity improvements and to implement those, and the  
25 productivity improvements that we model which are basically  
26 the product improvements associated with operational flying  
27 in a way, everything to do with scheduling and aircraft  
28 selection, are a small share of the total range of  
29 productivity improvements that you would expect them to be  
30 able to realise even in the context of the alliance.

31 And so, we feel again that our estimates there of the

*Applicants (cont)*

1 scope for productive efficiency gains, that our estimates  
2 are extremely conservative. That doesn't mean that, in yet  
3 another state of the world where they merge the entirety of  
4 their operations and became a single entity, they might not  
5 be able to do more, but the policy question here, as we  
6 understand it is, is the world better off with this alliance  
7 or no alliance; not, is the world better off with this  
8 alliance or a full merger?

9 **CHAIR:** Can I just interrupt for a second. Professor Willig is  
10 leaving in five minutes, if there are any further questions  
11 for him. Anthony, please.

12 **MR CASEY:** Just on the metalogical(?) principles. For example  
13 we appreciate your statement in your paper yesterday; you've  
14 listed transparency and avoidance of bias and the appeal to  
15 real world data and so forth is desirable characters of a  
16 model. Is consistency another issue for modelling for you?

17 **PROF WILLIG:** Consistently certainly sounds like an attractive  
18 word, but what's the context?

19 **MR CASEY:** I'm just wondering in particular why freight effects  
20 are not modelled within the Cournot framework, given that  
21 the schedules are there to model them, and it would be at  
22 least possible conceivably to expand the model to represent  
23 the freight market as well.

24 **PROF WILLIG:** Off my hand I don't know that that's true, but it  
25 certainly sounds plausible that one could build a model of  
26 the freight market which is certainly interrelated to the  
27 passenger market as the folks from Virgin; it's hard to  
28 forget what they said about, an airplane isn't really an  
29 airplane, it's just a flying steel cylinder into which  
30 either people or freight could be stuffed. They didn't seem  
31 to care one way or the other as long as they covered their



1 costs.

2 If I'm an economist saying things like that I'd  
3 apologise in advance, but from them it sounded very real.  
4 It's true that one would perhaps have to model freight  
5 together with passengers in a unified framework. It strikes  
6 me that perhaps given what they said one couldn't really  
7 model freight separately, since freight and passenger  
8 service in some respects seem to be joint products of the  
9 same aircraft capacity.

10 **MR CASEY:** Another characteristic is transparency, would you  
11 agree that a general equilibrium model like the Monash  
12 model, for example, is readily appreciable by even a small  
13 minority of economists?

14 **PROF WILLIG:** Even particularly, yes. No, you're right, those  
15 general equilibrium models are really hard to understand.

16 **MR CASEY:** In some way you have to relax certain criteria to  
17 make certain models admissible.

18 **PROF WILLIG:** I don't know about that, but they are  
19 particularly -- obviously what they're taking on as  
20 modelling are an order of magnitude more complex than just  
21 an industry model since it's an entire economy with all of  
22 its important interrelationships that need to be modelled,  
23 which is why even more simplicity under the hood is usually  
24 required, hence the input/output framework and the use of  
25 multipliers, which obviously are really over-simplification,  
26 but it's the kind that are used in almost all practical  
27 applications that I've seen where the phenomenon are  
28 importantly of the kind that involve changes in the overall  
29 equilibrium of the economy.

30 So, I think standards of use are that that kind of model  
31 is in general practise where policy makers need to quantify

1 impacts.

2 **MR CASEY:** Sure, although there are CGE models that avoid  
3 input/output tables.

4 **PROF WILLIG:** No, absolutely right.

5 **MR CASEY:** In that case, is a way to make up for the weakness of  
6 a model, according to one criterion, to use others to make  
7 it more robust, such as sensitivity testing?

8 **PROF WILLIG:** Well again, sensitivity testing is always good,  
9 but I think it's valid, and I've seen this in my own  
10 practical work, that sometimes general equilibrium models  
11 may have some appealing properties but actually seem flawed  
12 for the purpose s that might be at hand.

13 So, just doing it in more models doesn't necessarily  
14 provide more comfort or even raise a red flag if they give  
15 different answers; if one could understand what are the  
16 relative strengths and weaknesses of the models and you use  
17 the model for the purpose, which seems like it's relatively  
18 strong and not biased for the purpose to which the model run  
19 is being put.

20 **MR CASEY:** Okay, perhaps I was simplifying too much your  
21 statement about sensitivity testing. I wonder then could  
22 you explain what you think the role of sensitivity testing  
23 is in modelling?

24 **PROF WILLIG:** Well yeah, there are some inputs or some  
25 assumptions that might be evident in the modelling where  
26 one's intuition, or experienced intuition would suggest that  
27 there may actually be the need for some over-simplification,  
28 or some guesstimation rather than estimation that went into  
29 that part of the model design.

30 And in a situation like that, which is generally the  
31 case in some feature of the model or other, it's really

*Applicants (cont)*

1 important to try to understand, either quantitatively or  
 2 qualitatively, what the impact of the particular choice of  
 3 design would be on the answers that matter, and how much  
 4 would the answers that matter change if some reasonable  
 5 variation were made in that portion of the model design.

6 So, it's testing the areas that seem to matter the most,  
 7 where the uncertainty about the construction is valid and  
 8 perhaps inevitable.

9 **MR CASEY:** Thank you.

10 **MR PETERS:** Just one more question --

11 **CHAIR:** Is it for Professor Willig?

12 **MR PETERS:** No, sorry.

13 **CHAIR:** I think we better allow Professor Willig to go. I  
 14 wouldn't want to be responsible for you missing your flight,  
 15 but I will thank you once again and wish you a good trip  
 16 back.

17 **PROF WILLIG:** Thank you.

18 **CHAIR:** Next time we have a Baumol-Willig case, we'll give you a  
 19 ring. I'll bet you don't lose too many of those.

20 **PROF WILLIG:** It's against the statute for me to open my mouth  
 21 in such circumstances. Thanks.

22 **CHAIR:** Thanks again.

23 **[Professor Willig exits the conference]**

24 **MR PETERS:** This is really just a follow-up question for  
 25 Professor Ergas: He suggested that the assumption of pure  
 26 Cournot pricing which is built into the NECG model is not  
 27 likely to bring a bias. However, if pricing were sharper  
 28 than Cournot in the counterfactual, for instance, because of  
 29 greater competition in that state of the world, then this  
 30 would introduce a bias. Please, would you comment on that?

31 **PROF ERGAS:** What we tried to do was really this: That we looked

1 at what does the literature tell us about aviation markets,  
2 and we found in the literature a pretty good degree of  
3 support for the kind of modelling approach that we've  
4 adopted. We also looked at the test that was developed by  
5 Brander and Zhang for whether you were in the presence of  
6 Cournot behaviour, and we found that by-in-large the market  
7 at issue was reasonably well described by that Cournot  
8 assumption.

9 There was then the question of, is it conceivable that  
10 there is such a difference between the factual and the  
11 counterfactual world that, for some reason in the  
12 counterfactual world, you would no longer be in this type of  
13 framework. And, what we attempted to address in the slides  
14 that we've provided, and in admittedly rather summary form  
15 our presentation yesterday, was the fact that when you look  
16 at the factual relative to the counterfactual world as we've  
17 modelled them, there isn't really as big a difference as all  
18 that.

19 So, for example, the capacity growth that we've modelled  
20 is fairly broadly consistent with the historic trends, and  
21 the difference in aggregate capacity between the factual and  
22 the counterfactual, though obviously some of the details of  
23 that are in the confidential material that has been  
24 provided, is not such that you would credibly believe that  
25 it would completely change the player's behaviour.

26 As a final test, we looked at what the parties  
27 themselves and their financial advisors believed about how  
28 the factual and counterfactual worlds would behave. What  
29 you are dealing with here are entities whose boards are  
30 taking very significant commercial decisions that involve  
31 many hundreds of millions of dollars, and so, you would

*Applicants (cont)*

1 expect that they and their financial advisors would draw on  
2 the full range of their expertise and understanding of these  
3 markets to have a view about how the world would look with  
4 and without the proposed alliance. And when you examine  
5 that material, again what you find is not that we have  
6 understated the intensity of competition in the  
7 counterfactual, but rather that we've tended to overstate  
8 the extent of price increases in the factual. And so, if  
9 anything, our approach which adopts this modelling framework  
10 to both the factual and the counterfactual looks  
11 conservative.

12 As I say, it's consistent with the literature, it's  
13 consistent with the kinds of tests we've run which are the  
14 tests that are set out by Professors Brander and Zhang; it's  
15 consistent with the historical behaviour that has led to the  
16 current observed market outcomes, and it's conservative  
17 relative to the views that the parties' financial advisors  
18 themselves take.

19 **CHAIR:** We'll take two more questions and then we're going to  
20 close this session. Thank you.

21 **DR PICKFORD:** Can I just go to the productive and dynamic  
22 efficiencies issues. In your presentation notes on your  
23 page 8 you refer to, I presume it's a study dated 2000,  
24 demonstrating an analysis of technical efficiency for Qantas  
25 and 25 other airlines. I'm not sure whether you have time  
26 to actually go through that now, but it would be good to at  
27 least get access to this or know what it is please.

28 **PROF ERGAS:** The study at issue is an analysis that we have  
29 carried out and that we have referred to on this occasion,  
30 and others, and that we are very happy to make available if  
31 it would be of use to you.

1 **CHAIR:** Thank you, we will take up that offer.

2 **DR PICKFORD:** There's been a number of references to the term  
3 legacy carriers and airlines with legacy costs. I'd be  
4 interested to hear to what extent these airlines have costs  
5 that are inflated because of their legacy positions and what  
6 is the nature of these inflated costs, which seem not to be  
7 suffered by new entrants into the industry.

8 **PROF ERGAS:** Well, is your question referring specifically to  
9 the modelling that is addressed in this slide, or is it more  
10 general than that?

11 **DR PICKFORD:** No, that more general issue.

12 **PROF ERGAS:** I see. Sorry, I thought you were asking about the  
13 technical efficiency study. It's undoubtedly true that the  
14 airlines who have a history, as it were, of operating in  
15 regulated environments that on some routes still operate on  
16 at least partially regulated environments, that in those  
17 environments there are costs that have developed over the  
18 years and practise s that have developed over the years that  
19 are not sustainable going forward.

20 What we believe is that, when you look at certainly the  
21 Qantas performance, which is the one that we've studied most  
22 closely in terms of performance over time, where we've  
23 developed the total factor productivity index and looked at  
24 its behaviour over a long period of time; what you see from  
25 that is that Qantas has in recent years significantly  
26 increased its total factor productivity, and we note that  
27 those increases in total factor productivity have occurred  
28 also in contexts where, for example, alliances such as the  
29 joint services arrangement with British Airways proceeded.  
30 So, the types of alliances that are at issue here.

31 Are there further efficiencies that the airlines can

*Applicants (cont)*

1 derive? We believe that there are, and of course the  
2 modelling that we do where we look at the savings in fixed  
3 costs that arise from the alliance, and the better co-  
4 ordination of flights and so on, that all of those are  
5 improvements in productivity and gains to society as a  
6 whole. That's why, even though there is in our modelling  
7 some deadweight associated with the higher prices that we  
8 model, there is a productivity induced saving in cost, which  
9 is that 4% of cost that is taken out, that is significant,  
10 and again to society as a whole.

11 So, that's a further improvement relative to what we've  
12 modelled in our TFP work. Can they do more in terms of  
13 shedding other costs? Well, the history of capitalism as a  
14 way of organising economies is that firms in a market  
15 environment are constantly driven to find those ways of  
16 reducing costs, and we're sure that they will do so.

17 However, it must also be said, and this has been  
18 emphasised better than I can do it by the airline  
19 representatives, that there are real differences between the  
20 output that an FSA provides and the output that a VBA  
21 provides. And so, those differences in output, which  
22 correspond to differences in services that are valued by  
23 consumers will invariably involve some differences in  
24 resource costs. But it may be highly efficient, from  
25 society's point of view, for those higher resource costs to  
26 be incurred if they will allow more highly valued outputs to  
27 be supplied to the public.

28 **CHAIR:** Okay, I would now like to thank you, the Applicants, for  
29 the opening presentations and willingness to address  
30 questions throughout. We have found it beneficial to have  
31 sessions with the company's management, a number of members

*Applicants (cont)*

1 of the board and the external economic experts.

2 I'd also like to acknowledge the assistance that the  
3 counsel to the Applicants have given me in trying to manage  
4 the process to ensure that we have the opportunity to fully  
5 consider the Applicants' case in an effective and efficient  
6 manner. So, I thank you all once again and, of course, you  
7 will have final right of reply at the close of the  
8 proceedings. So, thank you.

9 **MR P TAYLOR:** Thank you Madam Chair for our part, thank you for  
10 the Commission's assistance during the course of the last  
11 few days. If there are clarifications that the Commission  
12 seeks at any stage, many of our witnesses will be remaining  
13 available right through to the end of the Conference period.

14 **CHAIR:** Thank you, Mr Taylor.

15 Now, just before you get up I would like to welcome  
16 Infratil and also thank them for their patience and ask that  
17 they and their advisors please come forward to present their  
18 submissions. I don't propose to break, so we will start  
19 again in about 2 minutes, thank you. [**Pause**].

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**PRESENTATION BY INFRATIL**

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3 **CHAIR:** Okay, I would like to reconvene this session please.

4 And, once again, welcome Infratil and ask if you would,  
5 please, introduce the people who would be speaking today,  
6 Mr David.

7 **MR DAVID:** Thank you, Madam Chair. I am Grant David from  
8 Chapman Tripp. I have with me my colleague on my left, Neil  
9 Anderson. We're here on behalf of the following people,  
10 Gullivers Pacific Group, Infratil Limited, the major  
11 accommodation providers, Kerry Prendergast the Mayor of  
12 Wellington, Talley's Fisheries and Wellington International  
13 Airport.

14 In terms of the corporate representatives of those  
15 persons that I have with me, on Neil's immediate left I have  
16 Mr John Sheridan who is the Chief Executive of Wellington  
17 International Airport. Next to him I have Mr Phil Walker  
18 who's the Chairman of Wellington International Airport and  
19 of Glasgow Prestwick International Airport. Lurking in the  
20 back, but not at the table is Mr Tim Brown who's the Chief  
21 Executive of Infratil Limited.

22 Moving around to the other side of the table we have our  
23 independent experts that we've engaged to assist us and of  
24 course to assist the Commission; they are, as we continue  
25 around, Dr David Stone, Kieran Murray from LECG, Dr Graham  
26 Scott from LECG, and I of course have omitted out most  
27 egregiously Professor Jerry Hausman who is to the side of  
28 Mr Phil Walker there.

29 As I said, Madam Chair, we are here to assist the  
30 Commission in making its determinations. We are expressly  
31 not here as opponents to the Applicants. The Commission's

1 process of course is not intended to be an adversarial one  
2 and we don't want it to be. As was pointed out by  
3 Mr Peterson, with whom I agree, the Commission is required  
4 to provide for as little formality and technicality as the  
5 requirements of the Act and the proper consideration of the  
6 application requires. That applies in respect of both of  
7 the applications, I concede.

8 But that provision does mean that the Commission and the  
9 Applicants must still have regard to the express statutory  
10 requirements. That the ability to provide for little  
11 formality and technicality cannot override what the statute  
12 expressly requires, and I refer in particular to identifying  
13 the benefits and detriments applicable to the particular  
14 application and to confining conditions that the Applicants  
15 would seek to have imposed confined to the alliance  
16 proposal.

17 I propose to deal with those legal issues later. The  
18 Applicants rather unkindly have described my arguments as  
19 highly legalistic, so I intend to let the lawyer go last on  
20 this occasion.

21 Now, the Applicants have also been a little bit unkind  
22 in saying in their cross-submission that we -- -- the  
23 parties I represent, that is, lack either the technical  
24 airline experience or direct industry knowledge to comment  
25 in any useful way on the bulk of their application; indeed  
26 they say that we are only qualified to comment on things  
27 like access to facilities at Wellington Airport and the  
28 selling of passenger tickets.

29 But, in fact we represent of course a major supplier of  
30 services to the Applicants in the form of the terminal and  
31 other services provided to airlines at Wellington

*Infratil*

1 International Airport, as well as to the acquirers of --  
2 major acquirers of the various passenger air services and  
3 air freight services that are provided by the Applicants.

4 So, we are major suppliers to and major customers from  
5 the Applicants, and we would also say that we represent some  
6 of those parties who could reasonably be expected to be  
7 major beneficiaries of the very significant tourism benefits  
8 that the Applicants claim will result from their  
9 applications.

10 Now, the very nature of our respective businesses means  
11 that we take a strong interest in and we have a close  
12 familiarity with the business of airlines. Wellington  
13 International Airport, as you'll be told later, was used by  
14 almost 4 million passengers in its last financial year, and  
15 Glasgow Prestwick that figure was approaching 2 million.  
16 Significantly in relation to Glasgow Prestwick the business  
17 of that airport is mainly low fare short haul passenger  
18 services to Europe and the -- as well as freight services,  
19 and that means that the operators of that airport, including  
20 Mr Walker, have extensive firsthand experience at dealing  
21 with true value based airlines. Indeed, we would say they  
22 have more extensive firsthand experience than the Applicants  
23 themselves.

24 Further, the airport company's major shareholder  
25 Infratil continues to be both active in investigating  
26 investment in emerging airports, both in Europe and in  
27 places like Auckland with Whenuapai. So, to put it bluntly,  
28 Infratil is used to putting its own money where it perceives  
29 dynamic change to be occurring in the aviation sector. So,  
30 we do claim to have the firsthand knowledge that the  
31 Applicants are denying us.

1           Mr Sheridan also brings his 12 years experience as a  
2           senior executive in Ansett New Zealand and in Ansett  
3           Australia. Mr Walker, for his part, brings over 32 years  
4           personal experience in the aviation industry with some 20 of  
5           those years with Qantas itself.

6           We have also sought the expert opinion and advice of  
7           Dr David Stone on aviation matters. Dr Stone for eight  
8           years led the Ministry of Transport's International Air  
9           Services section, and in that capacity had developed a close  
10          familiarity with New Zealand's international air transport  
11          policy. By way of example only I mention that he associated  
12          New Zealand's bilateral arrangements with some 27 countries  
13          during that time. For the past six years he's been an  
14          independent consultant on aviation matters.

15          We've been obliged to seek expert economic and public  
16          administration assistance to enable us to deal with the  
17          voluminous experts' reports that have been submitted to the  
18          Commission by the Applicants and to listen to their equally  
19          voluminous comments over the last three and a half days.  
20          Some of that material was submitted to us under extensive  
21          claims for confidentiality, and indeed some of that was not  
22          made available to us until the 1st of August.

23          The very model that was used by the Applicants' own  
24          economic consultant, NECG, was not finally released to us  
25          until the 7th of August after we again requested it at the  
26          Commission's pre-Conference meeting. Now, we are not  
27          whinging, we are simply pointing out that we have had a  
28          volume of material to deal with and that's why we have  
29          secured the expert economic assistance of these gentlemen  
30          here.

31          We have been assisted in the process, to refer to them

1 in particular, by Mr Kieran Murray from NECG. Mr Murray has  
2 got a broad experience in the infrastructural reform. We  
3 have also more recently, to help us respond to the volume of  
4 economic and other arguments being advanced by the  
5 Applicants, secured the assistance of Dr Graham Scott of  
6 LECG and Professor Jerry Hausman of MIT; both of those  
7 gentlemen of course will be well known to Commission  
8 members.

9 We say again, the Applicants' claim that only they have  
10 got the knowledge and experience relevant to the  
11 Commission's inquiry, and we say that is a rather bold  
12 assertion with which we don't agree.

13 As to why we're here, the issue is not whether the  
14 Applicants have made the right business decision in entering  
15 into the equity proposal and the alliance proposal; whether  
16 they have or they haven't will be determined ultimately if  
17 those proposals are able to be implemented by their fate in  
18 the marketplace.

19 We say that the only issue for the Commission to decide,  
20 and for us to comment on, is whether those proposals are in  
21 a form -- indeed in a form in which authorisation -- the  
22 authorisations have been sought would be likely to  
23 contravene the Commerce Act, and if they would be likely to  
24 contravene the Commerce Act, whether they individually would  
25 result in such benefit to the public that they should  
26 nevertheless be permitted to proceed.

27 Given that the relevant provisions of the Act involve  
28 competition tests, that assessment obviously requires the  
29 Commission to listen to the suppliers too and customers of  
30 the Applicants, as well as to their existing and potential  
31 business rivals.

1           It also requires the Commission to seek the views of  
2 those with particular knowledge of the areas, and in  
3 particular tourism where the public benefits have been  
4 claimed. And I say again, it's clear that we represent,  
5 throughout our corporate representatives and our experts, a  
6 cross-section of those people.

7           Our interests are not contingent, nor are they  
8 tangential to the matters before the Commission, and nor are  
9 they motivated by the kind of self-interest that so often  
10 underlies an opposition to a merger proposal. Having strong  
11 commercially viable airlines flying into, within and from  
12 New Zealand with the benefits that tourism and the on-flow  
13 of benefits to other areas of the economy brings, is the  
14 interests of all New Zealanders, we agree with that.

15           Where we do part company with the Applicants, however,  
16 is that we remain unconvinced that these outcomes will be  
17 achieved by allowing Air New Zealand to be subsumed by  
18 Qantas.

19           We recognise that the Commission faces a daunting task.  
20 Both of the Applicants are firms of major significance in  
21 their respective homelands, as well as to their thousands of  
22 employees and of course the millions of passengers that they  
23 carry each year. They are both very powerful firms, and in  
24 the case of Air New Zealand, the New Zealand Government of  
25 course is currently the majority shareholder. Indeed, the  
26 Applicants in their cross-submissions attach a particular  
27 significance to this fact, and Dr Scott will deal with that  
28 point shortly.

29           Both of the Applicants -- both of those firms currently  
30 have a very substantial presence in many of the markets in  
31 and to and from New Zealand in which they operate.

1           Now, despite the fact that the Commission's task is a  
2           daunting one, for those reasons I don't think it's  
3           necessarily a difficult one. We are not going to engage in  
4           the kind of war of attrition with the Applicants here. On  
5           the contrary, we think that the Commission in its Draft  
6           Determination has got the matter mostly right. We agree  
7           with most of the Draft Determination's provisional  
8           conclusions, but there are some areas where we think that  
9           that expertise and that personal knowledge, and our experts'  
10          expertise can be brought to bear to reinforce what the  
11          Commission itself has indicated its thinking is.

12          As to why we say the Commission's task is not difficult,  
13          that's because when you boil down all of the material that  
14          you've heard over the last three and a half days, the  
15          factual situation is this: The Applicants are the only major  
16          players in most of the markets they operate in within  
17          New Zealand and Trans-Tasman. So too with the Auckland-LA  
18          route. The Applicants currently face some fringe  
19          competition on some of the domestic routes and they  
20          potentially face fringe competition in the form of the Fifth  
21          Freedom carriers on some of the Trans-Tasman routes.

22          The Applicants currently face no competition on the  
23          Auckland-LA route and there is no potential new entrant in  
24          respect of that route that would satisfy the Commission's  
25          own test for new entry; that is likelihood, extensive,  
26          timeliness and sustainability. But, and you would have  
27          heard this morning, the Applicants do face a threat of  
28          imminent entry on the Trans-Tasman from both -- from Virgin  
29          Blue, and that's a competitor that has competed hard against  
30          both of the Applicants in Australia. Both of the Applicants  
31          have felt the effects of Virgin Blue's entry into the

1 Australian market.

2 So, to avert that threat, or to mitigate the effect of  
3 that threat the Applicants want to respond by cooperating or  
4 colluding in the form of the alliance and by merging. Now,  
5 I heard one of the counsel say "this is an alliance, it is  
6 not a merger". A 22.5% acquisition will bring the parties  
7 well within the associated person status for the purposes of  
8 this country's merger legislation. They will be well above  
9 the 15% that the Commission has indicated in its own Merger  
10 Guidelines as where for a public company the threshold lies.  
11 They will be bound together by the alliance and they would  
12 be -- they would have a degree of cross-directorships. All  
13 of the indicia that the Commission has set out in its own  
14 Merger Guidelines for associated persons are present. They  
15 would effectively be one head in the market for the purpose  
16 of competition analysis.

17 Now, to offset the competition consequences of the  
18 alliance and that what I say is a merger, the Applicants  
19 point to benefits that will primarily be in the form of a  
20 claimed 50,000 extra tourists who will be able to come to  
21 New Zealand because Air New Zealand will be able to access  
22 Qantas' resources. In particular Air New Zealand, if it  
23 goes into the alliance, and if it goes into the merger or it  
24 is subject to the acquisition, will be able to access the  
25 network and sophisticated IT and other facilities that  
26 Qantas Holidays has.

27 Qantas Holidays will not provide, we were told  
28 yesterday, those services at present because to do so would  
29 be contrary to the strategic interests of its sole  
30 shareholder, Qantas. In other words, there is a refusal to  
31 supply that Air New Zealand faces.



1           Now, it does seem that it's an extreme reaction to a  
2 refusal to supply for the supplier and the supplyee to want  
3 to agree prices in and otherwise cooperate in all the  
4 markets in which they operate, and for the supplier to  
5 demand a big chunk of the equity of the supplyee simply as a  
6 precondition to entering into a supply arrangement.

7           I suggest there would seem to be other arms-length  
8 commercial mechanisms and indeed possible legal remedies  
9 that should perhaps be tried first to overcome that refusal  
10 to supply; certainly before the Commission is even asked to  
11 contemplate authorising such extreme and irrevocable  
12 arrangements.

13           Given Qantas Holidays and its shareholders' seeming  
14 substantial degree of market power in relevant markets in  
15 Australia and in Trans-Tasman markets, perhaps some thought  
16 should be given to the legal status of that refusal to  
17 supply under s.36(a) of our Act. I know there are a number  
18 of Australian lawyers present, so perhaps they could reflect  
19 upon that refusal to supplier status under s.46(a) of their  
20 own legislation.

21           Now, I put that forward not because we are anti-Qantas,  
22 or anti-Air New Zealand. On the contrary, as I said before,  
23 our own businesses are very dependent on the custom and the  
24 services that those airlines and other airlines provide, and  
25 the customers, travellers that they bring. There's no doubt  
26 on our part that effective and efficient air services and  
27 their preservation are vital to a country as remote and as  
28 longitudinally challenged as New Zealand is, or that Air New  
29 Zealand's continued involvement is crucial to providing  
30 those services.

31           Indeed, we say the New Zealand Government's retention of

1 the Kiwi Share in Air New Zealand and it's willing to  
2 refinance it in exigent circumstances two years ago are  
3 clear evidence of that. But the fact that the Government is  
4 involved in Air New Zealand as a shareholder should not be  
5 allowed to cloud the issue that the Commission itself has to  
6 determine. Now, Madam Chair, with those opening comments  
7 I'd like to turn now to Dr Graham Scott to address the  
8 particular issue of the Government's involvement.

9 **CHAIR:** Just before you do, I think we may have one or two  
10 questions, thank you.

11 **MS BATES QC:** Just by way of clarification, Mr David, I think  
12 you said "faced imminent entry of a VBA on the Tasman", but  
13 you didn't mention the New Zealand domestic route.

14 **MR DAVID:** Sorry. By way of clarification, I should have said  
15 the New Zealand domestic routes as well.

16 **MS BATES QC:** Just a thought on the s.36(a) suggestion, while  
17 that might get -- might, I don't know -- get Air New Zealand  
18 access to Qantas Holidays, it wouldn't be in a particularly  
19 good spirit of cooperation, would it?

20 **MR DAVID:** Well, Ms Bates it's --

21 **MS BATES:** I'm just practically asking you that; what would the  
22 consequences be.

23 **MR DAVID:** When -- if I have a client come to me and say I'm  
24 faced with a refusal to supply, indeed my clients are  
25 usually the other way around, but if I'm faced with a  
26 refusal to supply I don't usually say to them, well maybe  
27 you can enter into a cooperation agreement with the person  
28 you want supply from and you can agree to fix prices with  
29 them in downstream markets, and maybe you can sell to them  
30 about a quarter of your equity and then they might say, yes.  
31 I would look at other possible remedies first.

1 **MS BATES QC:** I do understand that point, but if you had to  
2 force it through that kind of action you might not get the  
3 corporation that you might otherwise get. I accept there  
4 might be other ways to explore that, but if you had to go to  
5 that extent, it might be rather grudging, that's all.

6 **MR DAVID:** There is always an interface between parties to  
7 contractual arrangements, Ms Bates. Sometimes they're  
8 willing, sometimes they are less willing.

9 **MS BATES QC:** And it just then depends on how effective the less  
10 willing will be likely to be, I think. It's just an opening  
11 comment from me.

12 **MR DAVID:** Yes.

13 **CHAIR:** I'll just follow that up. I thought the angle might  
14 have been that you were suggesting that those -- a great  
15 deal of the benefits were available to them through --  
16 without having to have this arrangement authorised and  
17 therefore we shouldn't give weight to those benefits, but  
18 I'm not sure if that was the point.

19 **MR DAVID:** I think the issue is, to be a benefit that can be  
20 counted it needs to be a benefit that is not available to  
21 the Applicants but for the arrangement.

22 **CHAIR:** Yes, I thought that might be the point you were trying  
23 to make. Okay. We'll probably come back to that I think,  
24 yeah. Okay, we're happy to proceed.

25 **MR DAVID:** Dr Scott.

26 **DR SCOTT:** Thank you. Commissioners, the topic I wanted to  
27 speak to is some issues in competition policy and other  
28 public policies that are raised by this proposal for an  
29 alliance. I should say in advance that this topic is very  
30 well known to you, and you might wonder why I would raise  
31 it, but it does seem to me to be important.

1           The question is how competition policy relates to other  
2 policy interests that the Government has in this proposal.  
3 I'm really only appearing in front of you because other  
4 Applicants to my hearing have invited you to take into  
5 account issues that are not in my view entirely relevant to  
6 your considerations, or certainly only marginally relevant  
7 to them.

8           The Government has many interests in this proposal. I  
9 counted as many as seven in a report that Kieran Murray,  
10 Colin Lynch and I prepared in August last year, and can be  
11 available to the Commission of course if you wish to have  
12 it, if you don't already.

13           The sound application of competition law is just one of  
14 these issues that the Government has in relation to this  
15 application. And, there is a lot of history in New Zealand  
16 in addition to best practice principles of public policy  
17 more generally that point to the problems that commonly  
18 arise when the instruments of policy that were designed to  
19 be implemented on their own terms, under their own  
20 legislation, with their own institutions, are bundled  
21 together without transparency or guiding principles or  
22 objectives. And, that earlier paper expressed our views and  
23 a lot of evidence in relation to those points.

24           But more specifically to today's consideration, the  
25 integration of competition policy with other instruments of  
26 what is termed "industry policy", a rather vaguer notion,  
27 and even wider considerations of the Government again going  
28 beyond industry policy is the business of the Cabinet,  
29 and/or the co-ordinating machinery that serves it.

30           It is not the business of the Commerce Commission, in my  
31 submission, except in the very constrained authority which

1 it has, of course, to be concerned with the public benefit  
2 in making its judgments.

3 In the Gas Control Inquiry draft framework paper that  
4 the Commission prepared recently it has expressed its view  
5 very clearly, and in my view correctly on this subject, and  
6 I quote from it:

7 "In the long-term New Zealand consumers in general  
8 benefit from continuous improvements in the allocation of  
9 resources, the quality of products and production processes,  
10 all of which are usually encouraged by the competitive  
11 process".

12 The message is clear; and the implied answer to  
13 Mr Dixon's statement to you the other day where he said,  
14 "It's up to you to decide how much competition you want".  
15 It seems to me the answer is, from what you've said  
16 yourselves, as much as you can get unless there is clear  
17 public benefit, which is itself seen, usually but not  
18 exclusively, in terms of promoting competitive market  
19 conditions. But you've received submissions that to my ear  
20 invite you to take a somewhat different tack.

21 Mr Dixon said for example, and I quote again:

22 "Competition and other Government policies have clashed  
23 with sound industry policy with the result that over-supply  
24 of airline services has been allowed to continue. Indeed,  
25 it has been encouraged. Although a few established carriers  
26 have been allowed to fail, the responses of many governments  
27 has been to provide financial assistance to their airlines,  
28 either overtly or covertly".

29 I would suggest that protecting airlines from the normal  
30 application of competition laws, if indeed anybody is  
31 proposing this to you, and it seems to me this proposal

1       arguably does, is exactly such covert financial assistance  
2       as he's referring to.

3       I took it that Mr Dixon was criticising other  
4       governments of course when he said this, but I also  
5       interpreted the comment within the context of his submission  
6       to you as meaning that he might want the Commission to  
7       temper its application of competition law with a concern for  
8       what he called sound industry policy, to avoid damaging the  
9       companies through too much competition.

10       This interpretation, it seemed to me, is supported by  
11       Mr Dixon's comment that "within reasonable limits what is  
12       good for the airlines will benefit consumers". Whatever the  
13       term "sound industry policy" is taken to mean, and it seems  
14       to me it has a number of possible interpretations, I'm  
15       suggesting that it is not the responsibility of this  
16       Commission to contribute anything to it other than the  
17       principled and thoughtful application of competition law.  
18       And in the cross-submissions that the Applicants made on the  
19       18th of July this year, they say:

20       "The Government's intentions in its role of shareholder  
21       of Air New Zealand are critical in assessing the  
22       counterfactual from a commercial and pragmatic perspective.  
23       The Commission must have regard to the intentions of the  
24       majority shareholder, particularly when the Commission has  
25       placed importance on Government funding in its conclusions  
26       regarding Air New Zealand's vulnerability in the  
27       counterfactual. The fact that there is a formal procedure  
28       in the Commerce Act for the Government to comment on an  
29       investigation is not relevant".

30       Well, I have some trouble with this. For the reasons  
31       outlined in our paper of August 2002 there are very good

1 reasons for the Government to stand back from this  
2 application to the Commission -- I think the Government was  
3 wise to do so -- and stand back from these proceedings. If  
4 competition policy, transport policy, fiscal policy and  
5 other policies affected by this application are to be  
6 integrated in some way by the Government, the Commerce  
7 Commission is not the place to do it.

8 The precedence that would be setting for future hearings  
9 where a Government owned or controlled firm was an applicant  
10 would be unmanageable to say the least.

11 A further example of what I see as an invitation to take  
12 into account matters that are on or beyond the edge of your  
13 jurisdiction is the proposition that Air New Zealand's  
14 public good promotion of New Zealand as a destination should  
15 enter as a critical part of your evaluation of the  
16 application. Mr Norris said to you that:

17 "If Air New Zealand ceased to be a separate entity  
18 Tourism New Zealand's budget would need to rise to over 155  
19 million per annum to purchase similar public good exposure".

20 This may be true, but Air New Zealand is not doing this  
21 as a public service but as a business expense from which it  
22 expects a return. The fact that there are spillover  
23 benefits to others in the economy is part of normal  
24 commerce, just as investors by tourist -- investments by  
25 tourist operators in New Zealand create spillover benefits  
26 for Air New Zealand.

27 The public policy issue in this is whether there are  
28 grounds for the Government to support more of this kind of  
29 promotion than would otherwise occur. Governments always  
30 have done this and will continue to. The public policy  
31 issue for the Government in this, however, is whether the

1 level of such promotion is sufficient from a public interest  
2 perspective and, if not what, is the most efficient and  
3 effective way for it to intervene to ensure that it is?  
4 This is not for the Commission to get involved in, in my  
5 submission. It can take account of the fact that this  
6 expenditure is occurring with some spillover benefits, but  
7 that is well short of accepting that it should allow a  
8 competitive situation in the market that it would not do  
9 otherwise in order to support this activity.

10 Well, to sum up. Firstly, the Government has several  
11 potentially conflicting public policy interests in this  
12 application before you. Secondly, its decision to stand  
13 back from this hearing will assist it to balance and  
14 integrate those interests down the track in whatever way it  
15 chooses to do. The decision to do this on the part of the  
16 Government was not irrelevant as the cross-submission  
17 asserts. Its effect is properly, in my view, to keep  
18 pressure off the Commission to adventure into some poorly  
19 defined industry policy and set unmanageable precedents for  
20 the future. The Government is free, if it wishes, to  
21 intervene in several other ways. This could even include  
22 something like it did in relation to the dairy industry.  
23 But, as I said initially, all this is well known to the  
24 Commission, but perhaps there is some value in rehearsing it  
25 on this occasion. Thank you.

26 **CHAIR:** Thank you, Dr Scott. Let's just see if we have some  
27 questions.

28 **MS BATES QC:** Yes, Dr Scott, you probably don't disagree with me  
29 on this, but competition law, although it's our primary  
30 focus in applying it, it is our primary focus, it is not the  
31 end of the story as you know because why we're here is,



1 we've got a discretion to authorise some lessening of  
2 competition on the basis that the public benefit might  
3 outweigh or does outweigh the detriment. Do you accept  
4 that's the position?

5 **DR SCOTT:** Yes, of course, your authorities do enable you to  
6 make departures from simplistic versions of competition law  
7 in pursuit of the public benefit. But my point was that you  
8 have -- there are two points really; one of them is that you  
9 have defined public benefit in a number of ways, and I  
10 quoted one of them as putting considerable emphasis on  
11 competitive conditions in markets.

12 And secondly, there are much wider definitions of the  
13 public benefit that can also be brought into bear on this by  
14 other Government policies. In other words, your definition  
15 of the public benefit, it seems to me, to be not nearly as  
16 broad as the Government's; you have a much narrower vision  
17 of it.

18 **MS BATES QC:** I accept we have a formula which we work to in  
19 assessing that. You're not saying, are you, that we're  
20 varied from that at this stage?

21 **DR SCOTT:** No, what I'm suggesting, though, is that some of the  
22 submissions that you've had might be inviting you to do so.

23 **MS BATES QC:** Okay. In terms of Air New Zealand and its  
24 provision of dollars for promoting tourism, whether or not  
25 that's an economic rational thing for it to do, I just want  
26 to clarify what you're saying. I think it is that it's not  
27 something we should take into account, but that disappears  
28 because either Government or industry has the ability to  
29 step up with -- to step up with the dollars and -- if it  
30 chooses to and fill the gap.

31 **DR SCOTT:** Well, my -- I chose my words carefully in respect to

1 that, and --

2 **MS BATES QC:** I'm not trying to put words in your mouth, I'm  
3 just testing what you're saying.

4 **DR SCOTT:** No, no. What I said was, obviously you have a broad  
5 mandate to consider the question of economic and public  
6 benefit in relation to this proposal. But that, if the  
7 submission in the way it was made is inviting you to say  
8 that you would tolerate a competitive condition or create a  
9 competitive condition that you would not otherwise do on  
10 that ground alone, that it seemed to me that you shouldn't  
11 do that. The reason for that is that the Government has a  
12 much wider range of instruments available to it to address  
13 that issue, and also the fact that there are spillover  
14 benefits from Air New Zealand into the economy more widely  
15 arises as a normal commercial processes.

16 **MS BATES QC:** I agree with you, but are you saying we cannot  
17 take that into account as a detriment?

18 **DR SCOTT:** No, I would argue that it would be wrong to take the  
19 fact that such a public benefit might lead the Government --  
20 the decline of such a benefit might lead the Government in  
21 due course to decide it had to spend more money in some  
22 other instrument to bring it up to some other level which in  
23 its judgment it thought was necessary, should not be an  
24 argument that would lead you to have a competitive -- make a  
25 decision in this regard that you would not otherwise make.

26 **MS BATES QC:** I do understand the argument, thank you for that.  
27 What about the extra tourism dollars? You're not suggesting  
28 that we shouldn't take that into as a benefit, if we accept  
29 -- that's predicated on the basis we might accept that will  
30 happen, are you saying we shouldn't take that into account?

31 **DR SCOTT:** Your primary concern about benefit, as you've

1 expressed yourself, is benefit in the interests of consumers  
2 through the application of competition principles, which in  
3 turn lead to better resource allocation in the economy as a  
4 whole; as you've said in all your own documents.

5 So that taking account of the national interest and  
6 public benefit, you do need to focus I believe on the  
7 question of the benefit to consumers and that's the  
8 important point there.

9 **MS BATES QC:** Well, yes, long-term benefit.

10 **CHAIR:** I might just follow-up on this point if I can, and you  
11 quoted to us a piece that I believe was on the discussion  
12 document we put out on our inquiry into the gas pipeline  
13 business, the control inquiry. And Part 4 of the Act does  
14 refer to objective statements that are put in terms of long-  
15 term benefit to consumers, and it's very clear to me that  
16 the Commission has received extensive advice that focus on  
17 consumers there takes on a particular meaning and may have a  
18 wider meaning even than what we might look at under other  
19 parts of the Commerce Act.

20 And when we do cost benefit analysis under the  
21 authorisation parts of the Act, the practice of the  
22 Commission, and I think it's been endorsed by the Courts, is  
23 to look at public benefit to New Zealand, and it is not  
24 purely to say that a benefit is only counted as a benefit if  
25 it accrues directly to end-users or consumers, and we have  
26 generally counted benefits to whoever they accrue to as long  
27 as they accrue to someone in New Zealand, whether it's  
28 business or consumers.

29 So, I just -- I wonder -- well, I generally don't have  
30 any difficulty with the overall propositions you put to us,  
31 I do think there is a difference, in principle at least,

1 between the different sections in the Act, or the different  
2 parts in the Act.

3 **MR DAVID:** Perhaps I might attempt to respond to that CHAIR. I  
4 think that the landscape has change, the landscape was  
5 changed by the change to the long title of the Act in 2001  
6 where the purpose of the Act is now to promote competition  
7 in markets for the long-term benefit of consumers within  
8 New Zealand.

9 Now the previous authorisation decisions that were taken  
10 in relation to public benefit I think would have by-in-large  
11 occurred, and certainly the court cases that related to  
12 them, would have come about before that change to the  
13 legislation.

14 **CHAIR:** I understand that, but in applying the authorisation  
15 test when we look at benefit to New Zealand, which I would  
16 suggest to you we would probably still interpret that way,  
17 and generally this Commission has considered it appropriate  
18 to consider that if benefits accrue to business in the long-  
19 term they will accrue to consumers in some form that  
20 consumers benefit where, for instance, there are efficiency  
21 gains by the businesses in the community and perhaps -- we  
22 have generally taken the view that that does not open up  
23 quite the same differential that perhaps some other  
24 jurisdictions do, who want to know that those benefits and  
25 can see that those benefits are fairly rapidly captured by  
26 consumers.

27 When we apply the net benefit test in an authorisation  
28 situation we don't necessarily discount benefits that appear  
29 to be accruing to business in the short-run. If there are  
30 economic benefits then we believe they're benefits to the  
31 economy as a whole. So, I just wonder if you have a

1 difficulty with that general principle.

2 **MR DAVID:** I indicated in this circumstance by the fact that the  
3 persons to whom the benefit is directly accruing would be  
4 the Applicants, one of which is presumably almost entirely  
5 owned by off-shore persons, so there'd be a complete leakage  
6 of benefit out of New Zealand, and in the case of the other  
7 applicant one that will become 22.5% owned.

8 **CHAIR:** I'm sure you're aware that even if some of the benefit  
9 accrues to foreigners, as long as it's not functionalist  
10 rents we can still count it and see that it benefits  
11 New Zealand because of the general proposition that we  
12 benefit from these sorts of cross-border investments and  
13 transactions.

14 But I guess I want to come back to Dr Scott and say to  
15 you in a case such as this, if it's not functionalist rents  
16 that are happening here, and in fact we can see, if this  
17 alliance were to result in economic efficiencies across the  
18 economy, even if they accrue in the short-term to businesses  
19 rather than directly to consumers, would it be your view  
20 that the Commission could take them into account in the cost  
21 benefit analysis?

22 **DR SCOTT:** Well, Commissioner Rebstock I certainly accept that  
23 it is true that in New Zealand we have been a little  
24 different from some other jurisdictions in insisting that  
25 all the benefit accrues to consumers, and indeed in other  
26 submissions I've made on other occasions I have certainly  
27 taken that into account. What I am arguing here, though, is  
28 that in precisely the way you did the question of rent comes  
29 up here, that you wouldn't be indifferent between an  
30 economic benefit that was entirely accruing to the producers  
31 because of the creation of rents that had their source in a

1 competition policy intervention from one where competitive  
2 conditions led you to believe that the normal interplay of  
3 the elasticities in markets and dynamics would lead that  
4 benefit to accrue more widely in the community over time.

5 **CHAIR:** Okay, thank you for that. Can I see if there are  
6 further questions for Dr Scott?

7 **MR CURTIN:** Perhaps an observation, I think we had a wee  
8 conversation about whether we needed to revisit the  
9 definition of benefits in this kind of exercise, but I  
10 understood your submission to be, don't change the way you  
11 go about looking at benefits. I thought your argument was  
12 there are all sorts of other extraneous arguments running  
13 around about the merits of this policy or that policy or  
14 that fiscal impact or the desirability or otherwise of  
15 having a national flag carrier and all sorts of things. I  
16 understood your submission to be not a revisiting of our  
17 standard process, but, if anything, a reinforcement to carry  
18 on the way we traditionally have and not have the  
19 calculations sullied by things that are not meant to be  
20 calculated.

21 **DR SCOTT:** That's correct.

22 **MS BATES QC:** If there's anything further you wish to pick up on  
23 the, Mr David, on the change to the Purpose Statement and  
24 how it might affect this test, feel free to do so at the  
25 time you are addressing the legal submissions.

26 **MR DAVID:** I'm content, Ms Bates, with responding to  
27 Commissioner Curtin that, yes, we are saying a rigorous  
28 application of the Commission's established policy in  
29 relation to public benefit analysis is what we are arguing  
30 for.

31 **MS BATES QC:** Yes, so you don't think it makes us -- I

1 understood you to be saying that the change to the Purpose  
2 Statement with a consumer --

3 **MR DAVID:** Obviously the change to the law needs to be taken  
4 into account.

5 **MS BATES QC:** Yes, but you don't think the approach the  
6 Commission's taken is inconsistent with that Purpose  
7 Statement?

8 **MR DAVID:** No, I don't think it's inconsistent at all.

9 **MS BATES QC:** That's fine. Thank you.

10 **MR DAVID:** Thank you Madam Chair, I shall move on now to Mr John  
11 Sheridan who's going to address you in relation to the  
12 impact of actual competition in the market, using data that  
13 he's observed at Wellington Airport and the importance of  
14 these effects in downstream markets.

15 **MR SHERIDAN:** Good afternoon. My name is John Sheridan, Chief  
16 Executive of Wellington International Airport Limited. Just  
17 as background, yes, I've been in the aviation industry now  
18 for 16 years, including 12 years in senior airline  
19 positions, and over four years as the Chief Executive of  
20 Wellington International Airport. I was the CFO, the Chief  
21 Financial Officer of Ansett New Zealand for 9 years, from  
22 the start up of the airline in 1987 through to 1996, and  
23 thereafter I held senior positions at Ansett New Zealand Air  
24 Freight and Ansett Australia. In my role at Ansett  
25 New Zealand I was heavily involved in decisions on aircraft  
26 purchase, Network Strategies, and pricing, amongst many  
27 other facets of the business.

28 The interest of Wellington International Airport Limited  
29 or WIAL as it's known in the application, our interest is,  
30 we are directly affected by the outcome of the Commerce  
31 Commission's decision on the application. A key driver for

1 the success of Wellington Airport, as it is for any airport,  
2 is passenger throughput. Landing charges at Wellington are  
3 based on passenger numbers, and many of the company's  
4 commercial revenues, such as retail spend, carparking and  
5 taxi usage, as examples, are obviously directly related to  
6 the number of passengers who use Wellington Airport.

7 The proposed alliance strategy foresees a reduction in  
8 the services through Wellington Airport, and an increase in  
9 airfares; strategies that will unfavourably impact on  
10 passenger numbers. So the objective of my presentation  
11 today is to clearly demonstrate the critical importance of  
12 competition for market stimulation and growth, and the  
13 continuing introduction of new product and services.

14 I'd firstly like to background and revisit the impact of  
15 Ansett New Zealand's start up of operations in New Zealand.  
16 I believe that this background is important as it so clearly  
17 demonstrates the importance of competition to the aviation  
18 industry here in New Zealand. Most of us here today no  
19 doubt can remember the horrors of the domestic aviation  
20 market prior to Ansett New Zealand's entry. The entry of  
21 Ansett New Zealand resulted in a quantum leap in the service  
22 standards and availability of discounted fares in the  
23 New Zealand domestic aviation market.

24 It is worth noting some of those improvements. These  
25 improvements were only brought about as a result of there  
26 being competition. Firstly upgraded terminal facilities,  
27 the introduction of aerobridges, improved service standards  
28 such as catering on the aircraft, lounge facilities and  
29 valet parking, to name just a few.

30 Most importantly the start up of Ansett New Zealand  
31 meant competition and the availability of discount fares.



1 My memory from those days is that the average fare  
2 dilution -- fare dilution being the actual average fare sold  
3 by the airlines versus the full fare -- the average fare  
4 dilution increased from 15% pre-Ansett to 35 to 40% from the  
5 day that Ansett New Zealand started services. I.e. Pre-  
6 Ansett, average discount 15%.

7 **MR PJM TAYLOR:** Is this against the --

8 **MR SHERIDAN:** The rack price, the full fare price. The day that  
9 we started up is 35 to 40% discount. I can also recall, and  
10 it's worth noting, that those discounts were only available  
11 on those sectors where Ansett New Zealand directly competed.

12 The introduction of discounted fares immediately  
13 resulted in a stimulation of the market. Passenger numbers  
14 through Wellington Airport increased by 20% in the first two  
15 years after Ansett New Zealand start-up operations.

16 At its peak, Ansett New Zealand had up to 40% market  
17 share on those sectors where it competed. I should also add  
18 an improvement and mirroring what David Huttner said this  
19 morning, we were very proud also of our smiles at 6 o'clock  
20 in the morning.

21 **MS BATES QC:** And a hot breakfast.

22 **MR SHERIDAN:** And a hot breakfast.

23 **CHAIR:** Can I just interrupt you for a second. One way to look  
24 at that is to say -- your submission suggests that while the  
25 alliance, in a sense, takes one player out of the market,  
26 we've been told that, and I think it's probably fairly  
27 clear, that we have imminent -- the imminent arrival of a  
28 fairly effective airline, and if you get such an immediate  
29 price reduction on the entry of Ansett on the first day, as  
30 you put it, and an immediate stimulation of the market  
31 should give you some assurance that Virgin Blue can fairly

1 rapidly have the same impact in this market. I'd be  
2 interested in your response to that.

3 **MR SHERIDAN:** The introduction of Virgin Blue in New Zealand  
4 most definitely will stimulate the market, and we strongly  
5 support their entry. They have been discussing their  
6 potential entry now for, what, two and a half years. It was  
7 April 2001 when the Virgin Blue aircraft landed here at  
8 Wellington Airport en route to Australia.

9 Timing on entry, the sooner the better. But the -- for  
10 their entry to be a precondition on approval of the  
11 application I'd defer to my legal experts as to the ability  
12 to have such a precondition. But the -- our view is that  
13 they've been talking for two years, if they started up in  
14 the next three or four months great, but don't know the  
15 timing.

16 **CHAIR:** If they started -- if they were starting up tomorrow  
17 would your concern go away?

18 **MR SHERIDAN:** Virgin Blue is not a full network airline as a  
19 Qantas or certainly an Air New Zealand is. They will not  
20 have the full network, be it in timings, be it in  
21 destinations as the current players. So, therefore they  
22 will -- any VBA, as we heard with Mr Webster, they will come  
23 in and they will pick and choose. They will select sectors  
24 where they can make money and so therefore we do have an  
25 issue that, yes, on those sectors where there is strong  
26 competition, may not have the concern, but across the whole  
27 network there would still remain concerns.

28 **CHAIR:** Isn't that exactly what Qantas is doing now? They  
29 haven't exactly aggressively challenged Air New Zealand in  
30 the market. I mean they have picked -- there is a bit of  
31 picking and choosing going on.

1 **MR SHERIDAN:** Yes, but they also have a strong alliance of  
2 course with Origin Pacific.

3 **CHAIR:** Wouldn't be anything to prevent Virgin Blue from doing  
4 the same.

5 **MR SHERIDAN:** Of course not.

6 **CHAIR:** So I wonder, you know, I understand that there is a  
7 timing issue, but beyond the timing issue I wonder how much  
8 of a wider issue there is if we saw in the case of Ansett's  
9 arrival here a day 1 response.

10 **MR SHERIDAN:** And of course Ansett came in with a full network  
11 in that -- not just the main trunk, but also on the regional  
12 network, be it to Blenheim, Nelson right through.

13 **CHAIR:** Right from the beginning was it?

14 **MR SHERIDAN:** Not right from the beginning, but certainly within  
15 about 18 months that full network developed.

16 **CHAIR:** And we heard from Virgin Blue earlier today that they  
17 thought within two years they will have established -- if  
18 they can effect entry and if they're able to expand -- they  
19 would expect it to take up to two years for them to  
20 establish a network.

21 **MR SHERIDAN:** But they will be focusing purely on jet services,  
22 as David mentioned today, they're not into the regional  
23 network, and flying regional services in their own name.  
24 They may have some relationships they may not. But they  
25 certainly wouldn't have the same relationships, for example,  
26 between -- as we had at Ansett, where you have inter-lining,  
27 where you have your baggage checked through on the same  
28 reservations system, same boarding pass and the like.

29 **CHAIR:** I know that I've interrupted you, but just one last  
30 question. How do you view the difference between having  
31 what we've termed as the factual and the counterfactual?

1 The factual being, one, the alliance and Virgin Blue  
2 entering, let's talk about in terms of the way we've been  
3 talking about it today; and the alternative of having both  
4 Air New Zealand and Qantas competing head-on with each other  
5 and with Virgin Blue. How do you see the differences  
6 between those scenarios in terms of the extent of the  
7 competition and market stimulation that would occur?

8 **MR SHERIDAN:** Which markets are we talking about? Are we  
9 talking about the domestic or on the Tasman, because it  
10 could be rather different between the two.

11 **CHAIR:** I think it would be helpful if you talked about both  
12 given your experience thank you.

13 **MR SHERIDAN:** Well, let's firstly talk about the Tasman. In  
14 respect of the Tasman the -- there is strong competition  
15 obviously between Qantas and Air New Zealand. One of the  
16 benefits of having both players there as separate entities  
17 currently is that they represent the two alliances  
18 throughout the world, being One World and Star Alliance.  
19 And should of course there be an alliance between Qantas and  
20 Air New Zealand then there is the question mark as to should  
21 one of those alliances disappear.

22 So, if Virgin Blue came in as a third player we would  
23 have comfort in that we've got the retention of the two  
24 current alliances, plus also Virgin, as we mentioned this  
25 morning, or as David mentioned this morning, was they will  
26 pick and choose, they will potentially open up new routes,  
27 they may go for example from Wellington to Coolingata which  
28 currently doesn't have a service. They may go from  
29 Wellington to Adelaide and create new markets.

30 So, I believe that should there be three operators in  
31 the Tasman out of Wellington and that should Virgin Blue

1 pick and choose and to create new markets, yes, there could  
2 be room. The factual of where you've got Air New Zealand  
3 and Qantas forming the alliance, I have a concern with  
4 respect to -- I can come -- if I may, that's covered in the  
5 presentation later on if I may.

6 **CHAIR:** That's fine, please, go ahead.

7 **MR SHERIDAN:** Thank you. In the period of the mid-90s through  
8 to 2001 there were very few initiatives launched in the  
9 market. Nor was there any change in the capacity offered by  
10 either Air New Zealand or Ansett New Zealand, and as a  
11 result domestic market growth in the seven years through to  
12 November 2002 averaged only 10.3% per year. The description  
13 of it being a benign competitive environment domestically  
14 over this period is certainly apt.

15 This period was dramatic, however, in that it included  
16 the Ansett pilots dispute in 1999, the receivership of  
17 Tasman Pacific in 2001, the start-up of Qantas airways  
18 domestic services in New Zealand and the growth of Origin  
19 Pacific.

20 The recent modest growth pattern changed dramatically in  
21 November 2002 with the introduction of the Air New Zealand  
22 Express product. In the past nine months, November 2002  
23 through to July 2003, domestic passenger numbers at  
24 Wellington Airport have increased by an average of 8.9% over  
25 the previous year on an annualised basis. That is the  
26 highest rate of increase since 1987, when Ansett New Zealand  
27 started operations.

28 As per data sourced from Statistics New Zealand,  
29 domestic airfares have had various significant increases  
30 over the past decade. We believe that these fare increases  
31 would have been a reason, a major reason potentially, for

1 the very modest domestic growth from the mid-1990s. In  
2 periods when fares have reduced, notably in 1987 and 2002,  
3 the market has jumped.

4 So, in summary, domestic market changes over the past 16  
5 years reinforced the obvious fact that effectively  
6 competition is an essential element of market growth and  
7 serviced product enhancement.

8 **MS BATES QC:** I might just interrupt you there, because I --  
9 when you say Qantas Airways Domestic started up in 1999, you  
10 mean the Qantas New Zealand company do you?

11 **MR SHERIDAN:** No, the Ansett pilots dispute was in 1999, the  
12 start-up of Qantas Airways domestic services was in 2001.

13 **MS BATES QC:** 2001. When was it that Ansett left New Zealand?

14 **MR SHERIDAN:** Ansett New Zealand was sold out to Tasman Pacific  
15 and Tasman Pacific went into receivership in April 2001.

16 **MS BATES QC:** Yeah, can you give us any clue as to why you think  
17 that happened? No? I mean in so far as it provided  
18 competition it didn't have staying power did it?

19 **MR SHERIDAN:** When I left Ansett in 1996, that's Ansett  
20 New Zealand the airline, in fact in that year and in the  
21 previous year we made a profit. The years subsequent to my  
22 departure -- like Ansett Australia, you can't point to any  
23 single one event or reason, and it is often a combination of  
24 a dozen reasons, e.g. the exchange rate movement, we had the  
25 Ansett pilots dispute, and the Ansett pilots dispute was  
26 crippling, I believe, for Tasman Pacific. Prior to the  
27 pilots dispute on services with where they competed they had  
28 market share through Wellington of about 40%.

29 Post pilots dispute they -- that market share came back  
30 to about 33, 34%, but over the subsequent six months they  
31 had issues with manning of aircraft and cancellation of

1 aircraft. It turned off a lot of their market, the business  
2 market in particular, when people had cancelled flights, and  
3 you found that their market share went down to about 28,  
4 29%.

5 So, their market share prior to receivership dropped  
6 from 40% down to 28%. That 12%, if you took it across the  
7 whole of their revenue base, would have been about 30 to \$40  
8 million. That 30 or \$40 million, 70 or 80% of that would  
9 have come off the bottom line.

10 **MS BATES QC:** Thank you, just one more thing. When was the  
11 period of benign competition?

12 **MR SHERIDAN:** I'd suggest about mid-96/97 when we saw no great  
13 initiatives you could say in the market, no great pricing  
14 initiatives and very little growth, would be about the 95/96  
15 through to early 2000.

16 **MS BATES QC:** Do you think that had anything to do with the  
17 demise of both Ansett and its successors?

18 **MR SHERIDAN:** And the lack of growth in the market.

19 **MS BATES QC:** Why was there benign competition, why did that  
20 happen?

21 **MR SHERIDAN:** That was post my departure so I couldn't comment.

22 **MS BATES QC:** You couldn't comment, you don't know?

23 **MR SHERIDAN:** No.

24 **CHAIR:** Can I just ask one follow-up question. This period of  
25 high growth, how much of it do you think is the introduction  
26 of Express as opposed to just some general recovery, to  
27 catch up from --

28 **MR SHERIDAN:** This is in the last nine months?

29 **CHAIR:** Yes.

30 **MR SHERIDAN:** My intuition would be that 90% of it would be  
31 because of the introduction of the Express product.

1 **CHAIR:** Rather than a catch up from a bit of a downturn in the  
2 airline business?

3 **MR SHERIDAN:** Correct. It's all about price. If we were to  
4 turn to the international market, for a period of 10 years  
5 from the mid-1980s, the bulk of international services to  
6 Wellington were codeshared between Air New Zealand and  
7 Qantas Airways. Market growth over this period was limited  
8 with a very sluggish annual growth rate of 4 to 4.5%. The  
9 codeshare -- this is sluggish by international standards and  
10 international standards into New Zealand.

11 The code sharing arrangement was discontinued in the  
12 mid-1990s, when full and effective competition commenced out  
13 of Wellington between Air New Zealand and Qantas Airways on  
14 the Tasman. This competition resulted in a substantial  
15 uplift in flight frequency with the substitution of the  
16 Boeing 767 aircraft with the smaller 737 aircraft on our  
17 most important Tasman sector Wellington-Sydney. Frequency  
18 to both Melbourne and Brisbane also improved around the same  
19 time. A survey of Wellington business leaders in 2000  
20 commissioned by Wellington Airport identified frequency of  
21 service as being one of the most important issues for the  
22 business market.

23 In contrast to the substantial increase in domestic  
24 fares, international fares have remained relatively flat,  
25 highlighting the presence of effective competition in the  
26 market in the recent past. International fares in fact have  
27 increased by only 4% over the 16 year period of 1987 to  
28 2003, contributing no doubt to the robust international  
29 passenger growth through the mid-1990s.

30 The elimination of code sharing, the introduction of  
31 effective competition and an increase in flight frequency



1       resulted in a sustained growth in the international market  
2       over the 5 years through to late 2000 of 55%. An annual  
3       average of 9.2% in contrast to the 4.4% growth over the  
4       period of code sharing and low frequency.

5       International services to Wellington have been cut back  
6       in the past two years with a consequential decline in  
7       passenger numbers. But it is interesting to look at the  
8       graph and note the interrelationship, the obvious  
9       interrelationship there between services and passenger  
10      numbers.

11      Turning to the factual scenario --

12 **MR CURTIN:** I just wonder if I could follow that up. No great  
13      change in international fares, steady increases in domestic  
14      is the picture you've shown. Would you care to hazard an  
15      explanation to as to why you see those different patterns  
16      happening when you'd assume that a lot of the drivers like  
17      aviation fuel and everything else and labour costs would be  
18      common on both sides?

19 **MR SHERIDAN:** I don't know the costings of the individual  
20      airlines in question, so I can't think -- make expert  
21      opinion or comment on the drivers, but from a market  
22      perspective, or my intuition would be that there was more  
23      competition on the Tasman than there was domestically.

24 **MR CURTIN:** I'll leave it there for now, thank you.

25 **MR SHERIDAN:** Turning to the factual scenario. The NECG first  
26      report details a scenario of reduced international services  
27      for Wellington Airport. The Applicants' case is based on  
28      substituting international frequency with larger aircraft  
29      and presumably a code sharing of services; in fact an  
30      identical scenario to what we experienced in the early  
31      1990's when growth was stifled. It is believed also that a

1 stated aim of the alliance is to improve yields for both Air  
2 New Zealand and Qantas. And improvement in yields of course  
3 means only one thing, an increase in average fares.

4 The management of schedules, yield improvement and the  
5 network will be simply managed through a proposed single  
6 control group. Regardless of how it may be described the  
7 factual scenario is an effective elimination of competition  
8 between two airlines that carry over 90% of passengers that  
9 use Wellington Airport.

10 **MS BATES QC:** I suppose as you would have heard the discussion  
11 between Professor Ergas and myself about what he called the  
12 conservative nature of the modelling he did, which was to  
13 leave the VBA entry out of the picture; if you add that back  
14 in, what do you then say about the propositions that you put  
15 forward here?

16 **MR SHERIDAN:** Of course if you overlaid a Virgin Blue into this  
17 scenario, yes, the red line there will upturn and as such  
18 will stimulate the market, which is why we are fully  
19 supportive, and always have been for the last 3 years, or 2  
20 and a half years, of Virgin Blue's entry and also supportive  
21 of the expansion of services of a Freedom Air. The true VBA  
22 with a strong network and strong presence. Most certainly  
23 it would impact, but without the entry as you can see there  
24 in the graph, the impact -- the likely impact is obvious in  
25 respect of where the passengers may grow.

26 **MS BATES QC:** Now listen, do you think that the Express fares  
27 had nothing to do with the imminent entry of a VBA?

28 **MR SHERIDAN:** Sorry, say that again?

29 **MS BATES QC:** Do you think that the Express fares had nothing to  
30 do with the imminent entry of a VBA?

31 **MR SHERIDAN:** I'd be speculating as to the strategic views of

1 Air New Zealand and I'm not going to turn my mind or  
2 speculate as to why they have done it. No I'd prefer not  
3 to.

4 **MS BATES QC:** I can see why.

5 **MR PJM TAYLOR:** If you go back to the previous slide, dot point  
6 3. Would it not also be the case that fares could be held  
7 constant and if load factors increased that yields would  
8 improve? Have I got the wrong end of the stick?

9 **MR SHERIDAN:** Yields are only per passenger per RPK, revenue  
10 passenger kilometred, so yield is average fare per person.

11 **MR PJM TAYLOR:** So a definitional issue?

12 **MR SHERIDAN:** Yes.

13 **MR PJM TAYLOR:** Okay thanks.

14 **MR SHERIDAN:** Just some market observations with respect to  
15 Freedom Air. It is worthwhile making several observations  
16 on the impact that Freedom Air has made in the Wellington  
17 aviation market. Freedom Air operated domestic services  
18 through Wellington from May 2001 to September 2002,  
19 following the receivership of Tasman Pacific. Freedom Air  
20 then replaced Air New Zealand services to Brisbane from  
21 October 2002. In neither case did the introduction of  
22 Freedom Air services produce any noticeable stimulation of  
23 demand. Having a limited number of services and a lack of  
24 brand penetration, I would suggest, in the Wellington market  
25 would appear to be the reasons behind Freedom Air having a  
26 limited impact.

27 So Wellington International Airport strongly believes  
28 that pricing and sufficient market presence are the key  
29 market stimulants, therefore we would welcome and encourage  
30 the expansion of Freedom Air services, along with the start-  
31 up of any other VBA.

1           So in concluding, I've highlighted several fundamental  
2 changes and competitive initiatives in the aviation market  
3 over the past 16 years that have stimulated the industry,  
4 namely the start-up of Ansett New Zealand, commencement of  
5 effective competition out of Wellington from the Tasman in  
6 the mid-1990s and the introduction of Air New Zealand  
7 Express domestically in November 2002.

8           These market changes reinforce the obvious, that  
9 effective competition is the critical essential element for  
10 market growth and product enhancement. The introduction of  
11 the Air New Zealand Express product is great for the market  
12 and we applaud that initiative. However, to suggest that  
13 that is it, is wrong. As Geoff Dixon stated, the industry  
14 must continue to re-invent itself.

15           It is competition that drives reinvention, not just in  
16 pricing, but in market product offerings, service standards,  
17 equipment, schedules, capacity and network. Without  
18 competition or even in a benign competitive environment,  
19 there is no incentive to make change. Continuing change is  
20 essential for Wellington to remain competitive in the world  
21 business, tourism and to be an attractive city for its  
22 residents.

23           It is therefore with serious concern that we contemplate  
24 a reduction in services as suggested in the NECG report, and  
25 an increase in average fares. This concern on competition  
26 is obviously fundamental to our objection to the  
27 application. The proposal will result in the elimination of  
28 competition between Air New Zealand and Qantas, the two  
29 airlines who carry over 90% of all passengers who use  
30 Wellington Airport.

31           And I would just finish up by making comment in respect

1 of the impact of reduced competition on the Wellington  
2 region. In tourism, tourism is a competitive industry. If  
3 fares to a location are higher, or availability of seats or  
4 holiday packages are limited, then that location will become  
5 uncompetitive and will miss out in favour of other regions.

6 If a city is more expensive to transact a business from  
7 or there is a lack of airline services to that city, then  
8 businesses will relocate their business elsewhere. These  
9 issues are obviously vital for businesses in reaching a  
10 decision on where they may set up a head office, or whether  
11 they should expand their current facility.

12 In today's environment city must be competitive to grow  
13 and to prosper. Thank you.

14 **CHAIR:** Thank you Mr Sheridan, just a few questions and then we  
15 will break for afternoon tea. You may have heard the  
16 suggestion in earlier proceedings that the Fifth Freedom  
17 carriers that fly into Auckland provide constraint, even in  
18 the Wellington and Christchurch Trans-Tasman markets, and  
19 I'd like your view on that, given your own background  
20 please.

21 **MR SHERIDAN:** I didn't actually hear the statement made, but I  
22 heard David Huttner's comment this morning and I would agree  
23 with his, that I find it difficult to believe it would have  
24 a significant impact on the fare structure out of Wellington  
25 Airport, out of Wellington.

26 **CHAIR:** The other question I wanted to ask you, it has been  
27 suggested to us that New Zealand can't support more than two  
28 airlines and if Virgin Blue enters somebody's going to go  
29 and it's going to be Air New Zealand, and it may not happen  
30 overnight but it's gonna happen, and I'd like to get your  
31 view on that proposition?

1 **MR SHERIDAN:** Well, when Ansett New Zealand started up in the  
2 first, certainly 5 years, we had tough times and we lost  
3 lots of money, but, yes, in 1995/96 we made profits, and  
4 thereafter -- after my departure -- be it with market share  
5 issues as well as cost issues, that turned into losses and  
6 finally receivership.

7         Could the New Zealand domestic market support three  
8 airlines, three full airlines, major airlines? My intuition  
9 would say no. On the Tasman I would suggest yes. As I  
10 explained previously with the new sectors that a VBA could  
11 generate, I believe yes.

12 **CHAIR:** Given your view about the domestic market, it seems to  
13 me that you may almost be suggesting we take a fairly short-  
14 term view, which is don't allow this alliance to go ahead  
15 because it will have an adverse effect on competition; but  
16 at the same time you don't expect more than two airlines to  
17 necessarily survive in the domestic markets. If they're not  
18 going to survive, it seems to me that as long as you have  
19 entry are you any worse off than you will be in the scenario  
20 where you can't support three airlines?

21 **MR SHERIDAN:** The factual scenario is it's not preconditional on  
22 a third airline coming in.

23 **CHAIR:** I know that, but let's -- I think things have moved on a  
24 little bit, to be honest, since that factual was written.

25 **MR SHERIDAN:** Well --

26 **CHAIR:** I mean that's probably an interesting thing to put to  
27 you as well. You've indicated, and I think this is part of  
28 the Commission, where we got to when we wrote the factual,  
29 was Virgin Blue had been talking a long time, but we didn't  
30 actually see them coming across the Tasman; but there's been  
31 a strong case put forward that now it's clear that they are

1 going to enter and they'll be in New Zealand by Christmas.  
2 Do you dispute that general view? How much confidence do  
3 you have that Virgin Blue will enter the Tasman and come  
4 across on the domestic --

5 **MR SHERIDAN:** I'm not going to speculate as to timings and  
6 entry, that is for them. We certainly are supportive of  
7 their entry.

8 **CHAIR:** Given your own position at Wellington Airport, I would  
9 suspect you'd know whether it's gotten more likely or not in  
10 recent periods.

11 **MR SHERIDAN:** We are different from an Auckland Airport. A new  
12 entrant like a Virgin Blue could start up at Wellington  
13 Airport tomorrow. There are check-in counters available,  
14 there is a common baggage make up area, there are gate  
15 positions available, so therefore the need for Virgin Blue  
16 to come and talk to us in detail is not there.

17 **CHAIR:** Okay, I accept that point. I just wondered if you had  
18 anything further to say about the other issues I've put to  
19 you.

20 **MR SHERIDAN:** No, our presentation and our view of the world is  
21 with the factual as we saw it.

22 **CHAIR:** Okay. Can I just see if there are further questions?  
23 [No comments]. Okay, what I would like to do is break for  
24 afternoon tea, and suggest that we reconvene at 10 past 4  
25 please and we'll continue with this -- sorry we'll be back  
26 at a quarter past, thank you.

27

28 **Adjournment taken from 4.00 pm to 4.20 pm**

29

30 **CHAIR:** Can I ask everyone to please be seated. I'd like to  
31 reconvene this session and before we return to the Infratil

1 presentations, there have been questions about how late we  
2 will be going tonight. We will be finishing at 6.15  
3 tonight, and I am proposing to start the session tomorrow  
4 morning at 8 o'clock and I'm assuming that we will be going  
5 in the morning again with the current presenters. I'm sure  
6 it will take additional time.

7 **MR DAVID:** On my estimation, I think we'll probably run about an  
8 hour into tomorrow morning, maybe an hour and a half.

9 **CHAIR:** Okay, that's fine, thank you. We'll take whatever time  
10 is required. This is the closest to being on time we've  
11 been all week, so okay.

12 **MR DAVID:** For the benefit of those that don't want to come in  
13 the morning, it will be the lawyer that is speaking, so  
14 those who want a late start...

15 **CHAIR:** I'll just check if there are any questions for  
16 Mr Sheridan before we go on. I think we've asked the  
17 questions we had, thank you Mr Sheridan. We'll go on to the  
18 next part of your presentation.

19 **MR DAVID:** Indeed, I think the next part will probably deal more  
20 directly with the question of potential competition, the  
21 impact of potential competition in particular from the value  
22 based airlines. I turn to Mr Phil Walker to address himself  
23 on that subject.

24 **MR WALKER:** Thank you. Thanks for the opportunity to speak this  
25 afternoon. Basically the purpose of my presentation is to  
26 critique the Applicants' case for the entry of VBAs, and  
27 essentially that case is that one, a VBA will come, most  
28 likely Virgin; that it will be successful by way of being  
29 able to set price and capture a market. In doing so, it  
30 will in fact erode the prospects of Air New Zealand,  
31 ultimately leading to its collapse, I guess, with the



1 overlay of what Qantas might be doing as well, but the  
2 argument in the VBA paper seems to be that almost Air New  
3 Zealand is fatally doomed with the on-set of VBA, and that  
4 the alliance arrangement is a better solution, settling down  
5 a market where there is one full service airline and one  
6 VBA.

7 What my presentation hopefully will communicate is that  
8 there is another view, and perhaps another story and that's  
9 based heavily on experience that we've had in other parts of  
10 the world, particularly Europe and you'll see that favour as  
11 we go through the presentation; leading to a conclusion from  
12 our point of view that VBA entry will be good, and it will  
13 stimulate sizable volume increase in the market.

14 So, we shouldn't just look at existing markets in  
15 deciding whether things can work or not, we should be  
16 looking to what can be done. I'll also make the proposition  
17 that Virgin won't be the same kind of killer brand that's  
18 often associated with all VBAs. I think there's some  
19 discretion you need to apply in looking at VBAs, and I don't  
20 think Virgin is at the -- as I say, the category killer end  
21 of the scale and I'll explain more about that as we go  
22 along.

23 Thirdly, I'm going to explain that I think Air New  
24 Zealand is pretty well equipped to tackle whatever this VBA  
25 might be. It's not a foregone conclusion it will fail in  
26 the battle and I'll give some examples as to that thinking.

27 So that, overall we think that an alliance will be bad  
28 for the aviation market in New Zealand and for the community  
29 more generally and lead to a stifling of the competition and  
30 importantly innovation in the aviation market. I'll come to  
31 that very shortly.

*Infratil*

1           Just a little bit about my background, because I think  
2           it's important to establish some credibility in this area;  
3           I'll do my best. As was indicated earlier, I head up  
4           the Airports Group with Morrison & Co, so Morrison & Co  
5           being the manager of Infratil, basically carries the  
6           responsibility for finding infrastructure assets to invest  
7           in, and my role is to head up that Airports Group within  
8           Morrison & Co. So basically charged with finding airport  
9           assets in different parts of the world, managing the  
10          acquisition process and then looking after them as ongoing  
11          trading units. So, I sit on the two boards of the airports  
12          that we currently own.

13          I've had 32 years in aviation, I had 20 years with  
14          Qantas in Australia. I joined as a cadet industrial  
15          engineer and completed an Engineering Degree and then a  
16          Postgraduate Management Degree at the University of New  
17          South Wales. I've worked in a wide range of operational,  
18          commercial and corporate areas at Qantas. I spent many  
19          years in a research and -- operations research and  
20          optimisation sort of role looking at the scheduling of  
21          things like airplanes, air crews, and looking at forecasting  
22          traffic levels and analysing optimal allocation of scarce  
23          resources to sort of attack those traffic patterns.

24          Also, a lot of work in areas like manpower planning and  
25          airport operations. I ended my time with Qantas running  
26          Australian airports for three or four years and that in turn  
27          led to becoming Chief Executive at Brisbane Airport for the  
28          Federal Airports Corporation where I became a supplier of  
29          airport services to Qantas. And at Brisbane where I was  
30          Chief Executive for about seven years we dealt with things  
31          like the single aviation policy that was coming through in

1 the early 90s, looking at converting potentially the Tasman  
2 to a domestic sector.

3 We had a lot of time with Air New Zealand in Brisbane at  
4 the time looking at their plans to hub through Brisbane and  
5 take advantage of their new found oncarriage rights and we  
6 were trying to build a new international terminal at the  
7 time, so it was very relevant whether these were going to be  
8 domestic airplanes arriving and going to one, terminals or  
9 internationals.

10 So, I guess the message there is, even though I was an  
11 airport operator we're very intimately linked to airlines in  
12 the process. Since 97 I've worked for Morrison & Co and  
13 I'll explain little bit about that work in just a minute.

14 Just turning to what are we trying to achieve, I  
15 mentioned before it's to take a look at the airlines case  
16 for VBA entry. But I want to firstly, I think, provide an  
17 overview of Morrison & Co and Infratil and the work we're  
18 doing in Europe with low cost carriers. I'd like to spend a  
19 little bit of time just trying to have a look at VBAs and  
20 make this point about, they're not all the same and try and  
21 position, particularly Virgin, and I think make some  
22 comments about Air New Zealand in doing that.

23 Then I'd like to go to the European aviation market and  
24 look at the impact there of low cost carriers, particularly  
25 what they've done to volumes, to yields and to  
26 profitability. This work will contrast somewhat with what's  
27 been shown in the proponents' papers based on the American  
28 market and I'll talk about some of the reasons there might  
29 be differences there.

30 Then I what to finish by sort of coming back to, where  
31 is Air New Zealand today as a so-called network carrier or

1 full service carrier, and what are their options for trying  
2 to meet both the FSA, the full services requirements as well  
3 as competing in a value based environment.

4 So, just a little bit about Morrison & Co and airport  
5 activity; essentially we've worked in this part of the  
6 world, Australia and New Zealand, through the late 90s,  
7 participating in the phase 1, phase 2 privatisation of  
8 Australian airports. And during that process we looked at  
9 many but ended up owning half of Perth, Alice Springs and  
10 Darwin Airports. And then in 98/99 was primarily focused in  
11 the New Zealand market looking at Wellington Airport. We  
12 actually at one point in time did quite a lot of work on  
13 Auckland Airport, there was some prospect it might have been  
14 sold through trade sales, so we actually studied that quite  
15 closely, although we didn't eventually participate in the  
16 public float.

17 Since late 1996 we've had an office in London and now  
18 Berlin, from which we have been studying the UK and European  
19 market -- aviation market. We realise that opportunities in  
20 this part of the world were coming to an end and we needed  
21 to be somewhere else if we wanted to continue to invest in  
22 airports. And our office in London spent a lot of time  
23 looking at the aviation market. What part of the market  
24 should we be in? Full service airlines in big airports, or  
25 should we be in the value based sector in small airports?

26 We actually had close experience in both. We spent  
27 nearly 15 months trying to buy Hamburg Airport, which is  
28 clearly a primary airport with all of the issues of big  
29 airlines and that sort of issue. And, as it turns out, in  
30 January 2001 we bought Glasgow Prestwick which is an airport  
31 about 35 miles outside of Glasgow and competes with the

1 intercity airport Abbotsinch in Glasgow.

2 Since we acquired Prestwick, happily, the value based  
3 market has lifted significantly, and we have now -- we  
4 bought it with about 700,000 passengers a year, and this  
5 year we'll do about 2 million, so we're seeing some of the  
6 impact of this rapid growth in market.

7 Ryanair is a very important customer and we have a lot  
8 to do with the way they run their business and their  
9 expectations and needs, both operationally and commercially.  
10 In looking at other airports around Europe, and we're active  
11 in Germany particularly, but Italy, Belgium, Ireland, we  
12 spend a lot of time talking to carriers of all sorts, but  
13 particularly value based carriers about what are their  
14 expectations of assessments of markets, what are their  
15 economic requirements, and in that way have really got a  
16 pretty reasonable understanding of at least what drives a  
17 fair part of their business.

18 Anyway, I guess the overall point here is that, if  
19 you're buying airports, the key value driver for an airport  
20 is obviously the airline, so you better understand them  
21 reasonably well if you expect to succeed. So we invest a  
22 lot of time in looking for airports to buy, but also in  
23 trying to get the best out of the ones we own to make sure  
24 we understand what's happening.

25 I probably don't need to spend much time on this slide.  
26 I think I summarised it just as we commenced here, that  
27 eventually the airline case is that Air New Zealand is at  
28 risk; Virgin's on its way, it will do a lot of damage by  
29 capturing or setting prices by taking market share and  
30 eventually eroding profitability, and that as a result some  
31 other action is more appropriate; that is form an alliance,

1 reduce the equation to one full service, one VBA, and  
2 perhaps everyone will be happy. We have a, I think, a  
3 different view of that.

4 The next slide is about VBAs. There's a tendency in the  
5 airline proposal just to use a single categorisation of  
6 VBAs, that a VBA is a VBA and creates the same threat no  
7 matter what. What I want to point out in this slide is that  
8 that is not the case, there are definitely levels of VBA,  
9 some of which are truly category killers that should be  
10 feared and will do significant damage if you try and compete  
11 with them; others almost downgraded, you know, there's a  
12 spectrum of airlines here, and some are pushing more --  
13 climbing up the scale toward more of a full service airline,  
14 and I'll sort of make that point in a minute, but  
15 essentially the -- those that I would categorise as the low  
16 low, cost agents; and I think the two good examples in  
17 Europe are Ryanair and North America Southwest, do all of  
18 the usual things that you hear about with VBAs; single  
19 airplane, point-to-point, quick turnarounds, no food, those  
20 sort of things; but they've got an overlay of further  
21 refinement of what they offer and further discipline their  
22 cost control that sets them a quantum above or below their  
23 competitors.

24 And in the case of Ryanair particularly, it is a very  
25 very strong focus on secondary airports; they're at Glasgow  
26 Prestwick not Abbotsinch. You'll see in another slide or  
27 two's time that in a way that creates almost the critical  
28 distance between them and easyJet in terms of cost  
29 structure.

30 But further people like Southwest and Ryanair have got  
31 absolute sort of focus on the things they do and have not

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1 drifted from the core, and I think some of the other  
2 airlines, as you can see down the page, are starting to add  
3 some extras, like loyalty programmes, like some sort of  
4 snacks on board, they mightn't be meals, but there's  
5 something there. Some degree of connectivity; you can  
6 actually go from Adelaide to Tullamarine and not see your  
7 bag at Melbourne -- sorry Adelaide to Launceston through  
8 Melbourne without needing to collect your bag. You just  
9 couldn't do that on a Ryanair network.

10 If you're going from A to C through B on Ryanair you  
11 must collect your bags as an arriving passenger, walk  
12 upstairs and spend another hour checking in. There's a very  
13 clear discipline that applies, and people like Ryanair,  
14 despite the inclement weather of Europe, refuse to use  
15 aerobridges. They can be there but they don't want to use  
16 them; they want to be able to load passengers at the front  
17 door and back door at once so they can achieve a 20 minute  
18 turnaround. Doesn't matter if it's snowing, they've got a  
19 turnaround obligation and to get the utilisation up for the  
20 day they want 6 or 7 sectors a day and they've got to do  
21 that sort of thing.

22 I think Virgin at Brisbane started out with the same  
23 arrangement, but they've now been offered Ansett terminals  
24 around Australia. You know, okay, we're carrying more  
25 business passengers, so we'll connect an aerobridge now and  
26 just load through one door. All of these things start to I  
27 think almost cloud the difference between a pure low low,  
28 cost VBA and someone that's coming up the value chain.

29 **CHAIR:** Why do you think the reason, on a percentage basis, the  
30 difference in cost structure might be between these two sort  
31 of varieties? Do you come to that? That's fine.

1 **MR WALKER:** I do attempt to quantify it on the way through, but  
2 my basic message is, certainly you should treat Ryanair and  
3 Southwest with respect, and they are dangerous. The others  
4 are doing different things in slightly different markets.

5 JetBlue, for example, has got an average sector length  
6 twice that of Southwest, and the Southwest sector length of  
7 800 kilometres is identical to the Ryanair sector length; 3  
8 hours is about it. Whereas others are transcontinental and  
9 they've got leather seats and in-flight TV, and it is a  
10 different product.

11 They're all called VBAs, but I think in looking at  
12 what's going to happen in New Zealand, you need to think  
13 more deeply about exactly what sort of product will be used.  
14 My assertion I guess is, at the bottom there, Virgin Blue  
15 are not in the low low cost category, they are higher than  
16 that, I'd basically pair them with easyJet in terms of their  
17 operational behaviour. They are interested in the business  
18 market, they are happy to serve main airports at Sydney,  
19 Melbourne, Perth, Brisbane and to come Air New Zealand.  
20 They do carry some overhead Virgin, by way of some of their  
21 sales are through an agency network on which they pay  
22 commission, Ryanair wouldn't do that.

23 They do have interline agreements. Absolutely Ryanair  
24 wouldn't have arrangements with United or Rex Aviation for  
25 transferring their passengers from a local flight to an  
26 international flight. Virgin Blue has now introduced blue  
27 rooms, their lounge in quite large areas of space and quite  
28 elegant looking terminals; there'll be an overhead there,  
29 both in terms of getting in and maintaining. They've  
30 comfortably now settled into Ansett terminals in Australia,  
31 in quite comfortable surrounds. Again, there'll be a cost



1 to that, and I haven't got any direct -- I've read that  
2 they're also considering loyalty programmes.

3 The point being that they are coming up the cost chain.  
4 Contrast that with Air New Zealand through its Express  
5 products, both domestically and now Trans-Tasman. More  
6 importantly, contrast it to Freedom, which is effectively  
7 taking Air New Zealand down in its cost structure. So  
8 you've got I think Virgin rising, Air New Zealand becoming  
9 more and more competitive through its innovation. So, at  
10 the end of the day the assumed wipe out that's inherent in  
11 the airline codes, I don't think can be that quickly  
12 concluded.

13 **MR CURTIN:** Just a point; one small question. How does JetBlue  
14 manage to have that value proposition and stay low cost?

15 **MR WALKER:** What is low cost? They are different to, if you  
16 like, some of the traditional carriers in their cost  
17 structure, but if -- all I'm doing here is, I'm not trying  
18 to make the comparison so much to the full brand carriers,  
19 the full service carriers, more just trying to pull apart a  
20 little bit the detail of the value based carriers. And I'm  
21 not even being critical of them, it's probably working  
22 commercially. But the point is, if JetBlue were to come to  
23 New Zealand with their product where they're looking for  
24 sector lengths of 1800 kilometres and, you know, it may not  
25 work, you better make sure you've got the right style of  
26 VBA.

27 And, I really think more than anything a three hour  
28 sector length -- you know, the really dangerous proposition  
29 for New Zealand and Australia would be a Ryanair, I think  
30 structurally there are problems. It's hard to have a second  
31 airport in Sydney or Melbourne to offer Ryanair or whoever

1 it is that capability, but that would be where the real  
2 fundamental threat might come.

3 I'd now like to just think a little bit about the  
4 New Zealand aviation market, and I might just come back to  
5 some of the questions that were posed to John along the way  
6 here. And, all I'm trying to do here is to break it up into  
7 elements that might fit the VBA type product. You know,  
8 where is, if you like, the threat? Where is the market for  
9 a VBA operator?

10 What I've done here is separated out international into  
11 long haul which would be oncarriage to say Asia, Europe or  
12 North America from the Trans-Tasman element of  
13 international, and then domestically I've tried to look at  
14 trunk, which would be pretty much jet operation, separating  
15 that from regional and provincial, and my basic thesis is  
16 that it's the middle two that provide, if you like, the  
17 market opportunity for VBA.

18 The first one and the last one, you have people looking  
19 for more connectivity, more convenience in their judgment  
20 about who to use, so price is not all critical in the case  
21 of international long haul. People will put a value on a  
22 bigger seat more -- something to eat, perhaps the  
23 convenience of not seeing a bag in London, those sorts of  
24 things, that's a full service target, and at bottom end  
25 similarly, if you're coming from Invercargill or somewhere,  
26 you don't want to wait until Wednesday for your flight.  
27 You'd like to be able to go once or twice or maybe three  
28 times a day. And, given the sort of aircraft that VBAs use,  
29 and the sort of frequencies they could put through  
30 Invercargill, that might be a consequence of trying to put  
31 a VBA through a regional sort of area.

*Infratil*

1           Now, the New Zealand aviation market is about 20 million  
2 people a year, and in Europe after 6 years of value based  
3 airline; started in 97 with deregulation, they've achieved  
4 about a 10% penetration of the total market. 10% of 20  
5 million is 2 million, there are -- so that, on today's  
6 market -- there's a 2 million market, if you like, implying  
7 the European impact. So, that a question is, what happens  
8 to the 18 million if the total market's 20, 2 are a target  
9 for VBAs, what happens to the 18? There's a lot of people  
10 applying the European ratio that don't get serviced, if you  
11 like.

12           Now, you can go to North America where Southwest has  
13 been around for 30 years and VBAs are about 25% of the North  
14 American market at the moment. So, if you apply 25% to 20  
15 million, you've got 5 million people being served by VBAs;  
16 what happens to the other 15?

17           My point is that there is an awful lot of people in the  
18 international long haul and in the domestic regional  
19 provincial that won't necessarily find their answer in VBA,  
20 and also the experience has been in Europe and North America  
21 that even people in the middle often choose something more  
22 than just the point-to-point travel to meet their needs, and  
23 these would be business people who want some other  
24 convenience; they'll be private people who have to be there  
25 on Saturday for the wedding, they can't go on Wednesday.

26           So, I think international experience, and even just the  
27 first pass of the structure of the New Zealand market has  
28 got to bring some caution about one full service; one VBA  
29 serving all the people. I think there'd be a large slice of  
30 the market would only have one choice, the full service  
31 carrier in the New Zealand marketplace, because the VBA

1 product wouldn't fit their need.

2 **CHAIR:** That probably depends how far the likes of Virgin Blue  
3 goes towards the -- and it appears from what we've been told  
4 that they are not going quite that far to a full VBA model  
5 or the low, low cost model. They're attempting to sort of  
6 meet the local needs and, to that extent, it probably  
7 dampens that effect, I would imagine.

8 **MR WALKER:** There's a couple of issues. One is what size are  
9 these markets and will it suit the model of VBA 737s decent  
10 frequency and so on. Many of the destinations just won't.  
11 Then there's the overlay of what's important to Virgin;  
12 where are they going to get their best yields? They'll have  
13 scarce resources, where will they put their airplanes? Will  
14 they put more frequency on Sydney-Melbourne or start a  
15 service between Wellington and Dunedin? They are questions  
16 they will take commercially -- there may be a basic market  
17 there, but they might put a priority somewhere else.

18 Rather trying to prejudge where Virgin might go in terms  
19 of penetration of the total market, at the moment I prefer  
20 to rely on what's happened in other markets and what level  
21 of penetration have they had there. I think that experience  
22 is, a lot of people are yet to find that VBA fully serves  
23 their need. I'm going to talk more about VBAs in a minute.  
24 I think it's a great story, but a lot of it is about new  
25 business; new travellers. It's not existing the market base  
26 that we're playing with almost, it's the creation of new  
27 opportunities for people to travel.

28 **CHAIR:** Can I just follow-up on this point though. You've  
29 compared and looked at what happened in Europe and in the US  
30 and the extent of penetration, but it might be arguable that  
31 the country actually that we're most likely to be similar to

1 in terms of the situation in New Zealand is Australia, and  
2 the penetration seems to have been much higher there in  
3 terms of that VBA experience, and I just wonder if you could  
4 comment on that.

5 **MR WALKER:** Dangerous as it might be, a first sort of reaction  
6 is that Virgin got a huge kick-on when Ansett ceased  
7 operating and, you know, whether one calls the other or not,  
8 I think there'd be many that would say that Ansett was  
9 affected by things beyond just the arrival of Virgin in  
10 terms of, you know, its lack of shareholder funds over time  
11 and its ability to make the right commercial decisions in a  
12 timely manner and move on. There was lots of time lost for  
13 all sorts of reasons, years leading up to what finally  
14 happened in terms of where management attention was and what  
15 was the mission for the organisation in terms of innovating  
16 and moving forward versus surviving or staying put. And I  
17 think it was almost inevitable whether it had been Virgin or  
18 Jack Frost; at the end of the day as soon as you lose 40% of  
19 the Australian capacity someone's going to be in demand and  
20 Virgin were there and took advantage of it.

21 In a way it's a reasonably -- you know, it's a single  
22 effect coming through as opposed to what would happen in a  
23 more broader sort of --

24 **CHAIR:** I understand that point, but if I understand what you're  
25 saying to us, is that this result in Europe and in the US is  
26 a bit demand driven depending what consumers want and that  
27 there's limit.

28 So, if that was the case I would have expected in  
29 Australia for them to have that initial effect from the  
30 collapse of Ansett. But then I would expect it to diminish  
31 as people shifted back to the type of service that, as you

1 suggest, they might prefer. And I'm not sure that we're  
2 seeing that pattern.

3 **MR WALKER:** Well, I mean, I used Virgin many times after the  
4 Ansett collapse because I couldn't get on Qantas. It was a  
5 question of if you want to fly you've got to take what's  
6 there, and I'm not sure that people were making their first  
7 choice; they were often taking their only choice.

8 **CHAIR:** What I'm saying; by now Qantas surely has put on  
9 additional capacity in Australia itself, and you'd expect  
10 then to see Virgin to start losing market share to Qantas,  
11 and I don't know if we see that pattern, if you're right  
12 about people being forced to use Virgin at the time of the  
13 Ansett collapse.

14 **MR WALKER:** Well, I think in part look at what Virgin's doing in  
15 terms of its -- the product it's now offering, and it's  
16 rapidly sort of pushing back towards the kind of service  
17 offerings that were there pre the demise of Ansett in terms  
18 of extra assistance as you move through airports and things  
19 and that, no doubt, is having an impact on how people are  
20 behaving and will increase over time their costs and what  
21 they can offer.

22 **MS BATES QC:** Well, you would have probably heard them say that  
23 most of it's on a user pay basis, so it's not quite the same  
24 model, is it?

25 **MR WALKER:** I know that is what they say.

26 **MS BATES QC:** You think they would be providing an unprofitable  
27 service for food and lounge and hot meals?

28 **MR WALKER:** I'm sure they're looking beyond just that piece of  
29 real estate called the blue room in making that judgment.  
30 They're trying to build corporate loyalty and corporate  
31 accounts and other things, and I'm sure, at the end of the

1 day -- I don't know the real economics, but it's a fairly  
2 heavy undertaking to take that kind of space at an airport  
3 terminal and operate in that way.

4 **MS BATES QC:** Well they told us they'd broke even.

5 **MR WALKER:** Well, that's fantastic.

6 **MS BATES QC:** Believe it if you will.

7 **MR WALKER:** Now, unfortunately it probably might have been  
8 better to have a look at this slide before the last  
9 discussion; be that as it may. This slide just looks at  
10 what is called the infrastructure European aviation market,  
11 so it doesn't take into account the Trans-Atlantic long haul  
12 traffic in Europe, it's primarily the domestic services and  
13 then the intra-European services.

14 The essence of this is that down the bottom there, low  
15 cost; no doubt it's on the move and it's been highly  
16 successful and these figures are somewhat out of date, the  
17 2001 figure, it's probably something like 10% of market  
18 share by now. But I guess my general point is that it's  
19 still a relatively small piece of the total aviation market.

20 **MR CURTIN:** I just wonder, I was doing a quick back of an  
21 envelope calculation here. If these growth rates continue  
22 as they have been, and I know Mr Webster from easyJet was  
23 saying they're doing 15, and the Ryanairs are doing more  
24 than 15% a year. Just, as I say, I don't have a calculator  
25 with me, but I reckon by 2007, yeah, the shares are going to  
26 be getting up there, so I wonder if it's just a matter of  
27 time.

28 **MR WALKER:** Reading the literature, most sort of judgments are  
29 made on what's happened in America over a much longer  
30 period, and 25% seems to be a figure that most people feel  
31 comfort with as some sort of ceiling.

1           Now, as the industry reinvents itself and traditional  
2 carriers look more and more to offer more value, who knows  
3 where the split will finally come. It's certainly the place  
4 of activity in aviation at the moment, but I think it's --  
5 you just need to make sure you don't leave behind the 80% of  
6 other people that do need to get from Invercargill to  
7 Washington and doing six VBA trips mightn't suit them all  
8 that well. There are a lot of people in that category.  
9 Just in making a judgment overall it's a question of,  
10 there's no simple answer, but you can either start with  
11 collective VBAs; no doubt they'll form an alliance in time,  
12 or you can try and take a full service product and slim it  
13 down in its cost structure and make it suit the same overall  
14 requirements.

15 **MS BATES QC:** Just a point about Ansett before we leave Ansett;  
16 I don't know if we're coming back to it or not, but the view  
17 the Applicants really put forward to us was that -- and  
18 Virgin also put forward -- was yes, it had been an advantage  
19 to the Ansett collapse because it allowed them to establish  
20 a very strong base and they'd managed to grow a lot quicker  
21 than they otherwise would. But they are now in a position  
22 where they do have a very strong base and it's put them in a  
23 lot better position, they say, to enter this market. They  
24 don't see entering this market as being a completely new  
25 exercise. Without saying whether that's right or wrong, I  
26 just wanted to ask what your comment was on that view?

27 **MR WALKER:** Well, I accept that they've got some corporate  
28 functionality established that would allow them not to have  
29 to go through the -- you know, the set-up infrastructure  
30 investment to make it happen. And I think most of the VBAs  
31 working well are quite scalable in the way they've designed



1 their business; they can create a new hub if they stick to  
2 their disciplines. I think, though, it will be interesting  
3 to see how Virgin construct the three legs, if you like, of  
4 their market, and will it be three VBA trips to move from A  
5 to C or A to D? Or will there be integrated, will you  
6 check-in in Adelaide and pick up your bag at Dunedin?

7 If they are starting to integrate their services, it  
8 won't be the VBA that everyone's talking about point-to-  
9 point, you know, through check-in, all those sorts of  
10 things; they'll be adding some value. Is that value going  
11 to come for nothing? I think it will be unlikely to happen  
12 that way. So, I'm not sure that you can assume that all of  
13 the same economics will necessarily present themselves if  
14 and when they do enter both Trans-Tasman and domestic  
15 markets.

16 **MS BATES:** Thank you.

17 **MR WALKER:** The next slide is about the makeup of the UK VBA low  
18 cost market, and as you can see it's clearly dominated by  
19 Ryanair and easyJet. Ryanair now having acquired Buzz has  
20 about 18 million passengers per annum, and are forecasting  
21 quite dramatic growth. I think something like reaching  
22 \$50 million passengers by 2008, and easyJet have got about  
23 17 million passengers a year and they've got a similar  
24 looking forecast for 2008.

25 Both parties have got in the pipeline quite large  
26 aircraft orders. I think the key difference is that easyJet  
27 is pushing more aggressively at a business market, and  
28 that's why they insist on being at primary airports, not  
29 secondary ones.

30 EasyJet has got some issues in terms of it will for a  
31 period have a mixed aircraft fleet, it's cutting over from

1 73s to A320s, some issues there about duplication of  
2 training and supporting the network. Both carriers are  
3 feeling the pinch at the moment; if you look at their  
4 yields, their average prices are coming down by sort of 4  
5 and 5% per annum as they find it's harder to keep the extra  
6 capacity filled.

7 So, VBAs have got their own set of economic  
8 considerations in terms of how to manage their business.  
9 And it's, I think, worth noting that whilst there's a host  
10 of new entrants aspiring here in the other third of the pie  
11 chart, there have been some sort of notable exits over the  
12 last little while. In fact, you know, if you look at  
13 Ryanair, Buzz has been consumed, Go has been consumed by  
14 easyJet, Deutsche BA has been almost given away by British  
15 Airways; I think it was sold for a Euro after easyJet  
16 declined to buy it because of its condition. Virgin  
17 Express; if you look at the operating margins on the right-  
18 hand chart, they're hardly a showpiece of economic  
19 performance.

20 Those that do it well can succeed, but there's quite a  
21 few others that I think for some the jury's already decided  
22 and for others the jury is still out.

23 Looking at the other side of the chart, I think this  
24 helps to make my point earlier about low low cost versus low  
25 cost. There's a clear difference. Ryanair is more than  
26 twice as profitable as easyJet, and has been so for quite  
27 some time.

28 **MS BATES QC:** Why is that? Sorry, did I miss that? Why is it  
29 twice as profitable?

30 **MR WALKER:** I'm sure there's lots of reasons. I think the  
31 primary one is their cost structure. They are perhaps -- a

1 couple of slides away we'll have a look at their relative  
2 costs. It's primarily that cost differential, sort of, I  
3 think it's 20% or something cheaper than easyJet, because  
4 they go to secondary airports and they've quite tighter  
5 disciplines. They're chasing a different market, mind you,  
6 but they are being highly successful in that slightly  
7 different market.

8 **MS BATES QC:** So, they're not competitors?

9 **MR WALKER:** They are competitors, they would overlap for 70% of  
10 their market, but there are some parts that they're trying  
11 to -- particularly easyJet chasing business traffic; they're  
12 going for higher frequency of services between cities to  
13 give business people more choice, and they're staying closer  
14 to city centres. If you go on Ryanair to Frankfurt you'll  
15 end up about an hour and a half away in a place called Haan.

16 **MS BATES:** Might be nicer.

17 **MR WALKER:** Well, you can have a glass of Moesel on the way, but  
18 if you want to do business at 9 o'clock you've got a very  
19 early start.

20 This next one, I just was trying to sort of again show  
21 this differential between the different classes of VBA, and  
22 this just shows over a period of time Ryanair is  
23 consistently averaged to a 24% profit margin, and if you  
24 cluster another seven carriers, that would include Debonair,  
25 Buzz, Virgin Express, GO, easyJet, you get something below  
26 the waterline in terms of economic performance; and the same  
27 in the States. Southwest is clearly successful and has been  
28 for a long long time, but it's not the case that everyone is  
29 successful.

30 This is the slide that shows some comparity of unit  
31 costs. Just looking at the left-hand side, it's basically

1 available seat kilometres, adjusted to an 800 kilometre  
2 stage length which is highly relevant when you're trying to  
3 compare carriers on a short sector length basis. And, it  
4 shows that Ryanair is significantly lower down the bottom,  
5 60% lower.

6 Perhaps I need to explain the top three flag carriers --  
7 this is some work done by McKinseys, and they've taken  
8 British Airways, Lufthansa and Air France and split their  
9 international European operations, so this is still within  
10 the intra-European market and their domestic operations, and  
11 you can see that Ryanair are at 4.5 US cents per ASK versus  
12 12 for those three carriers operating on their intra-  
13 European international legs.

14 Their domestic operations are far more efficient because  
15 they've moved through things like taking away hot food and  
16 slimming down the product and making it more competitive.  
17 But the key differences are down the bottom where Ryanair is  
18 way out in front and even compared to easyJet, Ryanair is  
19 still a long way in front at 4.5 versus easyJet's 7.1.

20 And again, look at just their general styles of  
21 operation, the sorts of things they do and don't do, it  
22 would be my assertion that Virgin is not a Ryanair; they are  
23 not in that level of -- you know, they're supplying a much  
24 more enhanced product than Ryanair and their behaviours by  
25 way of going to primary airports is more akin to easyJet.  
26 So, if you had to make a call right now about where is  
27 Virgin sitting, I would say certainly more closely to  
28 easyJet than Ryanair.

29 Another question is, where is the Express product for  
30 Air New Zealand sitting at the moment? What is the gap that  
31 they might need to close? And I think it would be

1 reasonably safe to assume that Air New Zealand, given its  
2 size and history of being reasonably innovative and so on,  
3 ought to be better than the European -- those three European  
4 carriers, particularly in terms of their performance.

5 So, I think the gap that Air New Zealand Express is  
6 chasing in terms of trying to compete with Virgin, is a much  
7 narrower one than you might conclude if you just somehow  
8 assumed all VBAs were like Southwest or Ryanair.

9 **MS BATES QC:** Just to pick up on that, because we were talking  
10 about that proposition with Virgin earlier in the day. The  
11 view put forward by Virgin is that you just can't look at  
12 Express fare and say that necessarily is how it is, because  
13 you look at the number of seats that are offering the  
14 Express fare and whether there are any restrictions on them  
15 and the view put forward was, well, the Virgin product is,  
16 you'll get much -- you'll get many many more seats at a  
17 lower cost without restriction; whether you accept that or  
18 not, just say it is right, well then is the Express fare  
19 really being competitive with the Virgin option?

20 **MR WALKER:** Well, I'm reluctant to even speak out on airline  
21 cost; to go to airline pricing is another step forward  
22 again. I think ultimately this is the key message; it's  
23 what your cost structure looks like that allows you to set  
24 your fares. And anyone that can maintain a significant  
25 margin on their unit cost has got to be positioned in the  
26 marketplace to, even if it's not on day one but over time,  
27 to offer more and more seats at that lower rate if they want  
28 to hold market share or stimulate market.

29 So, I don't know what percentage of, you know, the  
30 bottom fares Air New Zealand Express will be offering. My  
31 point here is, as they can get closer and closer to, say,

1 the easyJet level of performance, the competitive advantage  
2 of Virgin is removed, and therefore they are competing at  
3 that point.

4 **MS BATES QC:** They told us that that wasn't what they could do;  
5 that's why I'm quite pushed on that. They both said, no  
6 matter what they did, they could never bring their cost  
7 structure down to the Virgin level. So, where does that  
8 leave us?

9 **MR WALKER:** I suppose it's an open question.

10 **MS BATES:** It probably is, quite rhetorical, but...

11 **MR WALKER:** It runs against the evidence doesn't it? Look at  
12 Freedom; has that not been a change in innovation, in  
13 concept? Hasn't that shifted the cost of moving people  
14 across the Tasman? I think it's clearly doable; the  
15 question is, can you do it quickly enough?

16 **MS BATES QC:** And how much can you do it, given the current  
17 structure? How much can you change yourself?

18 **MR WALKER:** Current structure; well some things have been done  
19 haven't they? Freedom has been conceived at least, it  
20 mightn't be on the scale that's necessary, but you know, in  
21 a way there's more evidence for these things being possible  
22 in New Zealand than most other parts of the world.

23 **MS BATES QC:** I thought so too, I thought it might -- I put  
24 forward the proposition to them that if they couldn't make  
25 money on the long haul why not transform themselves into a  
26 VBA, they'll be well placed to do that, and they said it's  
27 very costly for us to do that, we're really stuck in the  
28 pattern.

29 **MR WALKER:** I suppose the issue here is, is it just too hard and  
30 they shouldn't try and what's the consequence of that for  
31 the wider New Zealand public? Or could they do it if they

1 put their minds to it and got on with it and what would that  
2 mean for the New Zealand public? And I think in terms of --

3 **MS BATES QC:** I don't have the answers, I'm just --

4 **MR WALKER:** Well I would have thought it's easier for two small  
5 organisations to re-invent themselves and re-engineer and  
6 improve their cost competitiveness than to combine them and  
7 make it an even bigger problem. History has shown that big  
8 things often get more unwieldy and more difficult to  
9 rationalise and re-engineer.

10 **MR PJM TAYLOR:** Not to be argumentative, but just to continue  
11 the discussion; I want to tease something out here. We  
12 heard evidence from Air New Zealand that the numbers to get  
13 out of the long haul and shrink back -- contract back I  
14 think they said -- was somewhere near -- [**confidential**  
15 **number mentioned**] -- at least that's how I recall it and it  
16 was -- [**pause**]. I apologise. A very large number.

17 That's thrown me. They said there was a very large  
18 number in terms of contracting down, and that it would be  
19 very difficult to manage that contraction and -- yes, I  
20 think I better just leave this.

21 **MR WALKER:** Let me make a more general point perhaps. That is,  
22 it depends where you start and finish in this, if you want  
23 to take the entire organisation across those four customer  
24 segments that I described at the start, then you've got a  
25 big problem. If you're prepared to dissect it a little and  
26 target some parts more than others, perhaps where the real  
27 opportunity for VBA is, maybe get a different conclusion.

28 But also too there is some things added by way of  
29 benefit, value benefit, if you don't lose all of the  
30 connectivity convenience things, that some people actually  
31 are pleased to receive and will pay a small premium to have

1 along the way. So, you know, it's a question of -- I'm  
2 suggesting that it's not a foregone conclusion that some  
3 improvement can't -- it's already happened, and could  
4 continue to happen.

5 I'm also making the point that Virgin is not Ryanair or  
6 Southwest. And, they've got their own pressures, I think,  
7 pushing their business, their unit costs the other way.  
8 There is a gap closing here, and I don't think the  
9 proposition that Air New Zealand gets vaporized is a result  
10 of the emergence of VBA. I don't think you can get to that  
11 point quite so quickly.

12 **MR PJM TAYLOR:** I understand your point.

13 **MR CURTIN:** These are obviously McKinsey's estimates and, I  
14 mean, it's a fascinating graph to look at actually; you  
15 could study it all day, I'd say, if you're an aviation  
16 analyst.

17 A couple of questions: I appreciate you're not an  
18 airline cost expert, but you probably have some feel. Do  
19 those numbers look realistic to you in terms of their  
20 relative importance?

21 The reason I ask is that somewhere earlier in the record  
22 we had somebody suggest to us that the baggage handling side  
23 of things was one of the things that put a layer of cost  
24 into the full service airlines that the VBAs didn't have.  
25 I'm guessing that would be in the passenger services box,  
26 which doesn't seem to be one of the biggest moving parts in  
27 the whole thing.

28 So, I just wanted a little bit of sanity check, if you  
29 like, on whether you think those McKinsey contributions are  
30 about right or not?

31 **MR WALKER:** Let me answer the first question. I've actually



1 seen this very same graph in a Ray Webster presentation on  
2 behalf of easyJet. So, I would have thought, if Ray thinks  
3 they're okay to show publicly, then they've got some  
4 substance and I'd rely on that in presenting them this  
5 forum.

6 I would say though that the version I saw from Ray's  
7 organisation had easyJet at 6.9 rather than 7.1, and Ryanair  
8 was at 4.7, you know, so maybe he knows more about their  
9 relative position, but -- and I'm not trying to reach  
10 ultimate conclusions out of this, just I guess make a more  
11 open point that it's not a foregone conclusion.

12 And your point about baggage handling, I would think  
13 that would fit more into the box called "airport charges".  
14 I think that one includes ground handling as part of the  
15 component of so-called airport charges. Passenger services,  
16 I think, is more the on-board entertainment, food, those  
17 sorts of things.

18 **MR CURTIN:** That would make sense because certainly the evidence  
19 earlier was that was a chunky lump of the difference.

20 **MR WALKER:** I should point out too, this is a comparison between  
21 the top three flag carriers and not one VBA versus another,  
22 and you get different outcomes. But I think it is  
23 interesting to note that, you know, the Ryanair cost of 2.6  
24 for airport charges is the biggest single item for them, and  
25 that's the one area where easyJet is quite different to  
26 them. The gap between the 4.5 and the 7.1 is almost covered  
27 by the 2.6 of airport element. So I think those things stay  
28 together.

29 **MR CURTIN:** Thank you very much.

30 This next one basically shows what some of the bigger  
31 European carriers have been able to do by way of pruning

1 their domestic costs compared to their international costs.  
2 It's basically a 25% improvement in their costs through  
3 things like rationalising what's on board and getting better  
4 seat density and that sort of thing.

5 I now want to talk a bit about volume and what happens  
6 in markets. And this basically shows Ryanair's entry to the  
7 Dublin-London market, and a market that for 10 years leading  
8 up to their entry was seen as a mature market, a million  
9 passengers a year, has increased four-fold. The key thing  
10 here is, Ryanair would have had very dramatically different  
11 prices to Air Lingus on that route, but it wasn't that they  
12 cannibalised Air Lingus' business, they created a new  
13 market. These were people that started going to London for  
14 the weekend or to see show.

15 This is the impact of genuine VBAs, it's not  
16 cannibalising, it's not what is the current market, who will  
17 get what, can we sustain two airlines or three; it's what  
18 could be there if the product, and almost product equals  
19 price in this low cost sector, if you can get the pricing  
20 right you can stimulate a lot of new activity.

21 This overlays, I guess, with just the social changes  
22 happening in Europe; suggests here too, people with more  
23 leisure time, more disposable income, singles with cash and  
24 intention, the ability to go somewhere, a city, or sun or  
25 skiing for a weekend has changed the pattern of travel.  
26 You've got on one hand from the supply side quite an  
27 attractive product being delivered, but on the demand side  
28 you've got all the demographic changes coming that give VBA  
29 a lot of momentum that perhaps wouldn't have been there  
30 10 years ago.

31 Also, I've read research that says that up to 60 or 70%

1 of people on VBA flights in Europe wouldn't have flown had  
2 it not been for the price they could buy at. So, you know,  
3 it becomes a very important determinant. I also read that  
4 31% of people that they surveyed made their destination  
5 decision as a spontaneous decision; browsing the web. So,  
6 they were going somewhere and they didn't decide where they  
7 were going until they scanned and found the price that  
8 suited. So, whether it was Barcelona or Vienna, it was  
9 determined by what price was on offer. That's the kind of  
10 thinking that comes into sort of a genuine value based  
11 market.

12 Just quickly now, other slides that basically show quite  
13 significant increases; Glasgow-Dublin 100% increase in the  
14 market. I think importantly here it's worth looking at the  
15 "all other carriers" line. It's not just the VBA that  
16 enjoys growth, it tends to have a pull-through effect with  
17 everyone else in the market. And no doubt there's some pain  
18 for the others in sort of getting there. But these are  
19 quite long time periods here, nearly 8 years or so of  
20 operation and the "all others" is still there at that level.  
21 Similarly on Glasgow-Paris, the whole market grows, not just  
22 the Ryanair component.

23 On the next one, London-Barcelona, this shows -- you can  
24 see more clearly here the traditional carrier at the bottom  
25 growing at the same time the VBA is growing. Now, the VBA  
26 has done extremely well. It's got, of the increase of \$1.1  
27 million, is that right -- low cost carrier got 800,000  
28 passengers by the end of the time period and the traditional  
29 carrier has gone from 600,000 to 900,000. So even the  
30 traditional carrier's got a 50% improvement in its traffic.

31 And on the right-hand one; again, not as dramatically,

1 but you can see the VBA has done well, well, but the  
2 traditional carrier has also seen its market grow. So,  
3 again just thinking about New Zealand, should we just look  
4 at those markets that exist today, and how does that pie get  
5 divided, or is there some room for there being a bigger pie  
6 over time?

7 Now, there are some stories where VBAs haven't worked,  
8 and during 2002 there were 30 routes on which VBAs withdrew  
9 around Europe. So, it's not all beer and skittles; there  
10 have been some negative results as well. And Go, for  
11 example, pulled off Madrid, Zurich, Lisbon. Buzz came off  
12 Helsinki, Milan Vienna, and easyJet pulled out of the  
13 London-Liverpool route. And, as I mentioned, those carriers  
14 that have no longer continued on, Debonair, Buzz, Go etc.

15 This next series of charts attempts to show -- and again  
16 I rely on McKinsey here -- to show for a disguised major  
17 European carrier.

18 **MR CURTIN:** I was just going to ask very briefly, was there any  
19 common pattern to the routes that they withdrew from, or?

20 **MR WALKER:** I imagine it was -- at the end of the day it's the  
21 economics, so it's a question of what loads were they  
22 getting and what were their costs on that route, and  
23 sometimes it's just substitutional. They've got, you know,  
24 finite capacity; suddenly they've got an airport opportunity  
25 somewhere in the sun and it's much more attractive to the  
26 market than somewhere not in the sun, so they'll move that  
27 airplane from A to B. In other cases they've gone out of  
28 business.

29 **MS BATES QC:** The applicant told us in the application lodged,  
30 and I think sticking with this perspective, that although  
31 the -- well, with the introduction of Virgin in Australia

1 the numbers of travellers grew, more people flew with the  
2 lower costs, that the revenue actually remained about the  
3 same.

4 So, I'm just going to ask you; is that consistent with  
5 the patterns that you've observed in Britain and Europe?  
6 You seem to be talking about growing the pie; are you  
7 growing it in dollars as well as numbers?

8 **MR WALKER:** This series of studies suggests that point. Maybe  
9 if I could -- I'll just step through these four charts.  
10 This is showing at the zero point is where the VBA came into  
11 the market and it shows 3 years afterwards what happened.  
12 And this shows that on entry over these three routes, if you  
13 look at the first box top left, which is the net passenger  
14 revenue, so total revenue, it's actually gone up. That  
15 could either be volume or prices that's driven the total  
16 revenue up.

17 If you go to the next chart, which is the profit per  
18 passenger, that's sort of coming down. So, volume's got to  
19 be a key part in this total position. You can see seat  
20 factor was up, that's going to improve profitability. So,  
21 that overall there is certainly an initial impact on two of  
22 the routes when the new entrant came in, but there is  
23 recovery in all three.

24 So, in this example you can see that there is -- the  
25 yield volume thing does conveniently work out positively.  
26 No doubt there are routes where it doesn't work out that way  
27 and I'm sure even in Australia there'd be some routes where,  
28 you know, the combined effect of price and volume don't give  
29 you a net improvement.

30 **MS BATES QC:** They say overall there's no net improvement at the  
31 moment.

1 **MR WALKER:** One of the big problems I think in the New Zealand  
2 and the Australian jurisdiction is there's no access to data  
3 for people to make independent decisions. If you look at  
4 the work that's been presented in the paper it's all based  
5 on the USA because the Department of Transport there insists  
6 that one in 10 flight coupons is available for analysis and  
7 you can reach absolute decisions. That's why it's very nice  
8 for economists to show you lots of American examples, it's  
9 the only place you can get data unless you're an airline.

10 So, this is one of the few moments as you go around the  
11 world where you can find someone that's actually done some  
12 work with some real data and some quantitative results.  
13 Different markets will obviously have different effects and  
14 different positions. I'm just suggesting that maybe it's  
15 not all exactly the way it's been presented in the  
16 application.

17 **MS BATES QC:** I don't know, because I don't know what -- I  
18 actually don't know what data that proposition was based on,  
19 but let's continue.

20 **CHAIR:** Just before you go on I'm going to interrupt for a  
21 moment because I want to handle something before anyone  
22 leaves this room. I just want to note that there was  
23 mention of some confidential information in the last  
24 questions, the previous question in terms of the cost of  
25 switching from a full service model to a value based model  
26 for Air New Zealand; and for the record I want to note that  
27 that information is subject to a confidentiality order.  
28 That order remains in place and therefore pursuant to  
29 Section 100 of the Commerce Act it may not be further  
30 presented, or used in any way or communicated by anyone,  
31 including the media. And it will be taken out of the public

1 record as well, I want to make sure everyone understands  
2 that that confidentiality order remains in place and that  
3 number is not to be repeated. Is there any questions on  
4 that?

5 **MR P TAYLOR:** No, that's fine.

6 **CHAIR:** Thank you. I apologise for interrupting but I just  
7 wanted to make sure everyone in the room knew what the  
8 status of that was.

9 **MR WALKER:** So almost my final piece is, well, where does Air  
10 New Zealand go, what are the options? Must it form the  
11 alliance and that's the only way it can live in a world  
12 where there's a VBA? And I'm almost starting to repeat the  
13 same themes, that I think, if anything, Air New Zealand is  
14 better equipped with the work it's already done  
15 understanding Freedom, understanding how to get to an  
16 Express model, to go forward and do more, try and close that  
17 gap.

18 Again I think on the other side the threat from Virgin  
19 may not be as acute as it would be if it were some other  
20 scheme of VBA. Things like the new aircraft coming for Air  
21 New Zealand, the 320 is obviously a great step forward, it's  
22 got a 15% seat cost advantage and other things. There's  
23 clearly a lot of capacity for continuing to refine that gap.  
24 And at the same time Virgin is starting to add more and more  
25 functionality to its product that I think will eventually  
26 show through by way of cost.

27 The -- there's some good examples around of the sort of  
28 initiatives that can change the operating economies for  
29 mainstream airlines. EasyJet, for example, gets 35% more  
30 seats on a 737 than KLM. That's because they, if you're not  
31 serving, on short sectors, food, then you don't need a

1 galley. If you're designing the product around something  
2 specific then you can do quite significant things to change  
3 those cost patterns.

4 Air Lingus has been under a lot of pressure from Ryanair  
5 being in its home market and gone through some very painful  
6 periods. But it last year reduced its cost 22%, reduced its  
7 staff by 30%. It's in the process of replacing its short  
8 haul fleet with a new aircraft type, either a 320 or a 737.  
9 It's opening 16 new routes in Europe this year. It's  
10 website is now taking 50% of its bookings and they hope to  
11 be to get 70% by the end of next year. They're claiming to  
12 have 3 million low cost seats in their network now, 3  
13 million a year.

14 So things can be done and I think also Air New Zealand  
15 has got almost an added benefit in that grey zone, the band  
16 between low cost and full service, where they can scale  
17 down, or draw people up into the higher category of service  
18 by using their connectivity and the sort of flexibility that  
19 they've got through their other infrastructure.

20 **MR CURTIN:** Sorry to interrupt you again, but that Air Lingus  
21 example, not to be too unkind to them, they were among the  
22 more sterotic(?) of European airlines. I just want to know,  
23 if they've made that improvement, did they do that without  
24 any kind of Government bail-out or Government equity  
25 injection do you know? I just don't know any more, I've  
26 been out here a while, but I don't know, how did they fund  
27 that?

28 **MR WALKER:** I'm not sure to be honest. In other cases I've read  
29 about European governments running into strife with the  
30 European Commission by assisting their airline, so it  
31 doesn't happen without people noticing; I'm sure there would



1 have been publicity, but it may have been given assistance.  
2 I guess all I'm reflecting on is that faced with competition  
3 there are choices you can make and things you can do to  
4 remain relevant. And someone -- and I think Air New Zealand  
5 has done that admirably in lots of cases, and there is I  
6 think a line of possibility other than saying well, it's  
7 very hard, let's go and make a more convenient arrangement.

8 **CHAIR:** I found that an interesting way of looking at it,  
9 because I was struck by the -- I found the session we had  
10 with the CEO of easyJet quite informative and he also  
11 advises Air New Zealand and his position was the best thing  
12 they could do is focus on developing their long haul  
13 business, and not try to take on this VBA head on, and he  
14 didn't agree with their -- he didn't appear to agree with  
15 the current strategy in his comments.

16 And it left me wondering about what Air New Zealand's  
17 strategy was. But if I look at what you've presented, it  
18 provides a pretty good rationale why they're doing precisely  
19 what they've doing. And while they've had that advice from  
20 a person running easyJet they've obviously rejected it and  
21 decided to go with the proposition that they can squeeze  
22 down their costs and confront the entry in the way that they  
23 are. So, it seems in a way to almost explain the strategy  
24 that has in fact being -- that we in fact see.

25 **MR WALKER:** I think you've got to look at the numbers as you  
26 form those judgements and, you know, I don't know, Ray  
27 looking at the world from low cost land, the entire aviation  
28 environment in Europe is sort of low cost, that's the  
29 discussion, that is the centrepiece. But you keep it in  
30 proportion, it's 10% of the total European aviation market.  
31 It's a bigger percentage than that of the UK market.

1 I haven't got as good a set of numbers as I'm sure Air  
2 New Zealand has as to what is the mix of that 20 million in  
3 the New Zealand market. I've tried to come at it from where  
4 is the capacity around the network, and some stats are known  
5 about the total number of international passengers and you  
6 can see the number of New Zealand and Australian residents  
7 moving backwards and forwards so you can back that element  
8 out. But the split between domestic trunk and domestic  
9 provincial I don't know about.

10 But applying Ray's judgment you should only be in long  
11 haul. How many people does that leave behind in the current  
12 customer base? And should all of those people be left to  
13 just one supplier.

14 **CHAIR:** I don't think he's making a judgment about, you know,  
15 what's best for the end consumer, I think the judgment was,  
16 where is the future for a full service airline?

17 **MS BATES QC:** I think he did also say that he didn't consider  
18 they had quite the critical mass to be successful on long  
19 haul, I stand to be corrected on that, but -- so that just,  
20 I mean Air New Zealand say they really struggle on the long  
21 haul, so -- and Webster says, well that's the way to go for  
22 full service airlines, but they need to be -- he is  
23 indicating they need to have some size.

24 **MR WALKER:** You're almost on to my next slide. My next slide is  
25 about, yes you can't afford to be alone in the world you  
26 need friends to have sort of impact, and there are other  
27 ways of getting sort of international presence.

28 And go back to the early part of the 90s when I was  
29 trying to build an international terminal at Brisbane, the  
30 debate was about should we build a Star Alliance terminal  
31 linking regional, domestic, international and a One World

1 terminal and allow integrated use; people come into the one  
2 building and get off their small aircraft on to a big one.

3 And that was the massive structural change going on in  
4 the industry. Everyone was talking about computerised  
5 reservation systems and the global alliances and how it's  
6 going to reshape the world. Now VBA is the crisis of the  
7 moment. How are we going to react to that?

8 I think there are different ways to solve the problem  
9 and the long haul connectivity product sort of thing is, you  
10 know the original attempt was to fit yourself into an  
11 alliance, you have commercial arrangements for oncarriage  
12 and so on, but you're still yourself and in your market and  
13 you've got a presence.

14 And to me this alliance question is quite an important  
15 one. The Star Alliance, in my view, is a much more useful  
16 one for New Zealand than the One World one. If you look at  
17 the coverage of the two, Star Alliance has got about 30%  
18 more RPKs, so it's got more scale. But I think more  
19 importantly it's got coverage. If you look at say Asia,  
20 where is the Air New Zealand representation through One  
21 World? What's the ability to communicate with travel agents  
22 and have journalists, travel journalists come and visit  
23 New Zealand, you've got Cathay Pacific essentially.

24 **CHAIR:** What's RPKs?

25 **MR WALKER:** Revenue passenger kilometres, just some attempt to  
26 rank the two in terms of size. But out of Star Alliance  
27 you've got All Nippon, the Japanese market is a pretty  
28 useful one; Asiana, Singapore, Thai, it's a much more  
29 compelling family of friends for Asia.

30 If you take central Europe, who will you rely on at One  
31 World? Iberia. You know, it's not quite as close to the

1 centre as you'd like to be. What have you got on the other  
2 hand? Austrian, Lauda, Lufthansa, Spanair.

3 I think in all of these things there's probably no, you  
4 know, golden answer, they are complex matters. But there is  
5 a very significant benefit to the New Zealand wider tourism  
6 industry by having these kind of networks. In fact today  
7 you've got both worlds covered, One World and Star Alliance,  
8 but left-hand side to some extent moves away.

9 **MS BATES QC:** But the -- you've got the Star Alliance at the  
10 moment, and say they are still struggling to make the long  
11 haul profitable, what can they do?

12 **MR WALKER:** I think I'd be starting at the basic building  
13 blocks, as I'm sure they are looking at their -- you know,  
14 what is the value they're delivering and how their cost-  
15 effectiveness and perhaps there are some routes that they  
16 shouldn't be on; you know, basically if the ultimate answer  
17 is that they just can't make it long haul, then what's the  
18 point? By tying up with Qantas, what's the certainty that  
19 Qantas can make it? At the end of the day it's going to  
20 come back to how effective you are in your cost  
21 competitiveness and how you can deliver product.

22 **MR CURTIN:** This may be a terribly basic question, perhaps we  
23 should know; but if I go to a travel agent and say, right,  
24 okay I want to go to Praague or Vienna or something, will  
25 the travel agent typically show me just a single alliance  
26 combination of flights?

27 **MR WALKER:** I should ask one of the airline people here. There  
28 are some different jurisdiction s and quite stiff rules  
29 about what people should be told; such that in the computer  
30 reservation systems there are disciplines that say the most  
31 frequent service, most direct service should be recommended

1 on the earlier screen of the displays. Those rules were  
2 introduced in the states when it was found that 85% of  
3 bookings were made off the first page and if you had someone  
4 else's supplied free computer system, American Airlines,  
5 surprise surprise all of the American connections showed  
6 first.

7 So in a lot of countries it is, you know, fairly  
8 honestly presented. But there will be pricing advantages,  
9 because there's proration comes into it, there's a total  
10 fare paid, and someone's going to get so much and the other  
11 carrier will get something else. Sometimes you can do most  
12 of the carriage and get the smallest piece of the fare if  
13 you're not friendly and haven't arranged things in advance  
14 with the airlines you're dealing with.

15 So your travel agent, you know, would be trying to steer  
16 you through the course of linking those airlines. I mean  
17 try doing it through six VBAs, you'll need broadband on your  
18 internet.

19 I'm essentially finished. My conclusions I've stated on  
20 the way through, so I won't drag you through those again.

21 Just one point. There was a question you asked to John  
22 about how many airlines can Air New Zealand support? And I  
23 was going to make two comments in that area. One is I think  
24 it's important to think not just about what is the market  
25 today but what might the market be given the sort of impacts  
26 you can have on travel patterns with the right price.

27 And the second comment I was going to make was about the  
28 Scottish air market, which we happen to know reasonably  
29 well. Scotland's got about 5 million people and an aviation  
30 market of about 20 million people, and it's serviced  
31 primarily -- full service by British Airways and British

1 Midlands, but it's also got very active representation of  
2 easyJet and Ryanair. So, there are two full service, two  
3 value based carriers that are wrestling in the Scottish  
4 market. As a rough metric, it seems like markets of that  
5 scale can support more than just one and one.

6 **MS BATES QC:** Just one further question I'll ask. Absent VBA,  
7 do you consider Qantas and Air New Zealand at this moment to  
8 be vigorous competitors; or absent threat of VBA?

9 **MR WALKER:** Maybe just back in history a little bit. Once upon  
10 a time there was a codeshare agreement that led to quite  
11 stable conditions on the Tasman. And I'm sure there were  
12 questions of profitability and, you know, yield and best use  
13 of resources and co-ordination basically.

14 That discontinued I think about the time Air New Zealand  
15 linked up with Singapore Airlines, joined Star Alliance.  
16 Suddenly it didn't make sense to codeshare with Qantas  
17 across the Tasman any more. And the burst in Trans-Tasman  
18 traffic we saw at Wellington Airport through 96, 97 -- might  
19 have been a bit later than that 97, 98, 99, I think was all  
20 about responding to the market. Suddenly it was realised  
21 that frequency was important and 737s came into the  
22 marketplace and all sorts of new things happened. There  
23 were daily connections, double dailies and that to me was  
24 when two people were competing.

25 **MS BATES QC:** What about domestically, what do you think there?

26 **MR WALKER:** Not such a good student on the domestic scene.

27 **MS BATES QC:** I won't pursue that. They seem to not be making  
28 any money, or not losing money --

29 **MR WALKER:** Right now I should think it must be very difficult  
30 at the moment for either party to know how hard to push or  
31 not push, given the uncertainty of all of this. They've got

1 to think about today but the future as well and I'm sure  
2 there are -- put the overlay of those sort of complexities  
3 in their judgments.

4 **CHAIR:** I'll just check and see if there are any further  
5 questions from staff or advisors.

6 **PROF GILLEN:** I have a couple of questions. One is you  
7 represent Ryanair as the benchmark along the low cost  
8 carriers, and I think that's probably true. But do you  
9 think that that's a fair characterisation of the kinds of  
10 models that one might think of for this area, and in  
11 particular because Ryanair clearly aims at the leisure  
12 market, they go into secondary airports and they go into  
13 leisure airports. I don't think there's a large supply of  
14 those kinds of airports in either Australia or New Zealand.

15 **MR WALKER:** I don't think Ryanair is a good, you know,  
16 assumption to make for this market. I guess that was one of  
17 my key points. Don't look at Ryanair and get worried that  
18 that's what's going to happen to Air New Zealand. I don't  
19 think this market is going to suit them, for the reasons you  
20 mentioned particularly the airport access one.

21 But I also think Virgin already is showing the signs of  
22 being persuaded to serve a wider audience. They're doing a  
23 lot more to try and make it comfortable for a business  
24 person to use their service and they're carrying freight on  
25 board their airplanes.

26 If you spoke to Ryanair about carrying freight, and we  
27 do, we've got a lot of freight that goes through Prestwick,  
28 we've got 10 flights a day to London from Ryanair, we  
29 thought about getting them to carry some freight down to  
30 London and they shut the door very quickly on us. It's just  
31 not in their model. Don't disturb me if it's not in my

1 model.

2 I think Virgin, though, are adding more and more full  
3 service sort of add-ons that -- and I think they're doing it  
4 probably because they're being -- you know, the market's  
5 saying they'd like it and ultimately there may be a small  
6 price to pay for that added convenience.

7 **PROF GILLEN:** I guess I would argue that when you look at the  
8 VBA model, is that one of the things they do is add these  
9 services on in a very different way than a full service  
10 carrier would. This morning, for example, Virgin made the  
11 point that with their lounges, for example, they will  
12 provide them but they provide them as long as they make  
13 money, and a lounge to a full service airline is a cost  
14 centre and to a low cost carrier it's a profit centre. So I  
15 think the management philosophy is very different with these  
16 sorts of things. It's the same thing with freight I  
17 believe.

18 So, one of the things that when I was listening to your  
19 presentation, when you look at low cost carriers, and the  
20 ones I'm most familiar with are WestJet and Air Canada; the  
21 difference of the relative values of their cost per  
22 available seat kilometres is a factor of 2 to 1, and WestJet  
23 is 50% of what Air Canada is on a comparable stage length.  
24 And that seems to be fairly common in the United States as  
25 well and I would expect it's probably common in Australia.

26 So, even though the Air New Zealand's of the world are  
27 doing a very good job on the Tasman and domestic, closing  
28 that gap is a fairly formidable process. I just want your  
29 comment on that.

30 **MR WALKER:** Unfortunately I don't know the Canadian situation as  
31 closely and I can't really comment on the carriers you



1 mentioned. But I think the -- a key thing here is that  
2 what's likely to work in Australia and New Zealand, and it  
3 seems to me that you don't have the underlying environment  
4 for a Ryanair, you know, of all of the benchmarks I can look  
5 at I think easyJet is probably the one.

6 When you look at -- if those numbers that are presented  
7 are anywhere near right and if Air New Zealand is somewhere  
8 near those European flag carriers, I'd expect them to be  
9 better; then I think the gap isn't as wide as to say well  
10 they're absolutely dead in the water, there's nowhere to go.  
11 It seems to me that there is some way to go. No guarantees  
12 you'll be successful, but there seems to be enough  
13 opportunity or possibility there to keep that alive as a  
14 possibility.

15 Another point about Ryanair, in fact on some of our  
16 routes out of Prestwick 50% of the people on board are on  
17 business, but they're doing business they didn't previously  
18 do. They are using the opportunity to jump on a plane to go  
19 to London or wherever it might be, again sort of opportunity  
20 over and above what was the old base market. They're happy  
21 to take the price and not worry about a lounge.

22 I think Virgin, there's a lot of corporate accounts in  
23 Australia and people are, even politicians are not using  
24 Virgin because it's not quite as comfortable and there  
25 aren't quite the frequent flyer points available and I think  
26 Virgin is being drawn in the direction of providing more of  
27 that connectivity comfort that is being called for in that  
28 market.

29 **PROF GILLEN:** Thank you.

30 **MS WHITESIDE:** We've just got a quick query about the material  
31 that's been supplied to us. Most of us stop at that point.

1 Mike here has two extra slides on his handout. One is  
2 Australian market developments and the other is New Zealand  
3 airfares. We're just wondering about that because it's  
4 actually really interesting information.

5 And secondly what the source of the New Zealand airfares  
6 slide is when you work out what's happened.

7 **MR WALKER:** For the sake of all gathered, I wasn't quite sure,  
8 there was a bit of discussion amongst our own team as to  
9 whether we should include this or not, it was getting a bit  
10 long, so I made an executive decision to pull it out of the  
11 talk and I asked that the -- you know, we only limit to the  
12 19 slides and we wouldn't get into that area. It seems that  
13 someone's got a copy of this version not the one that was  
14 clearly labelled for printing, and my apologies I tried to  
15 stop that. But I mean they are --

16 **MS WHITESIDE:** We've got the source of the Australian, but that  
17 one there, what's the source of it?

18 **MR WALKER:** This is the New Zealand, what's the -- Department of  
19 Statistics, it just shows airfares in real terms. This  
20 shows that, you know, over -- since 97 -- this one was  
21 actually done for that five year period and it's probably  
22 not fair to Air New Zealand not to show what's happened in  
23 the second half of 2002, because there's been a -- what's a  
24 fare decrease that's occurred since the Express came on, 15  
25 or 20%, so it actually came down, but it was on the back off  
26 essentially a 30% increase in real terms over that period,  
27 so it's come back down, that's good news, but we built in a  
28 lot of resistance to travel over that period, whereas  
29 internationally you can see that the airfares have remained  
30 quite, well relatively speaking, competitive.

31 And this one was the presentation of Australian domestic

1 fares showing the, I think it's the full economy is the top  
2 blue line, and the bottom one, the green line is the best  
3 discount available. I'm quite sure about the volumes of  
4 each. So, it's hard to reach an overall conclusion, but you  
5 can certainly see that Virgin has made an impact since it  
6 came on-line in terms of the discounted prices. But  
7 interestingly the, if you like, the headline economy fare  
8 has not shifted that much.

9 **MR CASEY:** Could I ask how the Stats New Zealand one is  
10 collected and compiled?

11 **MR WALKER:** I think it's simply taken off their website.

12 **MR CASEY:** Sorry no, I meant what their method is for collecting  
13 the fare data. The data set would be good, yes please,  
14 thanks.

15 **CHAIR:** Thank you for that presentation Mr Walker, and if we  
16 can, we'll move on to the next presentation.

17 **MR DAVID:** The next presentation was, we asked Professor Hausman  
18 and Mr Kieran Murray to review the economic evidence that  
19 you've heard over the last three and a half days and the  
20 next presentation, which will run on till tomorrow, is  
21 effectively their critique of the materials that you've  
22 heard.

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25

26 **PROF HAUSMAN:** I'm Jerry Hausman, I'm a Professor of Economics  
27 at MIT. I thought I'd just give a brief introduction. When  
28 I was last here I was doing telecommunications, so I thought  
29 I'd give a bit of a background in airlines.

30

31

So, I first started working for United Airlines in 1986.  
Contrary to Mr Sheridan, I don't put me leaving United

1 having anything to do with their bankruptcy. I left long  
2 ago. But I actually became interested in the computerised  
3 reservation systems. I did a lot of consulting for them on  
4 that. And, more lately I've switched over to the on-line  
5 systems like Expedia and Travelocity which are the two big  
6 websites in the United States.

7 I'd just like to make one point at the beginning which I  
8 think may have been missed here. As was just stated, in the  
9 United States we have the 1 in 10 fares data set from the  
10 DOT. And I think one thing that is very important to  
11 remember here, which I'll get back to later, is that there  
12 is a whole dispersion of fares out there.

13 I think -- I don't want anyone to have made the mistake  
14 and think that there is one fare; there is a whole range of  
15 needs being satisfied. What you can see in the 90s in the  
16 United States, even on point-to-point, is that you have  
17 fares right now between San Francisco and Boston on American  
18 and United. You can pay \$2,400 round trip, but the  
19 frequency is seven or eight per day. If you want to go on  
20 Southwest where there's been a lot of talk, the two closest  
21 airports are either Providence or Manchester; they're, you  
22 know, both 50 miles away. The secondary airport is very  
23 important. You don't fly into San Francisco, you fly into  
24 Oakland and you make probably two stops in between. So,  
25 there's a whole different level of service, and that's one  
26 thing I'm going to stress. Because, that turns out to be  
27 very important.

28 Then the other part of my experience is, I have also  
29 looked at a number of alliances, and again I don't want  
30 anyone to have the misperception -- I don't think anyone  
31 tried to fool people on this -- but there may be a

1 misperception that all these alliances, even international  
2 alliances, have been approved. One of the things I  
3 consulted on was the attempted alliance between British Air  
4 and American, which has been turned down at least two or  
5 three times in the United States, you know, for various  
6 reasons.

7 With that being said, since I usually lecture for an  
8 hour and a half, and I only have 25 minutes, if I get going  
9 too fast I want you to make sure to tell me to slow down.

10 I think there are three factors I'd like to start with  
11 and then I'll get into my talk. The first; throughout this  
12 I have assumed that Virgin Blue is going to enter. Okay, I  
13 had done these slides before the talk -- the presentation  
14 this morning, but in my factual, counterfactual,  
15 confidential counterfactual and any other adjectives you can  
16 think of with "factual" at the end, I am assuming Virgin  
17 Blue is going to enter. If Virgin Blue doesn't enter, this  
18 alliance should never happen because you're going to 2 to 1  
19 or 2.5 to 1.5, so that's not interesting from my point of  
20 view. So, I'm assuming they're going to enter.

21 I think the second point is, and this is where I'm going  
22 to differ from some of the economists sitting to my left is,  
23 once upon a time when you modelled the US airline market,  
24 for instance, where most of the academic work has been done;  
25 again, because of the availability of data, assuming a  
26 homogeneous product was probably not a bad thing to do. So,  
27 I mean, in those days it was a homogeneous FSA product, so  
28 you had American competing with United, competing with  
29 Delta. They matched price, pretty much offered similar  
30 service; everybody had their fares but they all had frequent  
31 flyer programmes, etc.

1 I think that's changed a lot now, and so, I would not  
2 put much weight on previous academic work in thinking about  
3 this market, because now you have a VBA product and you have  
4 an FSA product, and we've heard time and time again over the  
5 last three days when I was sitting in the back of the room  
6 about how they differ.

7 And that leads me to conclude that -- and Ms Rebstock  
8 brought this up a few times -- you need to think about this  
9 in terms of differentiated products. You cannot fool  
10 yourself into thinking that Southwest is anything like a  
11 full service airline.

12 My favorite story is, a couple of years ago, Southwest  
13 doesn't fly out of Boston, they tried to stay away from the  
14 expensive airports. I was in Kansas City and I had a  
15 meeting the next day, if I remember correctly in Phoenix,  
16 and this is when, you know, stuff was first coming on the  
17 web, and I got on, I said, jeez, this is just a great fare  
18 on Southwest rather than flying on a full fare airline, I'm  
19 just going to pay my \$115 or whatever it was and fly on  
20 Southwest.

21 So, I had a meeting in Kansas City, it was snowing, one  
22 of these horrible days. So, I'm at the airport waiting to  
23 get on my Southwest flight, and they came through, and even  
24 though I had a confirmed reservation, I never got on the  
25 plane. And, being me, I got into this shouting match. I  
26 was careful with my language with the gate agent saying,  
27 "you should run an auction to get those people off the  
28 plane, because I have a meeting tomorrow, and if you don't  
29 run the auction you should allow me to get on the plane and  
30 run my own goddamn auction. So, I get someone to out of a  
31 seat". That was the last time I took Southwest. It is a

1 very different product.

2 If that had been United or American they would have had  
3 the auction, even if they had over-sold the plane, and I  
4 would have been to Phoenix for my meeting the next day. I  
5 don't care about the meals, but I do care about making it  
6 when I want to go, and the products are very different.

7 The last point I'd like to make is, when you think about  
8 airlines like Qantas and Air New Zealand, my first bit of  
9 economic advising in this part of the world was with --  
10 probably I'll pronounce his name wrong -- Mr Keating who at  
11 the time was Chancellor of the Exchequer or Treasury  
12 Secretary, whatever they call him in Australia.

13 **MR CURTIN:** Treasurer.

14 **PROF HAUSMAN:** Treasury, okay, and this was in the late 1980s  
15 and I was doing a lot of work on taxation at the time, and  
16 his staff and I came up -- or I was just helping his staff;  
17 they came up with the idea -- of a trade-off between what  
18 the unions were up to in Australia, who have a checkered  
19 history at best, in my view, and tax policy.

20 And when you think about airlines -- this is true in the  
21 United States, this is true in the UK, and this is also true  
22 here -- is, you have to remember that these airlines came  
23 out of a regulated environment in which you had very strong  
24 unions who were very good at rent capture and have been able  
25 to maintain that pretty much everywhere.

26 Because, as the current president -- well, no know, he's  
27 now been fired -- as the previous president of American  
28 said -- Mr Cardy -- "if they put us on the ground for two or  
29 three weeks, we're Chapter 7", which means liquidation in  
30 the United States. I'm going to get to that later; that was  
31 a topic that came up earlier about rents in this industry.

1 I think you not only have to think about rents from the  
2 market power airline point of view, but also from the labour  
3 point of view. So, that's just sort of the economic  
4 background where I'm going to go.

5 Okay. So, in my view, the proposed alliance leads to a  
6 substantial lessening of competition. I'll talk about why  
7 that's so, and by a substantial lessening of competition I  
8 mean that airfares will be higher and consumers will be  
9 injured. So, this is looking very much from a consumer  
10 point of view at the beginning. And, in that respect it's  
11 my view that no antitrust authority looking to consumers  
12 such as a USDOJ would ever approve such a merger.

13 However, I am aware that under your authorisation  
14 procedures -- this was being discussed before -- and  
15 although I'm only an economist, not a lawyer, I do  
16 understand -- I think I understand the approach you're  
17 taking, which is not just looking to consumers but looking  
18 to the combination of consumer surplus plus producer  
19 surplus.

20 **MS BATES QC:** Can I just ask you to clarify what you mean  
21 exactly by, "airfares will be higher" given that you've said  
22 that you accept VBA entrance? Just by way of clarification,  
23 which fares?

24 **PROF HAUSMAN:** That's a very good question. What I'm saying is,  
25 I'm going to assume that Virgin Blue is in, as I said, in  
26 the factual, counterfactual and every other one. Given that  
27 that's so -- and I'll forget about some of the very small  
28 airlines -- given that's so, would it be better to have  
29 Virgin Blue, Qantas and Air New Zealand, or Virgin Blue and  
30 the alliance? And, my claim, based, of all things on  
31 Dr Winston's data when the econometrics is done, to my view,



1 somewhat better, is that airfares will be lower with all  
2 three airlines than with two.

3 So that -- this is very true in the United States, that  
4 I agree with Dr Winston, who's my former colleague from MIT  
5 so I want to be careful what I say; that VBAs do bring down  
6 prices but three is still better than two. That has been  
7 shown in study after study in the United States. In other  
8 words, VBAs don't give such a constraining thing that, if  
9 it's them plus one FSA, you get everything. You will get  
10 even lower fares with two FSAs, or as was said in Scotland,  
11 I guess they have two FSAs and two VBAs, so that's what I  
12 mean.

13 **MS BATES QC:** Okay, I'm glad we've clarified that.

14 **PROF HAUSMAN:** So, I know there's a question that the Applicants  
15 have put forward about whether Air New Zealand can survive,  
16 and I will get to that later.

17 **MS BATES QC:** I just wanted to clarify first of all; we'll get  
18 to that later.

19 **PROF HAUSMAN:** I think the balancing analysis, however, by NECG  
20 is based on a number of incorrect assumptions which I will  
21 get to. And especially, I think the effect of tourism is  
22 incorrectly treated. So, that's sort of my summary of what  
23 I'm going to talk about. The first part of the talk is to  
24 reply to a number of the other economists.

25 **MS BATES QC:** Are you going to point us in the direction of some  
26 of these studies after studies that show what you say?

27 **PROF HAUSMAN:** Sure, one can look at the RAND Journal of  
28 Economics.

29 **MS BATES QC:** I suppose our economists are better to address it.  
30 If you are, that's going to be good.

31 **PROF HAUSMAN:** I just completed such a study within the last

1 three months so, you know, it's...

2 **MS BATES QC:** I don't say they don't exist; it just would be  
3 nice to have them.

4 **PROF HAUSMAN:** No sure, okay. They may disagree with me, we'll  
5 see, but I doubt it.

6 **CHAIR:** Can I just ask you; when you said before that your view  
7 was different to the economists sitting to your left, you  
8 didn't mean Kieran Murray; you meant our economists?

9 **PROF HAUSMAN:** What I'm saying is, there seems to be consensus  
10 among your economists that the Cournot model is the way to  
11 model this, and I'm going to respectfully disagree with  
12 that.

13 **CHAIR:** I just wanted to be clear whether you had a disagreement  
14 amongst yourselves or...

15 **PROF HAUSMAN:** If Mr Murray disagrees with me, he's not  
16 indicated it yet. He may.

17 Okay, so I'm going to start off with Dr Tretheway. And  
18 in my view his analysis is distorted by an unsupported  
19 assumption that Air New Zealand will not make money on its  
20 long haul routes.

21 Now, I'm going to say that I have asked for data a  
22 number of times from counsel to break up or break down Air  
23 New Zealand's profitability, which they apparently haven't  
24 supplied. I mean, I've signed a confidentiality thing, so I  
25 presume I can see it. And so, they may be able to produce  
26 data which disagrees with me, but I will just say that I  
27 haven't seen it if so.

28 **CHAIR:** So, you think you can --

29 **PROF HAUSMAN:** Yes, I'm going to talk to a change in economics,  
30 which I don't think Dr Tretheway took into account. So,  
31 according to Dr Tretheway, Air New Zealand's survival would

1 be threatened by increased competition, undermining yields  
2 on its domestic services. And, he says -- these are all  
3 just quotes --

4 "For Air New Zealand the impact of low cost entry is  
5 likely to be dramatic. I understand that its international  
6 services collectively have essentially been breakeven at  
7 best. In those isolated cases when it's been able to  
8 achieve sufficient profitability to cover its cost of  
9 capital it has largely been due to contributions from its  
10 domestic services. When an LCC enters the domestic market,  
11 an event I view as being virtually inevitable, its domestic  
12 yield will plummet."

13 Then similarly he said.

14 "For Air New Zealand, where the long haul international  
15 network has only rarely been able to cover its capital  
16 costs, the loss of revenues and profits in the domestic  
17 New Zealand and Trans-Tasman may seriously undermine its  
18 financial viability."

19 So I take Dr Tretheway to be saying Air New Zealand's  
20 headed for the "scrap heap of history", to quote a well-  
21 known economist who used to sit in the British Library, and  
22 I don't think he has actually taken into account what has  
23 happened recently.

24 So, I said whether Air New Zealand is likely to make  
25 money in the future is a matter for business and economic  
26 analysis. He doesn't provide any supporting economic or  
27 business analysis for why Air New Zealand will continue to  
28 lose money on its long haul international routes.

29 My major point here is that conditions have changed  
30 markedly with the exit of United Airlines in March 2003,  
31 they pulled out right at the end of the month. Air New

1 Zealand is the only Star Alliance partner coming from North  
2 America. Air New Zealand receives feed from United Airlines  
3 and Air Canada, which is also a member of the Star Alliance,  
4 and to some extent Lufthansa which is also a member of the  
5 Star Alliance. And LAX-AKL -- LAX of course is Los Angeles,  
6 AKL is Auckland -- is now only Air New Zealand and Qantas.

7 So, although I have not seen -- you know, I haven't been  
8 supplied the Air New Zealand financial records -- it would  
9 seem to me that this is consistent with 2003 being a good  
10 year for Air New Zealand. I think the Air New Zealand  
11 representative said he had a good tailwind this year.

12 **MS BATES QC:** Can I just ask you about United and where it  
13 pulled out, because I understand it pulled out because it  
14 was a non-profitable route for it, and it said it was  
15 unlikely to ever return again.

16 **PROF HAUSMAN:** I'm going to agree with that 100%, Ms Bates.

17 **MS BATES QC:** There will probably be a very simple explanation,  
18 but no doubt you can give it to me.

19 **PROF HAUSMAN:** No, I asked, and they weren't profitable and  
20 they're not going to return, but that does very nice things  
21 for Air New Zealand when your major competitor from one of  
22 the major tourist markets disappears.

23 **MS BATES QC:** I understand that, I just wonder why they couldn't  
24 make a go of it.

25 **PROF HAUSMAN:** Oh, why they couldn't make a go of it was because  
26 they had an extremely high cost structure and they  
27 essentially were flying one plane in here per day. They fly  
28 two to Australia, and they were flying one here, and it's  
29 also my understanding that they had a higher component of  
30 leisure to business than they did in Australia.

31 Okay, so I'm going to agree with you. I say that entry

1 on US to New Zealand is unlikely. Re-entry by United or  
2 entry by another US carrier is extremely unlikely.

3 There was a claim by someone -- I didn't catch  
4 everyone's name -- that United would re-enter. I think -- I  
5 disagree, but I also think its rank speculation. I think  
6 anyone who follows the industry in the United States should  
7 know about the extreme financial deterioration of United.  
8 They continue to lose ever larger sums of money. If we were  
9 in the UK we could check what the spread betting was,  
10 whether they were going to go Chapter 7 and just liquidate,  
11 but we don't have that in the United States. There are a  
12 lot of people out there -- I don't have a view on this  
13 personally, but there are a lot of people out there who  
14 think that United is going to go Chapter 7 and just  
15 liquidate.

16 So, I just don't see how someone could say that they  
17 expect them to re-enter at any time in the near future. I  
18 mean 2 or 3 years down the road, 5 years down the road, who  
19 knows, but in the near future they have many more pressing  
20 problems than coming back to New Zealand.

21 **MS BATES QC:** I take it from what you say that Qantas is the  
22 only One World partner that flies that route.

23 **PROF HAUSMAN:** Yeah, I'll get to that too. I'll be glad to  
24 answer your questions now, I just have it all in the talk.

25 Okay, so Dr Tretheway makes a generalised statement:

26 "While the FSA product will be sought after by a large  
27 proportion of travellers, these markets are served by  
28 competing FSA and the degree of competition intensifies as  
29 the distance to be travelled increases."

30 This statement does not hold for Air New Zealand's  
31 longest route. Since United exited AKL-LAX, Air New Zealand

1 and Qantas have operated as duopoly. That was the point we  
2 were just discussing. I think entry on AKL-LAX is unlikely  
3 not only by United but by other people. United and the  
4 other US carriers do not have the financial resources to re-  
5 enter. American will not enter because it currently  
6 codeshares with Qantas.

7 It turns out that the two airlines that have the largest  
8 long haul feed into LAX, into Los Angeles, are American and  
9 United. American is in horrible financial shape too, they  
10 came within two hours of filing bankruptcy about a month  
11 ago. Their union finally caved just enough to keep them out  
12 of bankruptcy. But they also codeshare, they're One World  
13 as Ms Bates just said, they codeshare with Qantas. United  
14 I've already discussed. Air Canada codeshares with Air New  
15 Zealand and it also is currently in bankruptcy.

16 Other US Air lines are unlikely to enter in the medium  
17 run given their financial difficulties and their lack of  
18 feed from US origins to Los Angeles and their lack of  
19 alliances that would provide the necessary feed. So, I  
20 think it's extremely unlikely -- I mean I could of course be  
21 wrong I'm just looking into a crystal ball -- but I think  
22 it's extremely unlikely we're going to see entry.

23 British Air codeshares with Qantas and also has an  
24 equity stake in Qantas. So, I don't see it coming in  
25 either, and of course there's also -- you need to have an  
26 agreement between the two governments which may happen. But  
27 in my cynical view the State Department of the United States  
28 seems to want to slow it down as much as they can so they  
29 can continue to fly First Class to Heathrow, so we'll see  
30 whether it actually happens.

31 VBAs or LCCs are unlikely to enter the route as their

1 business models do not provide the services necessary for a  
2 12 hour flight. I think there's universal agreement on  
3 that. I haven't heard anyone say that they expect a VBA to  
4 start the flight.

5 So, absent the proposed alliance the duopoly between Air  
6 New Zealand and Qantas on this route would seem likely to  
7 persist for the foreseeable future. Air New Zealand  
8 currently has a number of competitive advantages on the AKL-  
9 LAX route relative to Qantas. Its cost structure is lower.  
10 Again I don't know exactly what it is, but reportedly its  
11 labour costs for flight staff are about 50% less than the  
12 amount paid to Qantas crew.

13 And Air New Zealand is also the only airline on which a  
14 passenger can fly from London to Auckland via Los Angeles  
15 without changing airlines, you know a convenience which  
16 Professor Willig and Ms Guerin-Calvert emphasised in their  
17 report.

18 Demand is currently growing on the route, as US and  
19 European interests in visiting New Zealand grows, Lord of  
20 the Rings, the Americans Cup and all this of course have  
21 been good for tourism.

22 If you look at visitor arrivals to New Zealand from the  
23 Americas and Europe combined now approximately are about the  
24 same as from Australia. So, there's been a big emphasis on  
25 increasing tourists from Australia here by Qantas Holidays,  
26 but American tourists have certain advantages that they  
27 spend over twice as much money as Australian tourists, and  
28 they don't root for the wrong rugby team.

29 So you want to take this into account. The statistics  
30 only are broken down between Australia and North America and  
31 Europe. I would expect that American tourists, if I could

1 get the data, probably spend more than double. And it's  
2 really quite a big difference.

3 **MS BATES QC:** Can I just interrupt you again. It's just you  
4 said the duopoly between New Zealand and Qantas on that  
5 route would be likely to persist.

6 **PROF HAUSMAN:** Yes.

7 **MS BATES QC:** Qantas has said, of course, they're going to be  
8 competing vigorously absent the alliance. Why do you have  
9 this view?

10 **PROF HAUSMAN:** Well, my view is, is that there's not going to be  
11 other entry from the United States, so that keeps it at two  
12 and you're asking me why I don't think it will be one?

13 **MS BATES QC:** No, I'm asking you why you don't think they will  
14 compete, given that they've said -- they've said they have.

15 **PROF HAUSMAN:** They will compete, but typically, if you're in  
16 that type of market you should be able to make money  
17 competing as a duopoly. If not -- I want to be very careful  
18 what I say here -- if not, your management should be  
19 replaced. I'll leave it at that.

20 **MS BATES QC:** So, the alliance will mean there's less  
21 competition, even in a duopoly can provide.

22 **PROF HAUSMAN:** Yes, and I'm going to get to that, that's a very  
23 important point of what I'm going to say. But again I don't  
24 know the numbers, but if you look at US Australia, it's  
25 Qantas and United now, everyone else has pulled out, other  
26 American Airlines were there but are long gone. Those are  
27 considered again, although I don't have the data, to be very  
28 profitable routes from the US to Australia, for both  
29 airlines. That's again a well run duopoly.

30 **CHAIR:** Can I just ask you one question, sorry for going back.

31 **PROF HAUSMAN:** No I'd be glad to.



1 **CHAIR:** But on the issue of who might enter that one particular  
2 route, I mean United was an alliance member with Air New  
3 Zealand, but it still competed with it on that route. So,  
4 is it automatic that none of these other carriers would  
5 enter because they're in an alliance with Qantas?

6 **PROF HAUSMAN:** No, you know if that were the only factor, but,  
7 for instance, if I remember correctly American at one point  
8 flew to Australia back in the late 80s early 90s. My memory  
9 might be wrong, but probably not, and they pulled out of  
10 that, and as I said that's a more lucrative market, and  
11 American is in horrible financial shape. So if we look at  
12 who flies to both San Francisco and Los Angeles who are the  
13 two major embarkation points you might think to come  
14 New Zealand, my point is it's basically American and United,  
15 Delta somewhat less, but it's basically American and United.  
16 They're both in horrible financial state, and they're both  
17 in alliances so they have less reason to do so.

18 **CHAIR:** I understand that, but I also suspect that --

19 **PROF HAUSMAN:** Name an airline I'll be glad to...

20 **CHAIR:** I suspect even if they're in horrible financial shape we  
21 don't presume that the current circumstances necessarily  
22 will persist for the foreseeable future. If there are rents  
23 being earned on the route, which is what you're suggesting,  
24 it still makes me wonder why somebody wouldn't come in and  
25 keep them away.

26 **PROF HAUSMAN:** I'd like to answer that in two ways. The first  
27 is a stock market which is not always right, but perhaps the  
28 best guide to the future that we have, things it is going to  
29 last for the next few years. If you look at the stock  
30 prices of United and American. The point has been made  
31 numerous times during these hearings that Southwest market

1 capitalisation is greater than every American airline by  
2 itself and I believe all US airlines combined. So, if the  
3 market thought that this was only a very temporary phase we  
4 would see much greater equity value.

5 **CHAIR:** I wonder if that was the test whether it also would  
6 inform us about the long-term prospects of Air New Zealand.

7 **PROF HAUSMAN:** Could be. That's a first point, but secondly,  
8 you know, I think we should name names here. Let's think  
9 about who might do it. And if you're gonna do it, if you're  
10 an American airline, US airline, in my view you need to have  
11 feed into LA or San Francisco. Delta tried, you know,  
12 pretty hard, to do well in both and they have retreated from  
13 both. That could be temporary. So, I don't see who we're  
14 naming, who's gonna do it. You know, I think that's the  
15 best way to think.

16 In terms of the rents, in terms of entry, what you need  
17 to think about, we have an integer problem here. And you  
18 can have rents with two, but three may be too many. This is  
19 a well-known problem in economics. So, in other words, if  
20 there are some rents being earned, if you're in a US carrier  
21 you can't come in and fly a half a 747 per week into  
22 Auckland. There are large fixed costs, you've got to have  
23 at least one 747, so you can certainly have rents being  
24 earned by two.

25 But again if their management is good they won't get  
26 too greedy at inside entry, or if you're a US airline if you  
27 enter you may well know what's gonna happen when you put on  
28 the extra capacity the rents could disappear and we've  
29 already run the experiment with United not being able to  
30 make money. So, there are many many markets in which rents  
31 are earned but not too much in terms of rents. You know

1 just enough to make sure that entry doesn't happen.

2 So, at that point -- it's 6.15 so I would just like to  
3 make my last two points if I could, then I'll be glad again  
4 to go back to this tomorrow. A number of passengers  
5 certainly would, you know, rather come -- US would rather go  
6 through Los Angeles than through Europe on Singapore because  
7 it's much longer and also much more expensive to go through  
8 Europe, so, I don't think that's a real alternative.

9 So, my conclusions for today are the market conditions  
10 summarised above in my view do not support Dr Tretheway's  
11 assumption that the AKL-LAX route will be unprofitable for  
12 Air New Zealand over the medium term. I think it could well  
13 be profitable. And this is Ms Bates' point, market  
14 conditions suggest that the alliance will remove competition  
15 from one of New Zealand's most important tourist routes.  
16 Auckland to Los Angeles would likely become a monopoly route  
17 under the alliance.

18 So, in my view, you know, you should look at airline  
19 markets, origin destination, I mean I certainly agree with  
20 the economists to my left on that point. And I would like  
21 to end the day with thinking you might want to think  
22 overnight about allowing a merger to monopoly in one of the  
23 most important tourists routes for this country, and I think  
24 I will end at that point.

25 **CHAIR:** I apologise for having to stop this in the middle of  
26 your presentation, it's -- but we will pick up tomorrow with  
27 it. And can I just ask if Mr Sheridan and Mr Walker will be  
28 here tomorrow as well? They will be?

29 **MR WALKER:** Could be problematic.

30 **CHAIR:** The only reason I'm asking is because I wanted to thank  
31 you before you leave. So if you're not going to be here

1 tomorrow -- you probably won't be then. I just on behalf of  
2 the Commission then would like to thank you and we certainly  
3 do recognise your industry experience as being very relevant  
4 to the issues we're dealing with, and have found your  
5 expertise quite use. So, thank you once again.

6 We will adjourn then until 8 o'clock in the morning, and  
7 we will then start again with Professor Hausman.

8 **MR DAVID:** For the planning purposes, it's always difficult to  
9 anticipate anything about Professor Hausman, but we'll  
10 assume he's going to last for another hour in the morning,  
11 with Dr Stone about half an hour, and myself about half an  
12 hour. So, we're looking at about two and a half hours  
13 possibly in the morning.

14 **CHAIR:** Okay, we'll work to that. Thank you very much.

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Hearing adjourned at 6.20 pm

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Resuming Friday, 22 August 2003 at 8.00 am

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