Polynesian Airlines

Further Submissions and Commentaries

In the Matters of;

Applications by Air New Zealand and Qantas (collectively the "Applicants") to Form an Alliance and for Qantas to purchase Shares in Air New Zealand (the "Applications")

And Including References to;

The Draft Determinations of New Zealand Commerce Commission (NZCC) and the Australian Consumer & Competition Commission (ACCC) collectively the "Commissions" dated 10 April 2003

Disclaimer: The contents reflect views and opinions that are based on experience and on material publicly available in the media, on websites and industry reports.

Numbers quoted are likewise based on publicly available information and are intended to be "orders of magnitude" to indicate to the Commissions essential matters that should be researched in depth. Polynesian Airlines accepts no responsibility for any errors or omissions in data.

Unless otherwise stated, figures are in NZD and exchange rates are USD 0.58 and AUD 0.88.

May 2003

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Introduction

It is submitted that there are several important issues that are material to the Commissions' treatment of the Applications that have not, so far, been drawn to their attention to enable appropriate weighing in the balance prior to the Draft Determinations being formulated.

Those several issues are very significant but do not appear to have emerged from either the Alliance airlines in their Applications or the NECG supporting data or from the submissions made to the Commissions by any other interested party.

Ref:	Q40	Comment on appropriateness of assumptions

Accordingly, Polynesian believes that the Draft Determinations are out of balance because matters of considerable Public Interest have not been recognised or assessed.

Ref:	Q50	Views on approach to detriment assessment
Ref:	Q51	Views on cost savings

Polynesian further submits that the Applicants are in pursuit of objectives that are highly desirable in the Public Interest but have not produced the most appropriate or the strongest arguments in support of their case.

In their pursuit of survivability through greater efficiency and lower costs, the Applicants are wrestling with major issues of financial viability and governance now confronting them but have failed to make a compelling case for the substantial restructure that is undoubtedly needed.

In their endeavours to protect the Public Interest, governments on both sides of the Tasman have also imposed constraints on their flag airlines (the Applicants) that would have resulted in insolvencies in a number of instances in the past but for intervention by the States and involuntary investments by the Taxpayers.

Although these constraints are deemed by the States to be in the Public Interest, their effect is to place the Applicants viability and profitability objectives in fundamental conflict; the adverse effects of which have not been given appropriate weight in the Draft Determinations.

Both applicants have recently benefited from the demise of competitor airlines in their respective markets but those are events unlikely to recur and the fundamental problem of cyclical and (currently) unprofitable international aviation markets is an ongoing problem requiring urgent resolution. As the sole flag airlines of their respective countries, Qantas and Air New Zealand have recently become extraordinarily dependent upon their domestic markets and both are vulnerable to domestic competition that only targets the high volume, high yielding routes that are the flag airlines only sources of profits at present.

Note: Strong domestic profitability is not historically normal in New Zealand. Low utilisation of aircraft is the principal cause. This is a function of a concentrated working day, high fleet gearing for morning/evening peak traffic movements, selection of aircraft with domestic capability but limited payload/range (e.g. for Tasman & Pacific Island operations), short distance sectors and extended ground time. Typically these factors have limited the utilisation of the aircraft in domestic service to only about 55-60 % of the daily block hours achieved by international fleets. This limited productivity can only be offset by higher fares than would be the case if the aircraft were fully productive. The latter situation appears to be the case in New Zealand at present.

Due to the business failures of competitors, the Air New Zealand and Qantas groups are, once again, the sole designated (flag) international airlines of New Zealand and Australia. This is an important fact because it means neither one can be allowed to fail, for reasons that will be explained later.

If the competition authorities of New Zealand and Australia take too narrow a view of the real situation, in which the sole remaining flag airlines are artificially constrained by Public Interest factors that restrict their ability to restructure, the result can only be an increased risk of flag airline failure and, thus, a heightened threat to the Public Interest.

That fact has not been sufficiently weighed in the Draft Determinations and Polynesian does not, therefore, agree with the Commissions view of the counterfactual.

Ref: Q4 Comment on NZCC definition of counterfactual

Unless a wider view is taken, the end result could be crisis for both airlines that could occur very soon.

The Commissions have posed numerous questions as to matters covered in their Draft Determinations but one of the most important questions is absent from the list, namely;

"What are the risks to New Zealand and Australia of the financial failure and liquidation of their last flag airlines?"

Both countries are effectively down to only one each now, after various start-ups and failures. (Note: Freedom is an Air New Zealand subsidiary, not an independent).

The Australasian situation is not unique; refer **Appendix 2.**

Safe, commercial flight capacity is inherently expensive to produce and so the ideal of "cheap fares" is akin to the Holy Grail; mythical and although keenly sought after is always beyond reach. The only attainable and sustainable possibility is for airlines to achieve the lowest cost of production consistent with a safe system.

The current business models in use by the Applicants do not represent their lowest available operating cost option and the Applications do not constitute compelling arguments that the Applicants would achieve that lowest cost option in future.

The Applications before the NZCC and the ACCC have underlying objectives of reducing production costs and increasing efficiency but have, unfortunately, also strayed into the highly emotive territory of retail competition.

That was un-necessary and ill advised because it has had the very predictable result of setting other stakeholders in the industry, the public at large and the Commissions against supporting the worthwhile components of what the Applicants have attempted to do.

As a reflection of the emotions the subject of aviation can stir up, many of the initial submissions made by interested parties appeared to be founded on combinations of jingoism and either self and/or vested interests focused only on a narrow view of fares and freight rates, as they affect themselves, rather than on Public Interest.

Given the carnage in the worldwide aviation sector in recent years (refer **Appendix 2**) the anxiety expressed by the Applicants about their survivability is well founded. The Draft Determinations do not reflect the realism of the risks faced by the Applicants and there is need for more pragmatism on the part of the Commissions.

Due to the absence of a full assessment of the impact on the Public Interest of the present aviation system, the Commissions have been misled and the following submissions attempt to rectify that omission by providing cogent arguments than have been advanced by the Applicants so far and, in so doing, persuade the Commissions to adopt a wider view of the Public Interest inherent in these Applications.

Where appropriate and pertinent, references are made to the 66 questions and requests for comment issued by the NZCC following its Draft Determinations. Not every question is addressed as the focus has been on practical matters as opposed to the theories, for example, used in the NECG report and NZCC questions 42-47 inclusive.

There is also commentary on matters that the NZCC did not cover in its 66 requests for comment list, a copy of which is attached for the convenience of readers **(Appendix 1).**

1. Executive Summary

From the detailed arguments advanced in the following sections, the following can be concluded;

1.1 The Applicants are both full service airlines (FSAs) and both are combined domestic and international operators as well as being the national flag airlines of their respective countries.

1.2 They are attempting to invent a relationship that will put their respective businesses on a sounder footing, in an increasingly high-risk environment, than is possible under their present organizational structures and business models. It is appropriate, therefore, for the Application to form an Alliance and to acquire shares be considered together.

Ref:	Q1	Approach of considering the two Applications together.

1.3 It is the Public Interest that the Applicants are allowed to substantially restructure their operations in order to reduce their business risks and also reduce the exposure of their national economies to the potential loss of infrastructure considered by States to be essential in the Public Interest.

1.4 The difficulties the Applicants face have their roots in issues of national sovereignty and Public Interest that should not be their concern but which, nevertheless, create all international flag airlines as artificialities that are externally constrained from following normal business practices.

1.5 The degree of artificiality is such that, had normal business practices and freedoms prevailed, both internally and across national boundaries, it is likely that neither Air New Zealand nor Qantas would now exist as independent airlines. The privatisation of Air New Zealand in 1989 would have resulted in its outright purchase by Qantas and, similarly, the privatisation of Qantas in 1992 would have resulted in it being purchased outright by British Airways.

1.6 The artificialities referred to are the result of constraints imposed in the Public Interest by national governments that have consequential ramifications and attendant costs. In short, the Applicants are tied by national sovereignty constraints that impose severe limitations on their business models and commercial activities.

1.7 Specifically, the respective national governments limit the extent of foreign participation in flag airline equity, thus constraining their ability to take willing, new equity partners on board. The other face of that coin is that it provides protection from foreign takeover.

1.8 The Applicants are also protected by their "national flag carrier" status that enables them to successfully project themselves as being essential to the tourism industries and the economic welfare of their home countries. The general acceptance of this assertion was recently demonstrated by the New Zealand government's (and several other States as well) financial rescue of its flag airline on precisely those grounds.

1.9 The Applicants, in common with (virtually all) international airlines, are structured into relatively primitive organizations that are duplicative and inefficient. They are un-necessarily cost-inefficient on a very significant scale. This is not entirely their choice but is, to a large extent, the result of the externally imposed artificialities referred to in 1.4 – 1.7 above.

1.10 In the past, the airline industry has relied on advances in aircraft technology to keep production costs low. As a result, the real cost to consumers of air travel steadily reduced. Big leaps forward, like the development of the jumbo jet, appear to be in the past and, in recent years, only marginal improvements in operating efficiency of proven designs have been evident. Nevertheless, the industry has created high expectations in the public's mind and created a huge propensity to travel that appears to be inexhaustible.

1.11 In such conditions, flag airline profitability would seem assured but the reverse is true. Due substantially to the fact that nearly every country has decided to have at least one flag airlines of its own and, because of the universally applied national sovereignty (Public Interest) barriers to cross-border consolidation, there are now too many flag airlines and too much capacity is produced (some industry sources suggest by as much as 30%). Thus, the industry is bedevilled with very high fixed costs and, at best, paper-thin margins driven by over-competition. That is popular with the public but is ruinous to airlines that are operating in a cyclic industry. A very well respected aviation commentator in Washington has aptly described the airlines as "busy fools" for their huge volumes and poor results.

The Applicants view of a likely "War of Attrition" is an accurate description of what happens in the aviation industry and is also an accurate representation of past behaviour that is likely to be repeated in the absence of approval to the Applications.

Because of their high fixed cost nature, airlines are driven to maximise turnover (thus, market share) so as to spread their fixed costs and overheads as thinly as possible. Loss of share is a direct loss of competitiveness that cannot be, and is not, tolerated.

Ref: Q5 Likelihood of War of Attrition

1.12 Nevertheless, flag airlines cannot defy business gravity and, in the most simplistic terms, either they charge fares that will cover their cost of production, plus a margin for renewal of plant and sufficient profitability to attract and hold equity investors, or they will fail. In the context of flag airlines, business failure occurs quite frequently (Refer **Appendix 2**) but liquidation does not follow as States are always forced to bail them out if they have sole designation.

1.13 The Applicants are torn between their desire to achieve a more effective and cost efficient structure and their fear of surrendering effective control. Thus, the Applications dwell extensively on the issues of control and governance

and attempt to invent a satisfactory substitute for what would ordinarily happen in a proper merger.

1.14 The abovementioned structural artificialities create inefficiencies that have considerable costs attaching to them. The preservation of “our very own national airline” in each country has its costs; many of which are hidden from the public gaze but which need to be exposed to ensure a full and proper debate on the Applications.

1.15 Airlines are burdened with the full range of business disadvantages. They are highly capital intensive, labour intensive, technologically challenged, foreign currency exposed (most purchases & expenses are USD denominated) and have to operate in a highly competitive environment that continually forces margins downwards. It would not be an unfair assessment to assert that most national flag airlines would not have come into existence, or would continue to exist, but for the original and ongoing support of their respective governments. That has always been the case and will still be the case in future, as long as the externally imposed, national sovereignty artificialities remain.

1.16 The development of competition laws in New Zealand and Australia, coupled with the reduction of regulation in certain sectors of their operations (such as freedom to set their own fares) and privatisation has resulted in mixed blessings for airlines since those external changes took place (mostly) in the 1980s decade.

1.17 In general, since the 1980s de-regulatory phase, the Applicants have not adapted by developing new business models that reconcile high fixed costs with fluctuating sales revenues. Their business risk increased sharply because their high costs remained highly resistant to management while revenues became vulnerable to new and stronger forces of competition coupled with extreme exposure to external events over which managements have no control.

1.18 Good relationships between airlines and their shareholders are obviously critical but they are hard to achieve when profits and equity values do not hold up. In general, airlines do not return their cost of capital, let alone a margin above. Thus, the shareholders have become increasingly wary of investing further and this has forced airlines to limit capital expenditures by renting aircraft rather than owning them but, even so, maximising borrowings to the maximum levels their bankers will allow even though the industry’s low margins will not support the servicing costs. This apparent anomaly is rooted in the bankers belief (so far well founded) that governments will be forced to act as underwriters if faced with the realities of a financial collapse of a sole flag airline.

1.19 In general, allowing for the fluctuations of good times and bad, airlines have found it increasingly difficult to achieve efficient funding as the result of the long-established and continuous decline in yields. Various devices were created to get over the problem that airlines were consistently failing to maintain the confidence of investors. For example, leasing aircraft has become the resort of many airlines that would otherwise fail to raise sufficient capital to enable the purchase of new aircraft. Leasing companies have sprung up in

considerable numbers and have prospered whereas their airline customers have not.

1.20 The established airlines, including the Applicants, are under increasing attack from new competitors that have developed more efficient business model concepts. The effect is a compounding of problems that do not augur well for the future of full service airlines.

1.21 For all of the above reasons, the business models operated by the Applicants have not worked, are deficient and both airlines are in need of a radical new solution.

The Applications represent a belated attempt to do that but Polynesian does not believe the arguments relied upon are persuasive, a view obviously shared by the Commissions. However, the following arguments will, hopefully, persuade otherwise.

2. Summary of Public Interest

Some impacts on the Public Interest are negatives that can be insidiously cumulative over time. Thus, in Table 1 below, some items relate to the hidden costs to the Taxpayer as well as the more obvious costs such as loss of shareholder value. These costs may be regarded as benefits if the advent of an Alliance removes such costs or at least substantially mitigates the risks that cause them. The risks associated with a sole designation flag airline business failure eventually pass through its shareholders to the taxpayer.

On the positives side, a conditional Alliance (i.e. conditional on Polynesian's submissions at Section 12) could enable the Applicants to reduce their costs substantially and lower their costs of production so as to enable a more sustainable, lower fares regime.

The sum of the negatives avoided and the positives achievable is assessed as the total Public Interest Benefit in the range $5.1 - 5.8 billion over 5 years. See Table 1.

This compares with the total advanced by the Applicants of only $1.56 billion over 5 years. Main differences include the fact that the Applicants altogether neglected to address the costs to the Public Interest of the present aviation system. Also, the Applicants approach to assessing cost savings was a progression over the first 5 years whereas the more realistic assessment in Table 1 is based on annual savings at maturity of projects.

The scale of the Alliance opportunity is much greater than the Applicants have argued and there is also considerable scope for reducing the risks to the Taxpayer that the Applicants did not address.

Ref:	Q61	Assessment of other benefits
Ref:	Q62	Any significant benefits omitted
Ref	Q64	Use of welfare rather than gross figures to express benefits.

Table 1 Public Interest Benefit Assessment

Item	Notes	Estimated Impacts	Average Value p.a.	Value 5 yr Tot. Mature Cum.
1. Disbenefits of Current aviation system				
1.1 Involuntary Taxpayer emergency investment	Taxpayer has twice had to provide emergency support.	$50 million (in 1981 $) $1,035 million (in 2001 $)	$50 - 55 million	$250 - 275 million
1.2 Avoiding future growth & replacement capital.	5 year fleet replacement & reduction in aircraft av. age	$700-1,000 million & could be more	$140 – 200 million	$700 – 1,000 million
1.3 Loss of shareholder value	Average ord shares 1999 was 567 million at high of $3.05 now $ 0.47	$1,46 billion	$209 million	$1,46 billion
1.4 Super profits NZ domestic	Margin increase since 1996 purchase of TNT shares & no aggressive competition	Surcharging est 5% of total market turnover	$80 million	$400 million
1.5 Losses by liquidated domestic main trunk jet operators during est 15 yr period	Ansett New Zealand Tasman Pacific Airlines Kiwi Air	$200 million $120 million $8 million	$21 million	$105 million
1.6 Subtotal Disbenefits (costs) to Public Interest			**$500 – 565 million**	**$2,915 – 3,240 million**
2. Benefits from modified Alliance system				
2.1 Rationalisation of Alliance operations	Savings in aircraft operations	Higher average load factors	Est. $140 – 210 million	$700 – 1,050 million
2.2 Rationalisation of Alliance fleets	Reduction in fleet numbers. Would probably take at least 5 years to achieve.	Reduction in fleet numbers	Est $105 million	$516 million
2.3 Maintenance specialisation and spares provisioning	Would probably take a minimum of 3 years to achieve	Est $70 million p.a. savings programme.	$70 million	$350 million
2.4 Incremental tourism benefit	Assumes Alliance approved on Polynesian conditions.	Alliance 5 x year programme with different generation method.	$129 million	$645 million
2.5 Subtotal Benefits of conditional Alliance			**$444 – 514 million**	**$2,211 – 2,561 million**
3. Total all items 1.6 & 2.5			**$944 – 1,079 million**	**$5,126 – 5,801 million**

2. Public Interest in Aviation - Definition

Polynesian submits that any attempt by the Applicants to retain, or even in large part retain, their current FSA business models will inevitably lead to repetition of past failures and consequential, accumulating risks of eventual costs to the Taxpayer. These would be made up, as they have been in the past, of very high demands for asset (both growth and replacement) capital as well as involuntary investments in times of crisis (bail outs).

Further, if the historic costs of an inefficient system can avoided this would amount to a significant Public Interest benefit in addition to any efficiency gains that can be made out of a new business model by the airlines. The costs associated with the aviation system and with past and present failed airline business models are substantial and should be recognised due to the high risk of them recurring if a radically different business model is not allowed to emerge.

Public Interest is difficult to value in absolute money terms and is often held to be "self evident" with no attempt to attach dollar values.

In the absence of appropriate legal definitions there is a tendency to equate Public Interest in the aviation field as relating to the levels of fares only. The Draft Determinations appear to follow that trend.

However, in the case of both Australia and New Zealand, it is submitted that the wider Public Interest in aviation consists of the following factors;

2.1 **Ongoing Availability of Comprehensive, Reliable and Safe Air Services**. It is not necessarily a "given" that the private sector market either can, or will, provide these services on a sustainable basis.

2.2 **Public Interest Community**. It is suggested that the geographical boundaries of New Zealand Public Interest encompass the provinces as well as the main centres and include those Pacific Islands that New Zealand has special relations with, such as Samoa and Niue. This is not a definition that is recognised or strictly matched by air service suppliers.

In the context of the low cost of production business model that is proposed later in this commentary, Samoa and Niue also have a compelling interest in a regional restructure of airlines.

> *Note;
> Samoa and Niue have substantial expatriate populations resident in New Zealand that represent high VFR movements by air and critical New Zealand tourist traffic that is critical to the economies of those islands. Lowering the cost of air service production is a vital issue for them also.

2.3 **Minimum Cost of Operations**. For example; joint management of resources to achieve lowest production cost and highest operating efficiency. Also, joint

management of aircraft that would allow maximum utilisation of aircraft to higher (and, thus, far more economic) hours per day than at present.

2.4 Reduction of Risk to the Taxpayer. A restructure could enable separation of production (low risk) and marketing (high risk). For example, production that is jointly owned and managed but competitive marketing that is commercially structured under each brand name. More sustainable profitability would lower the risks to the Taxpayer identified in Table 1 sections 1.1 – 1.5.

2.5 Safeguarding and Ongoing Development of Tourism Industries. The flag airlines represent essential infrastructure and, in their pursuit of optimising the commercial benefit from bilateral rights should be serving both their own commercial interest and their country's Public Interest.

2.6 Reasonable, but not Destructive, Marketing Competition. For example, by isolating and reducing the production cost, each airline's marketing entity would be obliged to earn a return from the process of purchasing production (of available seat kilometres or, alternatively, block hours) and reselling it. Thus, the focus would be on charging realistic fares to ensure recovery of that cost and earn a sufficient margin.

2.7 Protection of Employment. Creating a more sustainable business model would have the effect of removing, or at least substantially reducing, the high risks currently faced by the substantial work forces of the Applicants themselves as well as those of the numerous employees of supporting industries. The severe apprehension experienced by employees, whenever there is a cyclical downturn or an impending financial collapse, would be alleviated. It is in no way in the Public Interest for such highly labour intensive, essential industries as the remaining two flag airlines and their supporting services to fall into liquidation.

3. Public Interest – Delivery Mechanisms

Acting in accordance with international convention and treaty obligations and rights, as well as their own country specific policies, sovereign States attempt to give effect to the Public Interest by conferring certain rights, and imposing certain constraints, on their flag airlines. In the cases of both Australia and New Zealand those include;

Table 2 Rights Conferred and Constraints Imposed on Flag Airlines

Right/Constraint	**Benefit/disbenefit to Airline**	**Public Expectation**	**Advantage/Disadvantage**
Designation as flag airline	No price paid Considerable cash flow potential	Air Service provision	Has resulted in oligopoly or even monopoly behaviour
Substantial Ownership & effective control restricted to own nationals	Prevents foreign takeover. Disqualifies total foreign investment in excess of 49% limit Disqualifies foreign	"Our" own airline. Cheap fares and freight rates Support for Tourism Profitable investment	Retains substantial ownership & control in New Zealand hands. Prevents airlines from merging and gaining merger benefits. Disqualifies major sources

	airline investment beyond 25% limit	opportunity	of offshore capital. Transfers commercial risks to Taxpayer as funding source of last resort
Golden Share Kiwi Share	State retains powers that would normally lie with directors and shareholders of public companies	Retention of essential infrastructure	Protection of bilateral rights
Competition Laws	Focus is on fares/rates but not on costs	Real Competition and thus, “Low” fares/rates	In combinations with State imposed constraints, leads to inability to restructure in the face of market forces
De-regulated fares	Flexibility to manage revenue but at heightened risk	“Low” fares/rates	Degree of competition is destructively high and Not compensated for by de-regulated costs

From the above, it is clear that sovereign States are not prepared to let market forces operate without substantial intervention. The results of that intervention represent heightened expectations on the part of the public but much greater risks. The risks initially fall on the airlines and their shareholders but, in the final analysis, the consequences of sole designation, flag airline failure inevitably fall on the Taxpayer.

More detailed explanations of cause and effect now follow.

As noted, the right to extract commercial value from air service treaty rights is granted to flag airlines subject to certain controls that are imposed in the Public Interest by their home States. These controls operate in accordance with international conventions that the States are parties to and are given force and effect in bilateral treaties relating specifically to aviation.

Thus, national flag airlines are those that are “designated” by their home countries to operate the air services rights (jargon; “Bilaterals”) that belong to their home countries as the result of aviation treaties between pairs of countries.

These bilateral treaties create artificialities that are not normally present to constrain other industries that operate across national borders. As well, the international aviation conventions that the treaties are based upon are not about to be changed or eliminated any time soon – and certainly not in any timeframe that would satisfy any objective of sustaining the Applicants businesses in the foreseeable future.

Witness the refusal to approve the Air New Zealand application to alter the New Zealand government’s foreign ownership limits in favour of Singapore Airlines.

Specifically, the artificialities are;

- The right (and in practice often the sole right – or “sole designation”) to extract commercial value from their home government’s air service treaties. This right is not purchased and although it represents considerable cash flow

potential, does not appear as an asset in any flag airline's balance sheet. No monetary value is ever placed upon it but it nevertheless considered by the flag airlines to considerable value – as evidenced by the strong defence mounted by flag airlines whenever newcomers threaten their "sole designation". Sole designation, whether legislated or the result of market forces, is often quoted as being a form of monopoly that enables the holder to aggregate considerable mass over time. That achieved mass seldom, however, appears to have been a barrier to market entry for newcomers who can and do target specific niches.

- Air Service rights belong to governments, not to the airlines designated to use them. This means there is over-riding Public Interest in ensuring that the extraction of commercial value is optimised out of any given bilateral treaty. On principle, leakage of value to the foreign treaty partner's economic benefit is something to be avoided and since States themselves are unable to extract the "commercial value" this factor accounts for the obsession with retaining "substantial ownership and effective control" of designated flag airlines by the States themselves or their own nationals. While it achieves the objective of retaining control the effect is also to shut out foreign sources of willing capital.

- Sole Designation flag airlines are not allowed to fail financially (unless the designating country has more than one). Witness; Ansett Australia that was an international as well as domestic Australian airline but was allowed to fail as Australia still had Qantas to pick up the slack. New Zealand only had one flag airline left and was, thus, forced to financially rescue Air New Zealand. Even when flag airlines are privatised and not owned by their home governments, the reality of the potential loss to the economy of a State, in the event of its sole flag carrier failing financially, inevitably drives a decision to effect a rescue.

- Sole designation flag airlines appear to be highly attractive to banks and aircraft lessors (performing their role in substituting for capital) because of their very high cash flows and because designating countries are, in reality, "last resort" underwriters. The governments concerned may claim otherwise and even publicly refuse to acknowledge contingent guarantees before the onset of adverse events. When, however, they are faced with a choice of collapse or bailout of a sole designated flag airline, they have to recognise there is no choice at all and are forced to accept financial rescue as the only politically, socially and economically acceptable option. This implicit guarantee can (and often does) lead to airlines being encouraged and enabled to borrow (and lease aircraft) to an imprudent extent when equity (and aircraft ownership) may be far more appropriate but are not achievable.

- Because of the conventions governing ownership and control, flag airlines are immune to takeover except by their own nationals. Typically they have become very large scale, high risk, capital hungry businesses that are unattractive to potential open market buyers, partly because of the downside risk but also the intimidating scale of investment needed to acquire controlling equity. Other flag airlines seeking to buy for consolidation reasons or home

governments driven to protecting their economies and tourism industries appear to be the only willing buyers of controlling interests in flag airlines.

- The so-called de-regulation of the industry that occurred in the 1980s was, in fact, a limited exercise that owed more to public relations than economic sense. The reduction in government regulation was on the revenue side of airline operations only. Fares were allowed to float in response to market demand and competition laws were tightened but the artificialities that have the effect of driving airline costs remained in full force and effect. Cross-border merging or consolidating remained as prohibited activities and potential merger efficiencies were denied. The result was to make an already high-risk business even more so and, as a consequence, significantly increased risks to investors and, by extension, to the Taxpayers.

- The certainty of high costs and the uncertainty of reliable income have combined to discourage new market entrants, thus entrenching the established flag airlines as near monopolies that exhibit near monopoly behaviour. Their focus is primarily on retaining sole designation (thus market share) as the means of retaining monopoly components; thus, their predatory behaviour towards new or intended market entrants. Because of their acquired mass the Applicants airlines can sustain a higher threshold of financial pain in order to see off competitors and the Applicants have done so in the past. It is, however, important to register the point that would-be competitors frequently under-estimate the capital needed to establish a new airline and sustain it in business, particularly in the early stages. There have been numerous examples of very ill advised and under-capitalised attempts to enter the industry. The consequence that they fail is not the fault of the incumbent flag carriers who are often, unfairly, accused of predatory behaviour.

  It is a fact that air service production on any scale sufficient to represent a consumer friendly scheduling frequency is going to be *very* demanding in terms of financial commitment.

  For example, a single leased B737-300 that is worked to an economic productive level of at least 4600 block hours per year will have fixed costs (ACMI) of at least USD2200 per block hour and, depending on contemporary fuel prices, direct operating costs of about USD 2400 per block hour.

  The total financial commitment per year (and excluding any establishment costs) for just that one jet aircraft, at over USD 21 million (over NZD 37 million at 0.56), would be a daunting risk for even the biggest companies in New Zealand.

  On that basis, a single return flight per week by that aircraft Trans Tasman costs over NZD 3 million p.a. for operations only and before overheads. The cost to operate the same jet in the New Zealand main trunk market works out at an even higher hourly rate because the fixed ACMI costs remain the same while the attainable block hour productivity is much lower due to very short sectors and increased ground time and the short business day.

Ref: Q6 and Q7 Comment on capital costs for entry into the NZ main trunk market

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- As flag airlines, the Applicants have progressively gained in size and market power and, due to their underpinning of the tourism trade, they have attained the status of essential infrastructure in their home States.

Flag airlines that are combined domestic/international and fettered by Public Interest constraints belong to a species threatened with extinction in its present form.

Although still constrained by the same artificialities if they trade internationally the rise of so-called value based airlines (VBAs) demonstrates that different and lower cost business models are feasible.

Unlike in the days of full regulation, however, airlines today can and do fail financially in large numbers. A situation that was almost unheard of, prior to the mid 1980's post de-regulation of airline revenues.

Note: As an example of pre-deregulatory arrangements in the Trans Tasman market; Prior to deregulation in the 1980s, the airlines operated a pooling system on the Tasman with full approval of both governments. The effect was to balance passenger/freight demand with the supply of capacity and avoid costly over-production of ASKs and ATKs. Fares were controlled by government regulation and scrutiny.

Many that have not already ceased operations are survivors only because of financial intervention by their respective governments. Under normal business conditions (i.e. absent the artificialities referred to above) they would probably not now exist.

4. Public Interest - Inbuilt Costs

It is axiomatic that a business that would not exist but for artificial protections and privileges is being subsidised to remain in existence. In the airline industry the subsidies can be in the form of actual cash injections, as described above, or they can be more subtle, say, in the form of a real or implied licence to charge higher fares than would otherwise be the case.

The latter argument is relevant to the New Zealand domestic market where there has been the appearance of competition since the Air New Zealand purchase of the 50% TNT share in Ansett Australia (1996) and subsequently up to the acquisition of the final 50% from News Corporation and then during the term of Qantas New Zealand when Air New Zealand could dictate domestic air fares and its competitor-in-name-only had to follow.

More recently, with the entry of Qantas into the New Zealand domestic market in its own right (replacing the Tasman Pacific franchise arrangement) there is, again, the appearance of competition. Reality may be something else while the Applications are under consideration.

In the public's mind there may be a belief that competition exists in the New Zealand domestic market but in reality, even before the entry of Qantas in its own right there had been private arrangements between airline shareholders that effectively negated competition.

Even at present, while the Applications await final determination, there is no motivation on the part of either Applicant to actively compete in the main trunk domestic market.

That being the case, it follows that the Alliance would have little or no effect under the factual or counterfactual in circumstances of already negligible competition.

Ref:	Q23	Alliance lessening competition in the main trunk market.

The extent to which super profits were earned by the essentially non-competing airlines is difficult to assess but 5% of the total market turnover 1996-2002 seems not excessive.

5. Structures and Organization of Applicants

Unlike most major enterprises in different business sectors that operate internationally, the Applicants, typically of their contemporaries abroad and driven by the same Public Interest factors, have structured themselves as wholly customised and integrated businesses.

For example, they enjoy their own choices of aircraft numbers and types in their fleets, their own dedicated maintenance engineering resources, their own crews, their own dedicated presences at airports, their own customised IT services and so on.

This degree of customisation is a by-product of the "substantial ownership and control" Public Interest constraint that precludes flag airline mergers across borders. It is a very expensive and duplicative business model. This is especially evident when it is considered that, in the case of the Applicants, there is a comparatively narrow choice of jet aircraft types suitable for use on routes that are very often either common, or similar, to both of their networks. So similar, in fact, that joint operation and management is inherent in the Applications.

Rationalisation of the Applicants respective fleets, with consequential improvements in efficiency and reduction in spares holding costs, offers opportunities to avoid over-capitalisation as well as material reductions in production costs.

After stripping away the façade of glamour that cloaks international airlines, the facts remain that aircraft are, simply, production machines that, in a fleet, constitute a factory. Because of their extremely high capital cost, the factory machines should, ideally, be as much as possible the same type and should be run as productively as possible.

Daily block hour utilisation of aircraft must be intensive if the production opportunity is to be maximised. Thus, initial selection of the optimum types and productive capacities of the machines is paramount because multiplicity of aircraft types is extremely cost-inefficient. The inefficiencies include multiplicity and cost of aircraft spares, type specific pilots and maintenance crews as well as reduced inter-changeability in operations.

The Applicants have, as yet, postulated no form of co-ordination that would enable greater efficiency in joint fleet selection and rationalisation.

Caledon believes the opportunities (albeit over the longer term due to present commitments) for production cost reduction, through fleet rationalisation and better type selection, are considerable.

Caledon also believes that there are alternative business models open for adoption by the applicants that would not necessarily raise concerns on the part of the Commissions with respect to reduction of competition.

It is suggested that the Commissions consider the structure of the oil industry in New Zealand as a pertinent case. The Commissions may have concerns about some other competitive aspects of the oil industry but, be that as it may, this reference is made specifically to certain operational and capital investment features that appear easily transferable to the aviation sector in Australasia, namely;

5.1 The marketing (competitive) functions of oil company operations in New Zealand are substantially distinct from the operational (co-operative) functions.

5.2 Most of the principal operational functions and operating assets are shared. For example, there is a single jointly owned refinery through which each company processes its own crude oil at the same cost per barrel, a jointly owned pipeline from the refinery to Auckland that discharges into a jointly owned storage and distribution terminal. A joint venture tank ship operation distributes to seaports around the nation.

The point about these arrangements is that the hugely expensive assets needed by the four major oil companies to supply the market are not duplicated but one single set is shared. The results are enormous capital savings (that in any event could never have been justified), much higher utilisation of expensive plant and low operating costs of production and distribution.

Competition occurs on the marketing (income) side of the equation and consists of representation at the largest number of strategically located retail outlets, promotion of the separate brands by a multiplicity of activities and retail pricing strategies

In a small country like New Zealand, these arrangements are eminently sensible, least cost and very efficient. A side effect is that retail pricing to the consumer is very similar between companies. This is to be expected when the four companies are sourcing crude oil at virtually the same international rates and then processing and distributing it at exactly the same cost per tonne. Competition for market share on other grounds is, however, intense even though such similarity in costs makes it

difficult for much retail price differentiation to result. Nevertheless, the latter is a small problem compared to what the prices would have to be if all four companies had fully duplicated capital investment in facilities and needed to remunerate them from the small New Zealand market.

The Applicants appear to have attempted to replicate some of the features that are present in the oil industry business model but have not elected to go the whole way.

The estimates in Table 1 are suggested as being more realistic.

6. Governance

6.1 National Sovereignty

As noted earlier, issues of national sovereignty impact on flag airlines by denying certain functions from the purview of the directors. In certain situations, the Public Interest imperatives over-rule the commercial, thus tying the directors hands in crucial matters such as the nationalities of equity and controlling interest. Thus, important matters such as accepting large scale foreign investors, achieving the benefits inherent in a cross border merging of interests and capital raising are not in the directors hands but are subject to approval or veto of governments, even though they may not be shareholders.

This tying of the directors' hands has led to crisis after crisis in flag airline affairs. This suggests, very strongly, that these negative effects should be compensated for, in some acceptable manner and the thrust of these submissions is that the Applicants should be allowed to restructure their business models – at least as far along the lines as those suggested in the example in Table 6.

To achieve that, it is suggested that the Commissions enable the airlines to re-arrange their operations (i.e. the *cost side of their business* as opposed to the *revenue side* which should remain competitive) to extract the maximum in cost savings.

Briefly, this would involve;

- Joint management of principal operating assets including aircraft, crewing, maintenance and insurance.
- Progressive rationalisation of aircraft fleets to same makes, models and productive efficiencies.
- Specialisation of maintenance at workshops dedicated to specific aircraft types.
- Joint management of production capacity (but not fares) on routes to and from New Zealand
- Joint purchasing of operating consumables (aircraft spares, fuel, etc)

6.2 Airline Profitability

A predilection on the part of investors for dividends rather than increases in share value is a particular feature of Australasian share markets and applies to both the Applicants.

This has driven dividend payouts that, in retrospect, may have been better retained for plough-back into their businesses as alternatives to additional borrowings and may also have retained value in their share prices.

It is also observable that the situation can arise where a single shareholder achieves effective control (of the Board) and a strong possibility can then be created whereby that shareholder's interest comes into conflict with the airline's interests – for example in the accounting of profits and the declaration of dividends. This is not likely where there is a very high proportion of small shareholders and no major shareholder with a controlling stake but is certainly the case when there is a controlling shareholder.

The difference between these two situations has its roots in the differing methods adopted for privatisation. For example, the Australian government deliberately elected a policy of selling to large numbers of small public investors whereas New Zealand adopted a "trade sale" procedure that led to a single shareholder group gaining effective ownership and an ongoing controlling dominance at board level.

As a consequence there have been quite different issues of governance that seem to have favoured the Australian choice.

The sheer size and business unit diversity of airlines challenges accurate accounting and the situation is not improved by the conflicting demands of the business for additional investment and shareholders demands for dividends.

This has led to some accounting creativity in the industry that may have tested the bounds of prudence. Distortions have resulted from pushing out the boundaries of accounting rules in respective countries and led to the emergence of really difficult concepts for the accounting of special items.

Investors in public companies have become wary of public company accounting standards due to the disasters in the United States, Europe and certain parts of Asia in recent times. Practices such as accounting the sale of assets as operating revenues and revaluing balance sheet assets upwards, thus enabling disbursement of higher dividends, have been common.

In the technical sense, accounting for difficult items such as aircraft finance (i.e. hire purchase) and operating (i.e. rent only) leases has presented problems for the student of airline balance sheets. In reality, any aircraft lease is a liability to pay a rent for a given period of time and is a considerable commitment for future rent payments as well as exposure to punishing penalties in the event of default or early termination. The appearance of such a lease in an airline balance sheet as an asset on the basis that it represents a future resource, that can subsequently be amortised, stretches credulity.

Accounting rules differ between countries and this makes it difficult to compare airline performances. For example, rules for depreciating aircraft assets vary considerably between countries. Accordingly, it is necessary to take an extremely conservative view of all flag airline financial accounts. This is particularly relevant in the present industry downswing as the book values of assets in airline balance sheets may now be higher than market value. It will be interesting to see what treatment is given to aircraft asset values in the next round of annual profit/loss reports.

In May 2003 it was reported that the number of commercial jets parked in the United States desert was 2,129 and that was up nearly 4%, or 75 jets, since March. The same report further noted that airlines have been tapping the value of their fleets to raise capital and fund losses. The material decline in aircraft values has materially reduced the value of that collateral and that, as a consequence, balance sheet values may be 20-30% higher than market values.

Relevant to this is the fact that aircraft leases carry inherent liabilities for penalties in the event of early breach of the rental contract. In an industry downturn it is difficult to effect early return of leased aircraft against lessor resistance. Thus, in an airline contraction the future rental, contact penalty and return condition liabilities can quickly become a major financial liability. Such liabilities may not be shown as contingencies in airline balance sheets due to the high incidence of leasing. For example, United States airlines are estimated to own only 55% of their aircraft, the rest are leases of various kinds. The New Zealand flag airline’s fleet is only 36% owned.

Cash flow is the deciding factor, not announced profit/loss that may be influenced by numerous non-cash decisions like depreciation policy, asset value judgements, accounting for leases and so on.

Thus, profits that are declared by airlines can be illusory and the only real test is the strength of operating cash flows that are notoriously vulnerable to external impacts.

6.3 Shareholder Value

It is clear that there has been considerable destruction of shareholder value in many flag airlines since they were privatised. Refer **Appendix 2**. It is clearly demonstrated from events that the Taxpayer is the ultimate backstop for a sole designation flag airline that fails financially.

Accurate assessment of what that means in the Australasian context is difficult due to accounting treatment changes over time but even on a superficial basis, the reduction in shareholder value must be substantial.

Polynesian submits that it would be inadvisable for the Commissions to rely on statements of airline profits, or even balance sheets as accurate barometers of airline health. There are too many imprecise or judgemental factors involved. Note the multi-billion USD losses that have been reported by United States airlines in recent years. If those losses were cash then they must surely all have expired by now. Most US airlines are, however, still are still operating, in some cases courtesy of the US government, even though the State is not an airline owner in that country.

The United States Congress passed the "Air Transportation Safety and System Stabilization Act" early in 2002 that allows qualifying airlines to access up to USD 15 billion in emergency grant and guarantee assistance to enable them to continue in operation. Allowing the some of the world's largest airlines to fail was, clearly, not an option.

As far as the Applicants perception of their threatened future is concerned, Polynesian believes the Applicants are not exaggerating their assertions.

Ref:	Q3	Comment on the financial viability of Air New Zealand

The Applicants' current business models are failing, hence their anxiety to achieve change. Specific components of the problem (not necessarily all inclusive) include;

- Adherence to a demonstrably failing business model
- Not returning at least the average cost of capital over at least a decade
- Excessive borrowing to finance high risk expansion
- Loss of shareholder confidence (witness BIL and Singapore Airlines rejection of additional funds injection in 1991/2)
- Disbursement of dividends rather than re-investment.
- Losses on international routes due to persistent under-recovery of capacity costs.
- Unusual (and, possibly, unsustainable) domestic profitability windfalls from exploiting gaps left by failed or compliant competitors.
- Reliance on inflated domestic fares in the absence of active competition.

Some of these effects have been evident over at least the past decade in the case of Qantas and even longer in the case of Air New Zealand and for both airlines can be dated roughly from the dates of their respective privatisations that took both out of government ownership.

In recent time the most severe impacts on the Australian taxpayer have been the privatisation of Qantas where the airline's balance sheet was substantially adjusted by the assumption of debt by the government to the extent of a reported AUD2.5 billion, approximately.

Similarly, in 2002, the New Zealand taxpayer contributed NZD 865 million (plus a further NZD150 million pledge) to enable the airline to survive.

These are massive amounts but so also are some less obvious costs that can be sheeted home to airline business failures, such as;

- Ansett New Zealand lost an estimated NZD 200 million during its term in the New Zealand domestic market. Those losses would have been consolidated into the Ansett Australia group accounts and probably resulted in loss of tax to the Australian IRD.

- Ansett New Zealand's successor, Tasman Pacific (operating under a franchise as Qantas New Zealand) failed and was liquidated, leaving losses estimated at over NZD 120 million.

These losses were ultimately borne by taxpayers through the loss of tax revenues while airline staff and employees in supporting industries lost their jobs and their livelihoods.

Research in various countries, including New Zealand, has revealed that in a given population there is only a relatively small percentage that regularly purchases air travel.

The proportions are estimated to be roughly 80/20. That is to say 80% of the population travels by air only very occasionally or not at all and 20% are occasional or frequent travellers for business and social reasons.

By extrapolation of this argument, 80% of the New Zealand population is subsidising the 20% of frequent travellers who benefit if the airlines fail to charge the real costs of aircraft capacity.

Those "low fares" have eventually got to be made up by the public through (eventual) higher fares or the taxpayer through bailouts after business failure.

Thus, it can be argued that "cheap fares" are only transfers from the non-users of air travel to the frequent users and transfers of airline shareholder liability to Taxpayers.

7.3 Comparison of Existing v/s Possible Business Models

The following diagram illustrates the concepts previously discussed;

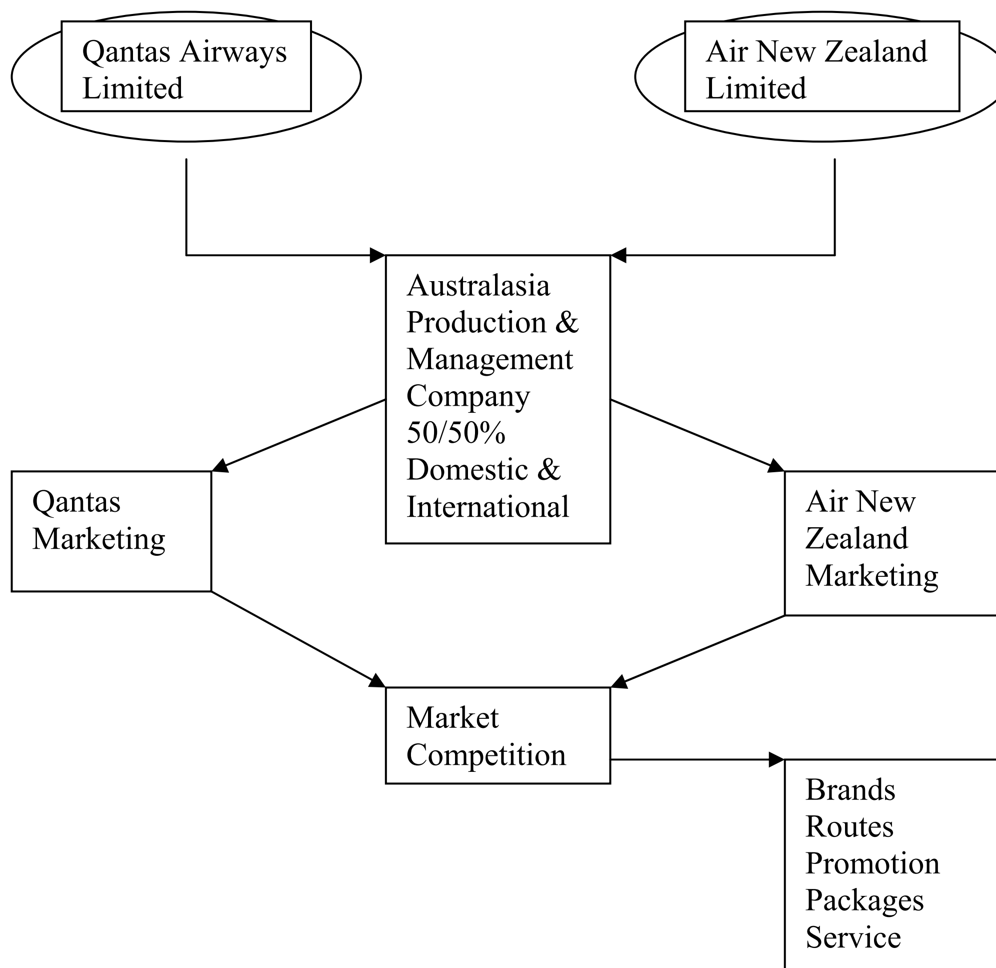
Table 3 Demonstration of Aviation Industry Duplication;

Qantas			**Air New Zealand**	
Fixed Costs	Aircraft: Customised		Fixed Costs	Aircraft: Customised
(Production)	Pilots: Own Type Rated		(Production)	Pilots: Own Type Rated
	Flight attendants: Own			Flight attendants: Own
	Insurance Own negotiation			Insurance Own negotiation
	Maintenance Own crews & facilities. Own spares			Maintenance Own crews & facilities. Own spares
	Dir Op. Costs: Custom Network			Dir Op. Costs: Custom Network

Variable Costs	Overhead: Customised		Variable Costs	Overhead: Customised
	Marketing: Competitive			Marketing: Competitive
	Ground Services; Customised Ramp handling Pax Check-in Aircraft servicing			Ground Services; Customised Ramp handling Pax Check-in Aircraft servicing
	Information Technology Customised			Information Technology Customised

The table reflects two completely separate and competing structures with attendant high cost. The items shown in red are those that represent un-necessary duplication of assets and resources. Where only some of the entries are in red there is still some scope for cost reduction. An alternative business model is suggested as follows;

Table 4 Alternative Low Cost Business Model - Example



Given the small size of New Zealand it would appear eminently sensible for the flag airlines to combine production resources and avoid expensive duplication in a manner similar to the oil industry.

The above model would have a number of advantages and would also solve a number of problems caused by the Public Interest constraints. For example;

7.3.1 Production costs could be cut considerably.

7.3.2 the sovereignty issue of “substantial ownership and control” does not arise.

7.3.3 Competition is retained but in a potentially less ruinous mode.

7.3.4 the production company can be structured as 50/50 ownership for the assets and resources used for routes in and out of New Zealand, thus avoiding issues of contested governance.

7.3.5 the combined assets of the two airlines can be employed to raise capital.

7.3.6 Risks to the taxpayers in both countries would be reduced, substantially, by a more robust business model.

7.3.7 Each marketing company could determine its own requirements for network and scheduling, and contract with the production unit for their supply. Directors and managers of the marketing companies would then be forced to stand or fall by their capacity demands and their subsequent sales strategies. If a marketing company should fail it can be replaced easily without affecting the production structure. The marketing could even be franchised and let out to tender.

Ref:	Q39	Fixing, controlling or maintaining prices

7.3.8 the tourism industries are better protected.

7.3.9 The Applicants staffs have much improved job security.

Compared with the suggested alternative, the current, separate business models are highly duplicative as to costs that must then be recovered in the fares charged.

8, Competition for Revenue

Normal business practice would see responsible directors insisting that management either;

8.1 Charges fares to cover costs and return sufficient surplus to add shareholder value and renew the production assets at the end of their economic lives or;

8.2 If fares are constrained by excessive competition, devise and adopt a business model with lower costs that is capable of achieving positive results.

The Public Interest artificialities previously described are preventing the degree of rationality implied in 8.1 as matters stand today. Thus, if the strong and ongoing public demand for low fares is to be even partly met then the cost of providing the airline service has to be reduced in a fundamental way, as in 8.2 above.

Both the Applicants have experimented with low cost business models (Freedom Air, NZ Express, Australian Airlines) but have scarcely been radical in their approach. Many of the high cost features of FSA operation have been retained or not extended network wide.

If a platform of sustainable fares is to be achieved that attracts additional custom, remunerates shareholders adequately, allows the Applicants to attract sufficient capital and avoids contingent liabilities for the taxpayers then the airline cost structure has to be massively altered.

The practical effect of the alternative business model given as an example in Section 7 could produce a reduction in the fixed assets of the Applicants, a reduction in Direct Operating costs of aircraft and significant reductions in loan charges and personnel costs as well as a large reduction in overheads.

Refer estimates in Table 1.

This would have the effect of making the Applicants more competitive than they are now, through increases in productive efficiency, and could enable a lower platform of fares while still retaining viable profitability.

Ref:	Q48	Likelihood of losses of productive efficiency
Ref:	Q49	Estimates of productive efficiency losses

Within the context of revenue competition it is necessary to comment on airline commercial Alliances, such as One World and Star, and address the question of whether they constitute barriers to market entry or not.

Much hyperbole surrounds the topic. These Alliances have achieved a high profile because the airlines have used them as publicity and promotional pegs on which to hang claims of benefits to the travelling public and, thereby, attract greater customer loyalty.

The reality may be somewhat different and past experience has been mixed.

These commercial Alliances were conceived as mechanisms that would allow flag airlines to access some of the benefits of consolidation when formal mergers are forbidden to them. Specific objectives included;

- Capture of more market share
- Greater cross-utilisation of networks
- Increased Revenue
- Operating cost savings
- Greater Asset and input purchasing power

Although they have been universally and publicly applauded by their airline members, these commercial alliances are not an effective substitute for consolidation and they do have considerable disadvantages and risks.

For example, on the cost side of the equation, it is not easy to achieve any real benefits out of, say, joint purchasing of aircraft or consumable inputs. In practice, the industry's penchant for customising aircraft means that no airline buys a "stock"

model off the Boeing or Airbus shelf and no two countries' regulatory regimes governing equipment appear to be the same.

On the revenue side, the mechanisms by which each airline member interfaces with other members networks in an Alliance can result in expensive ASK capacity being delivered in excessive amounts below cost.

In the system, operating airlines sell capacity to marketing airlines at preferential rates and so run the risk that the yields achieved are below actual cost or close out sales that the operator could have made itself at higher yields.

A curiosity of the airline industry is the frequently heard comment that "we must be doing well because we are always full". The pertinent questions should be "full of what?" and "are we full of traffic returning realistic net yields or full of low yield passengers transferred from partners in the Alliance?

As to whether membership of a commercial Alliance constitutes a barrier to market entry, these commercial alliances are, simply, extensions of the long standing industry practice of interlining that is freely available to airlines who join the industry's trade association, IATA, and use its services.

Note: VBAs do not appear to interline but, instead, stick to point-to-point operations within their own network. In that respect it is their choice to make themselves uncompetitive internationally, except on their own chosen network.

Given what is said above and also given that there are several commercial Alliances available to be joined, other than the two already mentioned, no market entry barriers appear to exist.

That also argues that there could not be any negative impact on Air New Zealand as a consequence of switching from Star to Oneworld. The partnership opportunities over its Asian and US routes are approximately the same, eg American Airlines v/s United.

Ref:	Q41	Implications of possible switch to Oneworld.

9. Competition for Markets

Polynesian agrees with the NZCC's definition of markets.

Ref:	Q2	Comment on market definitions

The topic of airline competition is the subject of much spin and the flag airlines have allowed the politically correct lobby to back them into the corner of saying such things as "we welcome competition" and "we are not afraid of competition".

The business reality is that of course they don't and of course they are!

Leaving that aside, it is clear that competition can vary in intensity and can produce quite different effects.

9.1 Nature of Competition

In the context of the Alliance, mild competition on the income side (Branding, representation, fares) can be consumer friendly because it can keep the airlines lean and is consumer friendly.

On the other hand excessive competition has proved to be merely destructive, with resulting damage to the Public Interest in varying degrees, up to and including the disappearance of an airline altogether (or recurring and costly taxpayer bail outs).

Competition on the income side of the equation should be preserved as far as the Alliance airlines are concerned but they should be allowed to practice a high level of operational cost integration at the same time.

This is a critical point because it is in the Public Interest that there should be competition on all air service routes so as to exercise reasonable control over fares and rates. The severity of competition should not, however, be such that it imperils the flag entity and exposes the Taxpayer to undue risks.

It is appropriate at this point to consider the nature of competition between airlines, in the practical sense and given what has been argued about artificialities affecting their behaviour.

International aviation in the South Pacific region is governed by small populations in countries that are well separated. Traffic volumes are correspondingly light and sectors of greater length than would be the case between high population countries in, say, Europe.

For example, trips from Auckland to Melbourne or Samoa, that we might typically think of as close, short haul journeys, correspond in distance and elapsed flying time with, say, London to Moscow or Athens that Europeans would consider medium haul at least.

Thus, the economics of airline operation in this region are always going to be a fragile combination of high fixed and operating costs and relatively low revenue opportunities. Consistent profitability will always be hard to achieve.

9.2 Competition by Production Cost

From the events of the recent past since deregulation (1980s) would-be new entrants to markets consistently under-estimate the financial risks of mounting and sustaining new air operations. There is no scenario under which air services can be cheap to produce although numerous hopefuls have appeared to believe otherwise.

The fundamental principle, that even experienced airlines do not always optimise, is to achieve the most economic balance between the necessarily high fixed and operating costs of a particular aircraft type and the payload/range characteristics that best fit the routes to be operated and enable maximum block hour utilisation.

This is competition by aircraft choice and, as the following examples for this region show, is the basic building block for airline competitiveness.

- **Good choice characteristics;** Latest technology (characteristic of new models) combination of airframe and engines, high capital cost, high payload capacity, fuel efficient, low seat/km operating cost, low maintenance, long range and ETOPS capability to service New Zealand main trunk as well as medium over-water routes such as the Trans Tasman and New Zealand-Pacific Islands.

- **Not so good choice (typical of older aircraft) characteristics;** Used type (inevitably) customised by previous owner(s), low capital cost, lower payload capacity, heavy on fuel, high seat/km cost, very high on maintenance, fewer route service options due to limited payload/range.

Clearly the judgement that has to be made is between the higher productivity of the newer models and the limitations of the earlier technology. The latter is cheaper to acquire but is more expensive to operate and maintain as well as having less reliability and route flexibility.

The quality of the choice will determine the competitive outcome, all other factors being equal. Since the second choice is often the one made by the new entrant, attracted by the comparatively low cost of entry, an often-fatal disadvantage is built-in at the outset, even without any reaction by an incumbent.

The most notable example of this in recent times was the unequal contest between, firstly, Ansett New Zealand (and, later, by its successor, Tasman Pacific).

The original choice by Ansett of the specialised STOL Bae146 jet with its slower speed, 4 engines, only 75% comparative payload, lower operating ceiling, higher cost maintenance and higher fuel burn was never going to be competitive over time against Air New Zealand's larger and more fuel efficient twin engined B737-200 and subsequent -300 types even though neither of those latter variants matched all the good choice characteristics noted above either.

Although credited with changing the face of air service to the public Ansett New Zealand, almost incredibly, lost over NZD200 million from its operations in New Zealand and its Tasman Pacific successor a reported NZD110 million during its short life.

These losses were not the result of predatory behaviour by the New Zealand flag airline. They were, simply, the result of newcomers mounting challenges, on an equivalent or better FSA model basis, without competitive equipment and competitive production costs.

The above examples are quoted to illustrate that successful market entry and sustained operations require a sound appreciation of the fundamentals. The idea that a virtual airline can be started by renting a pre-owned jet and paying operating costs out of cash flows generated by pre-selling of tickets has often seduced the would-be new operator with limited access to capital.

The cumulative effects of uncompetitive operating costs lead, have inevitably led to trip-up and collapse for those who made the wrong aircraft choice. In those circumstances the market incumbent do not need to react but, simply, wait.

Any entrant seeking to enter and compete a market must have resources equal to the financial risk that is being undertaken. This is not a barrier to entry, it is simply an investment imperative at any time.

Ref: Q20 Likelihood, extent and timeliness of entry to the main trunk market.

In the same context of competition, the public's perceptions of airline competition seem to be solely focused on fares whereas the fight is on the field of production costs, a different game on a different pitch altogether.

Low production costs can support a low fares regime but, obviously, a high cost platform cannot. Attempts to run a low fare strategy against an un-restructured cost platform is a formula for failure and, again, eventual bail out by the Taxpayer.

As regards the New Zealand main trunk, the Tasman and the Pacific Islands markets, there are no barriers to entry of new or existing airlines that satisfy the nationality and the safety/sustainability regulatory criteria that exist to protect the Public Interest.

9.3 Alliance Competition Model

It is clear that the Alliance, if not modified from what is proposed, will have the effect of reducing competition between the present incumbents on all the routes involved including, particularly, the New Zealand main trunk, Tasman and Pacific Islands passenger and freight markets.

The Applications give the impression of seeking to mitigate all forms of competition and in so doing the Applicants have strayed into very negative territory by appearing to promote a full cartel.

This has provoked negative responses from almost every quarter in the public arena as well as from the Commissions themselves in their Draft Determinations. The reactions of the two Trans Tasman governments, however, appear to be much more realistic and reflective of a greater appreciation of the fundamental problems of the industry and of their own two flag airlines. Both governments have given voice to an uncomfortable awareness of the financial risks (capital demand and involuntary investment to prevent failure of essential infrastructure) that both governments are undoubtedly exposed to.

This is also the case for the governments of Samoa and Niue who suffer similar anxieties and exposures that are even much more serious, given their much smaller and more fragile economies.

Ref: Qs 30/31/32/33/34/35/36/37

9.4 Wholesale Travel Services Market

Turning to the wholesale travel market itself, it is again necessary to put it into the proper context, which is that it is founded on a "principal and agency" relationship between the airlines and travel agents.

A major difference in business models between FSAs and VBAs is that the former relies on the travel agency system to a large extent whereas the VBAs do not.

In the context of this commentary, wholesalers are defined as the creators of holiday options that combine ground products with airfares in packages that are then retailed to the public either through the wholesalers own retail arms or via independent retail agents. Some wholesalers and retailers may be airline owned or may be independent but "preferred" under various forms of mutual agreement.

The agency system was originally created by airlines, acting in concert through IATA, to distribute their air services universally. A system of agents in every town could achieve this much more efficiently than the airlines could economically do themselves and the IATA interline system allowed the sale of multi-airline and multi-sector itineraries. Remuneration of agents is by way of sales commissions paid by the airline principals, although ASP support in cash is also prevalent.

Although originally cheaper than any other alternatives at the time, the system has always been viewed by the airlines as expensive and, in more recent times, as the airlines have come under intolerable profit pressure, these commission and ASP support expenses have become a focus for reduction.

Typically the system has cost up to 16% of the gross international revenues of FSA airlines, hence the strong desire on the part of the airline principals to achieve reductions or cheaper alternatives, especially in the face of new activity on some FSA routes by VBAs who do not incur the agency distribution cost and do not interline.

The traditional principal/agency relationship is now in transition as new, electronic, distribution systems like the internet enable the airlines to increasingly sell direct to the public, regardless of the geographical constraint that was a primary strength of the agency system.

The airlines are pressing hard to extend their distribution electronically, enhance their service offerings, reduce their costs and also avoid the tendency for agents to "prefer" other airline competitors. This is obliging the agents to replace airline commission earnings by focusing more on earning fees for travel selection and booking services rendered to the public that were previously free.

Airline websites are becoming increasingly user friendly and although they still have a long way to go in dealing adequately with multiple sector, multiple airline itineraries, the pace of improvement is rapid and unstoppable.

The result is more independence of airlines and a declining dependency on the agency system and fewer commission opportunities for the latter.

Under these circumstances, it is not possible to envisage any reduction in competition in the wholesale travel market, under the factual or the counterfactual, as the real competitors in this market are airlines, not agents.

Ref: Q38 Competition in the national wholesale travel services market

9.5 Competition from Value Based Airlines (VBAs)

It is unfortunate that so much of the debate about the Applications has been sidetracked by emphasis on this subject. The Applicants suffer from the Public Interest constraints, mentioned previously, that deprive them of flexibility whereas the VBAs have selected business models that, as nearly as possible, avoid those constraints.

The Applicants are expected to comply with a regime imposed on them that forces them into contortions in their attempts to emulate the production economics of recent start-up airlines.

The current heavy reliance of the Applicants on domestic operations for profitability is an easy Achilles heel for VBAs or potential VBAs to threaten.

Most VBAs around the world have exploited gaps left by the longer established FSAs who have left market gaps by forcing their customers to fly on route networks devised by the FSAs for their own operational benefit and, as well, have recharged the inflated costs of inefficient business models – albeit models that have been imposed on them imposed upon them by the Public Interest factors discussed earlier.

VBAs have been highly successful in exploiting their selected niches but they have had the advantage of starting with a clean slate. The result is evident from the following comparison;

Table 5 VBA v/s FSA – Typical Characteristics

Functions;	**VBA**	**Example**	**FSA**	**Example**
Market	Domestic	Southwest–USA Virgin Blue–Aust Ryan Air–Inter Europe Easyjet–Inter Europe	Domestic International	Air New Zealand Qantas
Service	Low Cost	Single, efficient aircraft type Minimum inflight Tel/Internet booking No Travel Agents Credit card Payment Provincial airports No interlining No loyalty schemes	High Cost	Multiple a/c types Full inflight Own Offices Tel/Internet Travel Agents Main airports Full interlinability Comprehensive loyalty schemes

With regard to the above table;

Firstly, VBAs typically and successfully use direct selling methods that by-pass the travel agency system. There is, therefore no barrier to entry created by the travel agency system.

Ref: Q12 Availability of travel distribution services.

Secondly: VBAs do not interline. Thus, they voluntarily concentrate on their own business model that features their own network only. Feeder traffic is, therefore, not an issue for them.

Ref: Q13 Feeder traffic as a barrier to market entry.

Thirdly, VBAs use telephone call centres and the internet for bookings. Thus, CRS and GDS systems as used by the FSAs (to enable interlining) are irrelevant to VBAs and so no barrier to market entry is present.

Ref: Q14 Access to CRS/GDS as a barrier to market entry

Fourthly, VBAs do not provide comprehensive catering and what they do make available can be sourced from a host of suppliers. Catering access is no barrier to market entry.

Ref: Q15 Access to catering services as a barrier to entry

Fifthly, VBAs do not employ loyalty schemes and appear to suffer no consequences as a result. Thus, loyalty scheme access has not been, and will not be any barrier to entry.

Ref: Q16 Loyalty schemes as barrier to market entry

Sixthly, VBA business models focus on consumer price. Rightly so, because that is the core of their business model and is aimed at the consumers predilection for low fares. (Note, however, that the public still expects safety and reliability as well as low price). Past experience has demonstrated that, under the low production cost, low price, limited network business models operated by VBAs new brands can become household names almost overnight, as with Virgin Blue, Kiwi Air and Freedom Air. Thus, brands are not a barrier to market entry.

Ref: Q17 Recognised brands as a barrier to entry

VBAs are not a new phenomenon and had their origins in the high volume charter markets within Europe. What is new is their emergence as scheduled airlines operating either in market niches that have been deliberately ignored by the FSAs (Kiwi Air's was a case in point) or exploiting market gaps that opened up as the result of FSA failures (Virgin Blue saw the opportunity that opened up to exploit that market gap following the Ansett failure in Australia).

VBAs are popular with the public because, in an extraordinary turnabout in public attitudes from the 1980s decade, full service is out and cut price is in. This has occurred even when a certain inconvenience is suffered, as is the case in Europe especially, by customers having to travel to and from provincial airports.

With respect to the Applications and the Draft Determinations it is necessary to clear the air concerning Virgin Blue and whether there are or are not barriers to its entry on the Tasman and on New Zealand domestic routes.

Since deregulation the Tasman has not been a reliable source of profits. It is high risk. The main trunk and provincial markets in New Zealand are already well served and only a few exploitable gaps remain at certain provincial airports.

These are dangerous battlegrounds for a VBA to attempt to enter. There is no huge gap as there was post Ansett Australia.

Thus, a VBA like Virgin Blue is facing much higher risks than was the case when it started up in Australia.

Also, Virgin Blue appears to be filibustering in its submissions to the Commissions and the Applicants have allowed themselves to become caught up in futile debate over what may be nothing more than spoiling tactics.

There are no barriers to entry by Virgin Blue either on to the Tasman route or the New Zealand domestic or provincial routes with one small exception that is in its own hands. Virgin Blue is acceptable as a "substantially owned and effectively controlled" Australian airline with full Trans Tasman and New Zealand rights provided Mr Richard Branson steps aside from the chairmanship.

Virgin Blue's arguments otherwise are specious and should be discounted accordingly.

If it wants terminal space in New Zealand or elsewhere then it should commit to new space, as every other airline has had to do. Witness; Ansett Australia's entry to New Zealand domestic operations and Kiwi Air. The New Zealand airports were only too keen to facilitate the construction of new terminals for Ansett to use. There is, consequently, no barrier except Virgin Blue's willingness to invest in facilities itself or, alternatively, negotiate for airports to construct facilities for it to rent. On the basis of past experience, airports are happy to do so.

There is no barrier to entry constituted by any lack of terminal access and there are no other barriers to entry of Virgin Blue on to the Tasman or into the New Zealand domestic or provincial markets. The fact that Virgin Blue has not done so is, obviously, its own commercial decision and not a consequence of any barriers.

Ref:	Q11	Availability of facilities as a barrier to market entry

Ref:	Q20/21/24/25/28/29

New Zealand's regulatory requirements (and Australia's) for new airlines seeking to enter air service markets have been framed in the Public Interest of ensuring safe and reliable operations. They apply equally to existing operators as well as newcomers and, accordingly, do not represent barriers to entry.

Ref:	Q8	Regulatory requirements as a barrier to market entry

It is extra-ordinary that the Applicants appear to be prepared to make concessions to compensate for alleged barriers that are non-existent. It is submitted that it is not in the Public Interest for a flag airline like Air New Zealand, in its substantially publicly owned status, to be offering the use of assets to any privately owned airline that may be balking at investing or commercial risk taking itself.

Thus, the conditions proposed by the Applicants do not appear to be targeted at any Public Interest benefits to New Zealand and are, therefore, considered to be of little merit.

Ref:	Q65	Likely effectiveness of conditions

Reference the debate about Freedom Air that has been generated by the Applications. This airline is a wholly owned subsidiary of Air New Zealand and is not, in any respect, an autonomous operation. It was originally created as, and remains to this day, a low cost defence against loss of business by new start-up or VBA type airlines. As such it was and is a perfectly valid reaction by one airline to a commercial action by another. Freedom Air is not a barrier to new market entrants but is a business model that a newcomer must compete with on equal terms.

Incumbent airlines are entitled to protect their own business by legitimate means.

Ref:	Q9	Comment on likely incumbent response.

The debate that has been generated concerning whether Freedom Air should be sold or shut down is also considered to be futile and mere PR obfuscation.

Freedom Air has no substance because its aircraft, facilities and equipment are all leased and it has no exclusive air service rights or licences that are not available to competitors. It has minimal staff that could easily be absorbed into the parent, as could the business it does. It is a "virtual airline" that, if closed, could easily be re-created at any time.

Because there is no substance there is nothing to sell and, therefore, no prospect of a buyer. It does not, therefore, represent any entry barrier, given that any new entrant is also likely to be a VBA with a similar or identical business model.

10 Tourism

The question of how the benefits of tourism should be assessed has been the subject of innumerable studies whose conclusions will not be repeated here but it is submitted that tourism is a bona fide export industry, of services mainly but also of goods consumed onshore.

Others may argue that most pronouncements of benefits by the industry itself are couched in gross terms and take no account of the real costs of inputs needed to service rising tourist numbers.

There is also a view that inbound tourism is only a benefit to the extent its earnings exceed expenditures by New Zealanders travelling overseas.

Nevertheless, inbound tourism is a significant source of overseas funds that represent export earnings on a very large scale and with a high rate of growth.

The Applicants have postulated considerable increases in inbound arrivals as the consequence of a promise to use the Qantas Holidays organization to promote and sell the New Zealand destination more intensively and also to sell onto Air New Zealand services as opposed to Qantas only.

The Alliance assertion that spending more on ASP and also selling onto Air New Zealand services could enable Qantas Holidays to create incremental inbound tourism business to New Zealand is not compelling. It would, instead, be much more likely to shift market share between the two airlines but is much less likely to result in much new business.

Ref: Q53 Qantas Holidays selling onto Air New Zealand as well as Qantas

If they apply sufficient resources, flag airlines can be effective creators of tourism to a greater extent than national tourism organizations (NTOs).

The flag airlines have revenue and profit imperatives driving their activities whereas NTOs are spenders of taxpayer's funds but have no income. NTOs can only claim to be contributors of the economic benefit from tourism, by such measures as increases in arrivals and increased tourist spending on shore, to which totals the airlines and the private sector tourism industry have also been instrumental contributors.

The reality, however, is that flag airlines and NTOs are both large scale and essential contributors to growth in tourism earnings for New Zealand – the former by pushing its own services and the latter by promoting the New Zealand destination in foreign, source markets – but neither can be effective in the absence of ground product that is attractive to buyers abroad and is available in sufficient and readily accessible capacity.

Ref: Q54 Flag airlines and NTOs as effective promoters of tourism

With respect to their plan to increase inbound tourism to New Zealand, the Applicants case is weakly constructed because, in practical terms, real increases in tourism can only be achieved if increased (or new) air services are targeted at corresponding increases in accommodation and other ground product capacities at holiday destinations. This is the case for domestic as well as international tourism.

A classic example in the industry is that of Fiji where development of tourism has been recurrent cycles of not enough hotel beds followed by pressure for new hotel investment followed by agitation for more flights. In the past there have been numerous attempts by airlines to jump-start the process by investing in hotels.

Airlines can only achieve incremental tourist traffic by selling into spare ground capacity at the ends of existing routes, or into new capacity at existing destinations, or into capacity in new destinations that are not yet served by international airlines.

The Applications do not feature any new destinations in New Zealand nor is there any assessment of unutilised capacities at the ends of existing routes. The apparent assumption is that spare capacity exists in the traditional tourist destinations and, consequently, there is no suggestion of opening new routes to new tourist destinations or development of new products at new locations even though the potential for all of those must surely exist.

It is an established fact that the lack of bednight capacity acts as an effective constraint on airline expansion whereas the opposite is also true if ground product capacity is unrestrained.

The original reasons for most national governments around the world becoming involved in aviation in the first place were, mostly, those same Public Interest factors that still pertain today.

Control of air services became too important (and politically sensitive) to leave to the private sector that was, in any case, proving to be an unreliable provider. The result was nationalisation (most countries) or subsidisation (USA) because governments needed to ensure reliable and safe air services for their own nationals that were demanding the means of travel intra and extra their own countries.

Tourism, as a mass market, arrived much later and only became feasible with the advent of the jet era and the introduction of the jumbo jet that made cheap, mass travel widely available.

Tourism has now developed to the point where it is considered vital to the national economies of many countries, including the New Zealand Public Interest Community.

The Applicants assessment of 50,000 additional inbound tourists to New Zealand is a moderate target given the relatively underdeveloped market potential. The means of delivery proposed by the Applicants are, however, unconvincing but it should not be difficult to devise a more robust better plan with more chance of success.

11. New Routes

By way of introduction to this topic, it is submitted that the development of Regional tourism is very much in New Zealand's Public Interest.

There are provincial regions that merit such development and already have the ground capacity available together with the will to provide any necessary, additional infrastructure.

An example is Southland where local ambitions, backed by sunk investment in ground product and infrastructure, have not been matched by any preparedness on the part of the Applicants to participate in any development project even when local interests are prepared to offer financial support to lower any airline risk involved in mounting new services.

The Commissions are invited to consider the paradox of a New Zealand national flag airline, whose controlling interest has, under great pressure and at huge cost, just been re-acquired by the State with justification on the grounds of Public Interest, primarily in tourism, being unprepared to negotiate with regions having potential for considerable development.

It could be argued that if the Applicants were serious about obtaining approval then some commitments in this regard, that would likely earn them considerable public support, would seem advisable.

Why, in the Public Interest, should the State rescue a flag airline if it subsequently sets its face against tourism development into its own country but, instead, elects to "leave it all to Qantas Holidays"?

The Applicants have offered undertakings to commence several new routes ex New Zealand into Australia but they appear to be aimed at business traffic and some tourism *but only into Australia*. The respective Commissions have indicated disagreement with any public benefits arising from those operations on the grounds that if they were potentially profitable the airlines would already be operating them.

From observations of the past behaviour of the Applicants, it appears that, over a long period of time, both have been extremely unwilling to experiment with new Trans Tasman routes except as the result of competitive pressure. Hamilton, Palmerston North and Dunedin are only now on the international circuit because of the intrusions of Kiwi Air and may only retain their status as long as there is a prospect of another VBA starting up.

Flag airline attitudes have been driven by a policy of holding costs to a minimum by operating as few international airports as possible and also by supporting their domestic arms and getting another bite at the cherry for flights between the main ports and the passengers' preferred destinations.

That policy does not appear to be in the wider Public Interest of tourism development as it adds both time and cost to each affected travellers itinerary.

There is no doubt, as the Applicants themselves say, that direct flights induce higher traffic numbers. Caledon believes that, from past experience, new direct flights into under-developed regions do induce new business that would not otherwise have flown, especially if backed up by concerted effort to promote package deal type opportunities. That is to say, again, combinations of air and ground capacities that are well promoted

Ref:	Q58	Commentary on direct flight effects.

The Applicants have stated a case for increased tourism inbound to New Zealand but have been less than persuasive about how they would go about developing existing routes and tourism potentials.

Still less have they been prepared to focus on other route and tourism opportunities that have been suggested to them but have been ignored.

Nevertheless, the estimates made by the Applicants for the conditional new routes from New Zealand into Australia appear to be reasonable, albeit on the conservative side.

That is not the issue, however, because these new routes could only benefit business travellers and, possibly, some tourism traffic inbound to Australia. There are no new routes into New Zealand proposed by the Applicants so the New Zealand Public Interest is not served and the conditions proposed are of no value to New Zealand.

Ref:	Q65	Likely effectiveness of conditions proposed by the Applicants

The tests for assessing incremental benefits to New Zealand that need to be applied by the Commissions are;

- What new routes targeting incremental inbound traffic to new tourist destinations within New Zealand are the Applicants prepared to offer?
- What new combinations of air and ground services are the Applicants' estimates of incremental tourism based on?
- What levels of investment promotion will be applied to develop traffic and achieve sustainability.

The applications are, perhaps in-advisedly, silent on these matters.

Ref:	Q56	Aircraft capacity and tourism infrastructure constraints

12 Recommended Conditions for Approval

The Applicants' anxiety about their future viability is well founded and is a matter of grave public concern. The Public Interest is consequently at risk and considerable contingent liabilities for the Taxpayers of both States are likely to arise in future (as

they have done in the past) if the present organisational structures of the Applicant airlines are not enabled to adapt.

It is submitted that the supporting arguments relied upon by the Applicants do not do justice to the merits of the Applications and it is, accordingly, proposed that the Commissions undertake further analysis of the matters canvassed in these submissions before reaching final determinations.

It is recommended that the Applicants receive conditional approvals from the Commissions for those components of their applications that would enable a joint, jet aircraft venture to be established to enable their costs of production to be significantly reduced, up to and including joint management of aircraft operations and their supporting assets employed in the following markets;

- New Zealand and Australian domestic, including provincial
- Trans Tasman
- New Zealand-Pacific Islands

It is further recommended that such approval be granted subject to the following conditions;

12.1 The Applicants establish a jointly owned, air service production unit that is to be independent of both airlines marketing arms and is to be the sole provider of saleable capacity to said marketing arms.

12.2 Polynesian Airlines to be included in the proposed joint venture provided that Air New Zealand and Qantas retain voting rights equal with each other.

Note: There is a precedent for this as the Applicants have attached Air Pacific to their Applications on the grounds that it is part owned by Qantas. Samoa also has a residual shareholding in Air Pacific originating from a previous recognition of a Community of Public Interest in aviation. Shares in Polynesian have also been offered to both Qantas and Air New Zealand within the last year.

> As a practical contribution to the wider public interest in tourism, the following two supplementary recommendations are also suggested for the Commissions consideration.

12.3 The Applicants to recognise the Public Interest in tourism development by adopting a positive policy of establishing joint ventures with provincial New Zealand interests with the objective of establishing new direct routes from Australia into new provincial destinations in New Zealand and that the Applicants establish a new Trans Tasman route into Southland via Invercargill Airport within one year.

12.4 The Applicants to produce, within six months of approval being given, a master plan for developing incremental tourism, inbound to New Zealand that

is based on a survey of ground plant availability. The plan is to contain estimates for adequate supply of air service capacity to both existing and new destinations within New Zealand as well as incremental airline investment in promotion and marketing of those destinations. The plan to be endorsed by an appropriate official body. For example, the New Zealand Tourism Board.

Ref:	Q66	Any other conditions that might be appropriate.

Appendix 1

Qantas Airways Ltd/Air New Zealand Ltd
Draft Determinations
Questions

1. The Commission seeks comment on its approach of considering the two applications together.

2. The Commission seeks comment on its market definitions.

3. The Commission seeks comment on the financial viability of Air NZ in the near term.

4. The Commission seeks comment on its definition of the counterfactual.

5. The Commission seeks comment on the likelihood of the “war of attrition” counterfactual as proposed by the applicants.

6. The Commission seeks comment on the capital requirements of entry to the main trunk market and particularly seeks comment on whether the capital requirements constitute a barrier to entry to the market.

7. The Commission seeks comment on the sunk costs of entry to the main trunk market and particularly seeks comment on whether the sunk costs constitute a barrier to entry to the market.

8. The Commission seeks comment on the regulatory requirements of entry to the main trunk market and particularly seeks comment on whether the regulatory requirements constitute a barrier to entry to the market.

9. The Commission seeks comment on the likely incumbent response to entry to the main trunk market and particularly seeks comment on whether the likely incumbent response would constitute a barrier to entry to the market.

10. The Commission seeks comment on the scale and scope required for entry to the main trunk market and particularly seeks comment on whether the scale and scope required constitutes a barrier to entry to the market.

11. The Commission seeks comment on availability of facilities required for entry to the main trunk market and particularly seeks comment on whether access to these facilities would constitute a barrier to entry to the market.

12. The Commission seeks comment on availability of travel distribution services required for entry to the main trunk market and particularly seeks comment on whether access to these services would constitute a barrier to entry to the market.

13. The Commission seeks comment on whether feeder traffic is required for entry to the main trunk market and particularly seeks comment on whether access to feeder traffic would constitute a barrier to entry to the market.

14. The Commission seeks comment on whether access to a CRS or GDS is required for entry to the main trunk market and particularly seeks comment on whether access to CRS or GDS would constitute a barrier to entry to the market.

15. The Commission seeks comment on the availability catering services required for entry to the main trunk market and particularly seeks comment on whether access to these facilities would constitute a barrier to entry to the market.

16. The Commission seeks comment whether loyalty schemes, either the presence of existing incumbent schemes, or a requirement to develop one, would constitute a barrier to entry to the main trunk market.

17. The Commission seeks comment whether the need to either have a recognised brand, or the requirement to develop a brand would constitute a barrier to entry to the main trunk market.

18. The Commission seeks comment whether the size of the main trunk market would constitute a barrier to entry to the market.

19. The Commission seeks comment whether access to pilots or aircraft would constitute a barrier to entry to the market.

20. The Commission seeks comment on the likelihood, extent and timeliness of entry to the main trunk market under both the factual or counterfactual scenarios.

21. The Commission seeks comment on whether Virgin Blue is likely to enter the main trunk market under both the factual or counterfactual scenarios.

22. The Commission seeks comment on whether Origin Pacific would be likely to expand in the main trunk market under both the factual or counterfactual scenarios. Alternatively, the Commission seeks comment on whether Origin Pacific would be likely to retrench in the event that the proposed Alliance proceeded.

23. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the main trunk market when compared with the counterfactual.

24. The Commission seeks comment on the barriers to entry to the provincial market.

25. The Commission seeks comment on whether Virgin Blue is likely to enter the provincial market under either the factual or counterfactual scenarios.

26. The Commission seeks comment on whether Origin Pacific would be likely to expand or retrench in the provincial market under either the factual or counterfactual scenarios.

27. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the Provincial market when compared with the counterfactual.

28. The Commission seeks comment on the barriers to entry to the Tasman market.

29. The Commission seeks comment on whether Virgin Blue is likely to enter the Tasman market under both the factual or counterfactual scenarios.

30. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the Tasman market when compared with the counterfactual.

31. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the NZ-Asia market when compared with the counterfactual.

32. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the NZ-Pacific market when compared with the counterfactual.

33. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the NZ-US market when compared with the counterfactual.

34. The Commission seeks comment on its preliminary view that the proposed Alliance would not have or be likely to have the effect of substantially lessening competition in the International market when compared with the counterfactual.

35. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the domestic airfreight market when compared with the counterfactual.

36. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the Tasman belly hold market when compared with the counterfactual.

37. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the international belly hold freight market when compared with the counterfactual.

38. The Commission seeks comment on its preliminary view that the proposed Alliance would have or would be likely to have the effect of substantially lessening competition in the national wholesale travel services market when compared with the counterfactual.

39. The Commission seeks comment on its preliminary view that the proposed Alliance would result in fixing controlling or maintaining prices and is therefore deemed to substantially lessen competition.

40. The Commission seeks further commentary and analysis on the appropriateness of the assumptions used by NECG in its model of passenger air service markets.

41. The Commission seeks further submissions on the implications of a possible switch by Air NZ to the Oneworld Alliance.

42. The Commission seeks further commentary and analysis on the appropriateness of the assumptions used by Professor Hazledine in his model of passenger air service markets.

43. The Commission seeks views on the appropriateness of Figure 2 as a stylised representation of the NECG model.

44. The Commission seeks further commentary and analysis on the assumptions used in the price discrimination model of passenger air service markets.

45. The Commission seeks further commentary and analysis of the appropriateness of the assumptions used by Professor Gillen in his model of passenger air service markets.

46. The Commission seeks comment on its assessment of the likely sources of losses of dynamic efficiency from the proposed Alliance.

47. The Commission seeks further commentary and analysis on the appropriateness of its estimates of dynamic efficiency losses associated with the proposed Alliance.

48. The Commission seeks comment on its assessment of the likelihood of losses of productive efficiency from the proposed Alliance.

49. The Commission seeks further commentary and analysis on the appropriateness of its estimates of productive efficiency losses associated with the proposed Alliance.

50. The Commission seeks views on its overall approach to detriment assessment in respect of these Applications.

51. The Commission seeks views on its estimation of cost savings?

52. How would the marginal tourist's expenditure differ from that of the average tourist?

53. The Commission seeks views on its assumption that Qantas Holidays would sell packages that include Air NZ airfares if doing so did not deprive Qantas of additional passengers?

54. How effective are the national tourism organisation's promotions? Can airlines promote national tourism as effectively?

55. The Commission seeks views on its estimation of tourism benefits?

56. How should aircraft capacity and tourism infrastructure constraints and risk affect the analysis?

57. The Commission seeks views on its estimation of scheduling benefits?

58. The Commission seeks views on its estimation of direct flight benefits?

59. Is the Commission correct in its estimation of engineering and maintenance benefits?

60. The Commission seeks views on its estimation of freight benefits?

61. The Commission seeks views on its assessment of other benefits?

62. Has the Commission omitted any significant benefits from its analysis?

63. Is the assumption of full employment valid for modelling impacts on the New Zealand economy?

64. The Commission seeks views on its use of welfare, rather than gross figures, to express benefits?

65. The Commission seeks views on the likely effectiveness of the conditions suggested by the Applicants.

66. The Commission seeks views on any other conditions that might be appropriate.

Appendix 2

Extracts from Media Reports: Aviation Industry in 2003; Attempting to Consolidate & Restructure

Airline	Country	Financial Solution	Result	Comments
Swissair	Switzerland	US 4.5 bn in gov't guarantees	Ceased to operate	Immediately re-structured and launched as a new airline, "Swiss" with substantial state funding. Still reporting losses
Sabena	Belgium	Cash Advances from gov't	Ceased to operate	Tried financial restructure Finally liquidated 06 Nov. 01
Canada 3000	Canada	None	Bankrupt. Ceased operations	Canada's second largest airline
Malaysian Airlines	Malaysia	Gov't repurchase of majority shareholding.	Effectively re-nationalized	Failed privatisation but considered essential to Malaysia's tourism industry as the only flag carrier
Ansett Australia Incl ; Skywest, Ansett Intern'l, Hazelton, Kendall	Australia	Aust Gov't Subsidy to Administrator	Voluntary Administration September 2001. Complete shutdown and temporary restart. Failed again in February 2002	Liquidation of whole Ansett group. The Australian government did not intervene because Ansett was a secondary flag airline and apparently not considered essential for State rescue while Qantas remained as the country's major flag carrier and tourist airline.
Air New Zealand	New Zealand	Gov't subscribes to new share issue	Effectively re-nationalized	Failed privatisation. Financial collapse averted by State intervention. 2002 loss reported as largest corporate loss in New Zealand history. Reconstructed with a total taxpayer commitment of NZD 1.035 million
Kiwi Air	New Zealand	None	Ceased to operate	Start-up with VBA-type business model but limited resources Operations not sustainable Liquidated with $8 million in debts.
Tasman Pacific	New Zealand	None	Bankrupt. Ceased operations	Operated as domestic franchise under the name of "Qantas New Zealand". Losses reported of over NZD 120 million
Impulse Airlines	Australia	Sale to Qantas	Merged with Qantas	Failed new Australian domestic market start-up
Air Pacific	Fiji	Cash Injection by Qantas	Under Qantas management	Over-expansion penalty

Garuda	Indonesia	Cash injection by government	Re-nationalized	In Problems since Asian Crisis
US International airlines including ; United, American & Delta	USA	Government cash grants and loan guarantees	Only temporary fixes	Heavy operating losses being incurred. Real problems of staying in business still lie ahead. Emergency support package by Washington of USD15 billion in grants and guarantees
Midway	USA	Chapter 11 bankruptcy	Protected from creditors	Joined into US Airways Express 2003
US Airways	USA	Chapter 11 bankruptcy, August 2002	Protected from creditors	Severe operating losses. 7th biggest US carrier Re-financed with USD900 million loan guarantee assistance from US government Emerged from Chapter 11 31 March 03
Aerolineas Argentinas	Argentina	Part assumption of debt By private sector	Part privatised	Announced intention to emerge from bankruptcy protection 2002
Royal Tongan	Kingdom of Tonga	Assumption of debt by government	Sole B737-200 returned to lessor	International jet operations ceased in 2001 but restarted late 2002 with leased B757. .
Flight West	Australia	None	Grounded and assets sold	A large regional domestic operator Assets acquired by Alliance Airlines – new start-up launched 31 July 02
United Airlines	USA	Chapter 11 bankruptcy	Protected from creditors while Restructuring its cost base Negotiating concessions from labour unions	Second largest US airline Re-structuring with new business model
American Airlines	USA	Restructuring finances	Reported to be avoiding bankruptcy Negotiating concessions from labour unions. Negotiating finances	Largest airline in the world Heavy losses eg reported biggest loss in aviation history of USD 3.5 billion for year to 31/12/02 Re-structuring
Canadian Airlines	Canada	Sought protection from creditors 2003 under Companies Creditors Arrangements Act	Negotiating concessions from labour unions. Negotiating finances	Largest airline in Canada Restructuring with new business model

Notes

1. The underlying issue for the whole aviation industry remains the state of world economies. Airlines tend to be the bellwethers of economies, typically leading trends by up to six months. There is still no sign of any improvement in the fortunes of the US or European majors so it must be assumed that any economic upturn in the US and other major world economies is, at best, still some way off.

2 In view of its influence in the region there has been considerable financial and aviation market interest in the bailout of the airline by the New Zealand government.

On 27 November 2001 it was announced that the government would subscribe to new shares in the airline and additional financing as follows;

- An initial loan of NZD 300 million was subsequently converted to equity at 24 cents a share.
- New shares were be purchased for NZD 585 million at a price of 27 cents a share.
- Government is prepared to commit additional capital up to NZD 150 million.

The net result of 1/ and 2/ above is that government owns 82% of the airline. The total commitment by the New Zealand taxpayer of 1/, 2/ and 3 above is now NZD 1.035 billion.

The flag airline reported a net loss of NZD 320 million for the year to 30 June 2002 on top of the net loss of NZD 1.425 billion that had been reported for the year to 30 June 2001 and the net loss of NZD 600.1 million the year before.

Appendix 3

Glossary of Terms

In the text of this document the meanings ascribed to industry terms and jargon are as follows;

1.	Available Seat Kilometre	Unit of airline passenger capacity production Saleable seats x Distance flown km
2	Available Tonne Kilometre	Unit of Freight Capacity Production. Saleable weight x distance flown km.
3.	Revenue Passenger Kilometre	Unit of Airline Passenger Demand Paying passengers x Distance flown km
4.	Revenue Tonne Kilometre	Unit of Airline Freight Demand Tonnes freight carried x distance flown km.
5.	Block Hour	Measure of aircraft utilisation Engine start-up pre flight to engine shutdown post flight. Usually quoted as block hours/day
6.	Flag Airline	Airline designated by a country to operate its air service rights. If there is only one, it is termed “sole designation”
7.	Bilateral	Air Service Treaty between two countries
8.	Public Interest	As used in public sector documents and Acts
9.	Route	One city pair v.v. i.e. Round Trip
10.	VBA	Value Based Airline i.e. Low Cost Model
11.	FSA	Full Service Airline on the traditional model
12.	Ground Product	Primarily hotel bednight capacity
13.	ACMI	Airline Fixed Costs. (even if a/c doesn’t move) Made up of aircraft ownership/tenure, crews, maintenance and insurance.
14.	DOCs	Direct operating costs (of aircraft movement). Made up of consumables eg fuel, catering, ground handling, air navigation, landing charges, etc
15.	Overheads	Management, Flight Operations, Sales & Marketing, Finance & Accounts
16	VFR	Visiting Friends & Relatives, not tourists

17.	PR	Public Relations
18.	ASP	Advertising and Sales Promotion
19.	Yield	Measure of Revenue earnings. Usually expressed in gross terms as cents per ASK or $ per ATK.
20.	Net Yield	More precise measure of Revenue earnings as actual cash received by airlines to bank after deducting costs of sales.
21	Interlining	Airline practice of accessing each other's networks in order to sell tickets to destinations outside their own network
22	Sector	City pair in one direction e.g. Auckland to Sydney
23	ETOPS	Description of aircraft range capability and regulatory approval to operate over water and distant from alternate airports. Acronym for **E**xtended range **T**win engine **Op**eration**s**
24	NTOs	National tourism organizations i.e. government entities.
25	IATA	Airline trade association. Acronym for **I**nternational **A**ir **T**ransport **A**ssociation
26	STOL	Characteristic of a specialised aircraft type. Acronym for **S**hort **T**ake **O**ff and **L**anding