SUBMISSION TO

NEW ZEALAND COMMERCE COMMISSION

on application by

AIR NEW ZEALAND LIMITED
&
QANTAS AIRWAYS LIMITED

Seeking Authorisation of Certain Restrictive Trade Practices

and of a Proposed Business Acquisition

Submitted by

Gullivers Pacific Group

Andrew Bagnall
Group Managing Director

14 February 2002

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1 EXECUTIVE SUMMARY

1.1 Air New Zealand Limited and Qantas Airways Limited (the Applicants) acknowledge that they propose to engage in restrictive trade practices.

1.2 The Applicants seek authorisation from the Commerce Commission under Section 58 of the Commerce Act to enter into extensive collaborative arrangements that will significantly diminish the current level of competition in domestic, Trans-Tasman and international airline and travel distribution services and GDS markets of New Zealand and Australia.

1.3 The proposal by the Alliance if implemented in its entirety would see a significant number of travel agencies, tour operators and associated services close down, which would lead to an even greater loss of competition and negative economic value to New Zealand.

1.4 The Parties to this submission operate businesses in the wholesale, retail, and corporate travel markets of New Zealand and Australia. Their businesses account for approximately NZ$1.0 billion in total sales per annum, or 28% of the Travel Distribution services market. They employ 1,200 owners, managers and staff who would be seriously affected if authorisation was granted for the proposed restrictive trade practices.

1.5 The Parties to this Submission understand that the New Zealand Commerce Commission may issue the authorisation if it is convinced that public benefits outweigh any competitive detriment.

1.6 The Parties to this Submission do not have access to confidential information provided to the Commission by the Applicants, particularly in regard to the likely consequences for Air NZ in the event that authorisation is not granted. This handicaps the Parties' ability to provide the Commission with a comprehensive, independent assessment of likely public benefits and competitive detriments.

1.7 On the basis of information which is publicly available, the Parties to this submission consider that both the Proposal by the Applicants and supporting analysis by the Network Economics Consulting Group (NECG) overstate likely public benefits and understate competitive detriments.

1.8 This Submission argues that other viable options are available to the Applicants which do not require the proposed strategic alliance, the joint operating arrangement, and the close coordination of Qantas and Air New Zealand services in the domestic, trans-Tasman and international markets.

1.9 The Submission also argues that the proposed collaborative arrangements are most likely to inhibit both existing competition and market entry by new competitors in all markets as defined by the Commerce Commission ref: Bodas (1996). Decision #278.

1.10 The proposal as submitted by the applicants would lead to the demise of the Travel Service distribution market and lead to a monopoly by Air NZ and Qantas. This would be to the detriment of other airlines and the New Zealand traveller.

1.11 The parties to this submission are concerned that the JAO as envisaged could result in Qantas having 50% capacity yet not one seat able to be sold as Qantas from New Zealand. This effectively would give Air NZ a total absolute monopoly on all JAO routes both domestic and international.

1.12 Finally, in the event that the Commission is still persuaded that public benefits outweigh detriments by the total case (including confidential information) presented by the Applicants, the parties recommend that the Commission implement appropriate constraints on the applicants. These constraints are suggested to:

i. preserve existing competition in affected markets,
ii. promote the prospects of entry by other suppliers, and
iii. rectify existing practices by the applicants which reduce competition in breach of the obligations of a dominant market player under the act.

2 INTERESTS OF SUBMITTING PARTIES

2.1 Parties to this Submission are: -

- Gullivers Pacific Group Limited – Retail
- Gullivers Pacific Ltd – Wholesale/Tour Operator
- Holiday Shoppe – Retail
- United Travel Ltd – Retail
- Biztrav – Corporate Travel
- Atlantic Pacific Radius – Corporate Travel
- Signature Travel – Corporate Travel
- Synergi Travel – Corporate Travel

2.2 The parties to this submission currently generate total travel product and service sales of approximately $1.0 billion per annum in New Zealand, that is 28% of the Travel Distribution Services Market. They employ directly 1,200 managers owners and staff. They handle the travel arrangements of approximately 400,000 outbound New Zealand travellers and over 500,000 domestic travel arrangements.

2.3 The Parties offer services to air travel consumers in competition with the direct retail and wholesale sales and distribution services provided by Air NZ and Qantas – and with wholesale and retail travel services provided by Air NZ and Qantas associated and subsidiary companies.

2.4 It is our view that the proposed arrangement between Air New Zealand and Qantas is anti-competitive and breaches Section 36 and 47 of the Commerce Act. The Alliance will not only place the combined airline in a dominant position against "other" airline competitors and in the markets of Distribution Services and Information Services, but through its ability to set fares, rebates, levies and promotional activity and capacity for the two airlines, will effectively remove competition on the routes they serve and the competitive tension a dual competitive pricing structure creates.

2.5 The Parties to this Submission request that all correspondence and notices in respect of this application be directed in the first instance to :

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3 MARKET DOMINANCE

3.1 In Decision 278 (Bodas 1996) the Commerce Commission identified 10 relevant markets which are all affected by the Proposal it is now considering. These relevant markets are:

i. Main trunk passengers air services (main trunk)
ii. Provincial passenger air services (provincial)
iii. Tourist passenger air services (tourist)
iv. Trans-Tasman passenger air services (trans-Tasman)
v. Other International passenger air services (international)
vi. International air freight services
vii. Travel distribution services
viii. Computerised information/reservation services
ix. Engineering services; and
x. Terminal/ground handling services

3.2 The Applicants seek authorisation to engage in the following restrictive trade practices

i) "Qantas and Air New Zealand will coordinate the following services and activities in respect of JAO networks:

all aspects of the pricing of the applicants passenger and freight services, including setting fares, rebates, levies and promotions, level of service fees, development of new fare products, pricing and promotion of holiday destinations, commissions and agency incentives and joint tendering for corporate and government accounts. The applicants will also coordinate procedures for pricing and inventory management. (Para 5.2 Page 8)…"

ii) *…"Facilitate Qantas Holidays maximising the provision of new tourism products, which utilise the JAO networks and promote New Zealand and Australia as a dual destination. (Para 5.7 Page 18)*

iii) *…Alliance Cooperation (non JAO business). Will explore joint purchasing options and may negotiate with suppliers on behalf of each other as expressly agreed from time to time. (Para 6.8)"*

3.3 The Parties consider that the proposed Strategic Alliance will provide the Applicants with a totally dominant position in the New Zealand markets for air travel and travel distribution services.

3.4 Section 3 (9) of the Commerce Act states that a person is in a dominant position if *...." that person as a supplier or an acquirer..... is in a position to exercise a dominant influence over the production, acquisition, supply or price of goods or services."*

3.5 Further, the section states that a determination of dominance shall have regard to :

3.5.1 Market share, technical knowledge and access to materials and capital;

3.5.2 The constraint exercised by competitors or potential competitors

3.5.3 The constraint exercised by buyers or acquirers.

3.5.4 Market Power

3.6 In Bodas 1996 (p63) the Commission stated

> *"In reaching a view on the market power a person has, the Commission considers all the relevant factors that constrain that person in its activities. The lesser the constraint a person faces, the greater level of market power and discretionary ability the person faces, the greater level of market power and discretionary ability the person has to behave in a manner different from the way a competitive market would allow. The Commission must, in this context, determine whether a firm is dominant in terms of the Act.*

3.7 McGechan J in Commerce Commission v Port Nelson (1995) 5 NZBLC 103,762 stated:

> *" The test for 'dominance' is not a prevailing economic theory, to be identified outside the statute. Nevertheless, it remains a term used in the context of a competitive structure, and inevitably economic concepts and technology intrude. 'Dominance' includes a qualitative assessment of market power. It involves more than 'high' market power; more than power to effect 'appreciable' changes in terms of trading. It involves a high degree of market control." (p63 Bodas)*

3.8 On this basis, it is submitted that both Air New Zealand and Qantas currently have a prime facie dominant market position in respective markets as defined in the Bodas report and Commerce Act. Both airlines act at will with the only consideration being their respective current capacity constraints and/or perceived market elasticity of demand or their shareholders wallets at the time.

3.9 The only criteria that has and currently stops optimisation of the profitability of a route is competition between airlines and distributors of airline services. It is the stated intention of the Applicants to create a Joint Airline Operation which would coordinate:

> *"all aspects of the pricing of the applicants passenger and freight services, including setting fares, rebates, levies and promotions, level of service fees, development of new fare products, pricing and promotion of holiday destinations, commissions and agency incentives and joint tendering for corporate and government accounts. The applicants will also coordinate procedures for pricing and inventory management.* (Para 5.2 Page 8)…"

3.10 The proposal before the Commission seeks authorisation for two airlines which are dominant in their respective home markets of New Zealand and Australia to co-ordinate their provision of capacity, flight schedules, pricing, sales, marketing, and customer service operations.

3.11 If granted, authorisation would expand the already dominant positions that Air New Zealand and Qantas enjoy in their respective home markets, on trans-Tasman routes, and on the most significant long haul international routes between Australia and New Zealand, the Pacific Islands, the Americas and the rest of the world.

3.12 The Travel Distribution Services Market in which Parties to this Submission operate would be seriously affected. If the restrictive practices now proposed were authorised, the outcome would be equivalent to Fontera owning its own dairy and supermarket chains and then forcing its retail competitors to buy its products at the same price, or higher, than Fontera's customers. Effectively, this would put competing independent distributors out of business.

3.13 In terms of other likely outcomes from the proposed Air NZ/Qantas Alliance, the Commission has previously concluded that

> *"A company which acquires a dominant position in a market would, by definition, find it profitable to reduce output and raise the price, compared to the output price which would exist in the same market if it were competitive." [Decision 278, paragraph 442, page 93]."*

3.14 The Commission has also previously concluded that:

> *"The lack of competitive pressures on a dominant firm is also likely to result in a product of inferior quality being offered. The company and it staff are likely to adopt a 'take it or leave it attitude to customers, aware that customers have no alternative to which to turn. As noted earlier, the level of service to customers in the domestic passenger air services market has improved significantly as a result of competition. Mr Copeland, for Qantas, emphasised the importance of flight frequency and punctuality, especially for business people. If competition should disappear the position might be reversed." [Decision 278, paragraph 469, page 100]*

3.15 Clearly, serious detriments will arise in the event the Applicants are authorised to engage in the restrictive trade practices associated with their proposal to form an Alliance.

4 CLAIMED PUBLIC BENEFITS & DETRIMENTS

4.1 Parties to this submission argue that, on the basis of information publicly available, the Applicants and their consultants (NECG) are significantly overstating the likely public benefits and under-stating likely competitive detriments that will be generated by their proposed Strategic Alliance.

4.2 The Applicants claim that the following benefits will be generated by their proposed Alliance, and would not be generated without it.

- Increased Tourism
- Increased engineering services
- Increased freight capacity
- Cost savings
- New direct flights

4.3 The Applicants also claim other unquantifiable public benefits arise from the proposed Alliance, such as:

- Enhanced connectivity
- Capital related efficiencies
- Increased global competitiveness; and
- Preservation of a New Zealand national flag carrier.

4.4 Parties to this Submission suggest that unquantifiable public benefits should be given little weight in the balance between benefits and detriments to be undertaken by the Commission.

4.5 Commentary is now provided on the other claimed benefits.

5 COST SAVINGS

5.1 The cost savings of $627M after five years [QF/NZ application, table page 106] are based on economies of scale and improved aircraft selection. No mention is made of the detriments, in the form of cost wastage that a monopoly market will undoubtedly bring. On the question of monopolies the Commissions Decision No. 278 made the observation:

> *"A dominant firm which faces little or no competition in the market is under less pressure to minimise costs and to avoid waste than one which needs to be efficient in order to survive in a competitive market." [Decision 278, paragraph 464, page 99]*

5.2 The Commission has concluded specifically on the question of Air NZ's efficiency when in a dominant market position:

> *Recent history shows that prior to the deregulation of air services, and to the corporatisation and then privatisation of Air NZ, that company suffered from high staffing levels and other excessive costs. While the inefficiency reflected partly an outmoded style of economic management of the economy, and partly government ownership in a protected market environment, it is also indicative of what might happen when a company enjoys a sheltered, near-monopoly position. [Decision 278, paragraph 465, page 99]*

5.3 The proposed cost savings may be helpful in the long run but of more immediate need is the need to focus on an efficiently run business.

5.4 For the last five years Air NZ has reduced marketing and sales costs (using its dominant market position) to reduce sales and marketing costs including that paid to travel distribution services by $101 million. In the same period Air NZ has reduced staff by 1,500 to 9,500 yet labour costs have increased by $105 million. More than 12½% (1,194) of staff receive remuneration in excess of $100,000 p.a. which according to Statistics New Zealand would place them in the top 2-3% of income earners in New Zealand (Air NZ Annual Report 2002). The biggest public benefit that Air NZ could produce is to turn itself into a more efficient airline.

5.5 The latest figures from USA Department of Transport indicate that the difference in profitability of a VBA versus an FSA airline lie with the efficiencies of management and operations. Both VBA's and FSA's share a common concern to achieve profitability from efficient operation with high load factors and good yields per revenue seat kilometre flown. The most significant difference is that FSA's strive for this by offering a greater spread of fares and services. (Appendix A).

5.6 Air NZ's greatest threat is that its own internal operating inefficiencies and costs, together with its investments in non core activities, will haemorrhage its ability to be economically sustainable long term without monopolistic authorisations requested in the Application.

5.7 In the calculation of the savings due to scheduling efficiencies of $47M [QF/NZ application, table page 106] no account has been taken of the detrimental effect to the traveller of reduced frequency of cheaper fares and lack of available capacity and back up, because one aircraft is to operate where two operated previously.

5.8 The Commission's Decision No. 278 has already made the following relevant observation :

> *"Two separate flights on a 'thin' route might suffer lower load factors (more empty seats) and hence reduced profit yield, whereas one code-shared flight, with fewer seats for each airline to fill, could have higher load factors, hence better profit yield." [Decision 278, paragraph 34, page 40]*

5.9 Logically the most likely occurrence of this will be on main trunk routes and Trans Tasman where competition has been prevailing and which will be largely eliminated by the proposed Transaction. The reduction in frequency of service and available capacity under the proposed JAO will be to the detriment of main trunk and Trans Tasman travellers.

5.10 Price elasticity of demand will not be sufficient restriction on fare rises. The NECG report overstates the importance of elasticity of demand, for business travellers (reference current revolt of business travellers in USA to perceived price gouging) (Appendix A) because it does not take into account the fact that these travellers have no practical substitute for air travel between New Zealand's main centres.

5.11 Business travellers, particularly, have an essential requirement to travel efficiently and therefore by air, to conduct export, trade and other related high levels of business in person. The Commissions Decision No. 278 made the observation

> *"The Commission concurs with Dr Gale's view, on the basis that speed and convenience are significant factors for most passengers using air services, and that air services generally constitute separate markets from other forms of transportation." [Decision 278, paragraph 111, page 54]*

5.12 The NECG report offers price elasticities of -0.70 for business customers and -1.65 for leisure customers and advises these figures were arrived at after discussion with the airlines [NECG report page 110]. In a competitive environment where business travellers have an alternative airline to choose on main trunk routes, price elasticity values such as these might apply, but in the monopolistic environment proposed by the Alliance, this theory has doubtful relevance.

5.13 The Applicants' submission places considerable reliance on the premise that barriers to entry are low for a VBA such as Virgin Blue and the threat of a new entrant will be sufficient to have the affect of restricting price rises on main trunk routes.

5.14 The Commission has already reviewed this proposition and concluded that:

> *"The Commission believes that an immediate, vigorous incumbent response would be mounted against a new entrant to the main trunk routes, whether a full service entrant or a value based entrant." [Decision 278, paragraph 100, page 90]*

"The Commission concludes that, together, the factors affecting entry as listed above, indicate that a new entrant, whether a value based airline or full service airline, must prepare for considerable practical and financial difficulty." [Decision 278, paragraph 103, page 91]

5.15 The validity of this conclusion is supported by the manner in which Air NZ addressed the consequences of the collapse of its main domestic competitor, the Tasman Pacific "Qantas New Zealand" operation, in April 2001. Freedom was immediately deployed on Main Trunk routes, instead of an expansion of the existing Air NZ main trunk operation. This deterred entry in strength by Qantas as well as any possible new entry by a VBA operator. Air NZ's approach alarmed its only significant domestic rival Origin Pacific to the point that it sought protection from the New Zealand Government (Ministry of Transport briefing paper to the Prime Minister 23/4/2001

5.16 Qantas tentatively committed, after a void of four months, one, then two, then finally three aircraft on their main route AKL/WLG/CHC - as a token gesture over the last 18 months - as it saw most of its New Zealand corporate customers on the Trans-Tasman and Pacific vanish to Air NZ. . Qantas maintains to this day that they lose money on domestic New Zealand.

5.17 The publicly available material in submissions from the Applicants and their consultants NECG lacks clear statements in regard to the operating capacity that they will commit to <u>all</u> the markets (including provincial New Zealand) that are to be operated under the proposed Joint Airline Operation (JAO) over its initial five years of operation. Some data is provided in Appendix C (pp 194-200) of the NECG Report.

5.18 However, there is no baseline data on the operating capacity that the Applicants are committing to all the affected markets prior to the initiation of the JAO to enable ready measurement of the immediate impact of the Alliance.

5.19 The immediate impacts on operating capacity in affected markets are more important than the longer-term "best intentions" of the Applicants, in the absence of any binding commitment by the Applicants to supply the capacity as outlined in their proposed schedules for first three years of a JAO.

5.20 It should be noted that a cost-saving objective of the JAO would be to optimise the utilisation of the various aircraft types at its disposal, and to rationalise the provision of capacity where the opportunity arises.

5.21 Without an immediate new entry by a significant competitor on trans-Tasman and Main Trunk New Zealand domestic routes, or on any other routes where Air NZ and Qantas are sole suppliers, it is difficult to see that the Applicants will have any incentive to do anything other than constrain capacity and increase price.

5.22 The Applicants and their consultants NECG assert that prospects for new entry by a VBA carrier will be enhanced by their proposed Alliance, and that they will be deterred by the threat of competition from constraining capacity and increasing fares.

5.23 The Parties to this Submission do not share the Applicants' view, and, for reasons advanced later in the Submission, believe the establishment of the JAO will deter new entry and diminish the growth prospects for incumbent competitors.

5.24 It should be noted that the NECG Report (p112) states

> *"there may be some competitive detriment in the provincial New Zealand domestic market."*

5.25 A clear and comprehensive account of the immediate impacts of the proposed JAO in markets currently served independently and competitively by Air NZ and Qantas and their subsidiaries and associates is essential to the calculation of the benefits and detriments arising from the Transaction.

6. TRAVEL DISTRIBUTION SERVICES MARKET

6.1 The Travel and Distribution Services market comprises activities of wholesale/tour operating, corporate travel management and retail distribution services totalling approximately $3 billion in New Zealand.

6.2 Travel Distribution Services may be analysed in three sectors.

6.2.1 Retail leisure distribution.

6.2.2 Corporate travel management.

6.2.3 Wholesale/tour operator.

6.3 Travel agents/wholesalers handle $2.2-2.4 billion and the balance is taken by Air New Zealand direct.

6.4 Air NZ and Qantas operate vertically integrated businesses supplying wholesale and retail travel distribution services as well as direct retail and corporate booking services via their call centres and websites.

6.5 The proposed Transaction would enable the Air NZ/Qantas Alliance to exercise dominance in the market for Travel Distribution Services, particularly in the business and tour operations travel segment of that market

6.6 Air NZ and Qantas airline services equate to between 70-80% of all airline sales for each and every travel distributor in New Zealand. The proposed Alliance not only concentrates the two airline's power in the airline services market, it also concentrates their power in the travel services distribution market.

6.7 Further, the modelling of the Alliance operation has not taken into account the impact that the inevitable reduction in the number of the independent travel agencies in New Zealand will have on the ability of foreign carriers to market their services in this country, particularly those who exercise fifth freedom rights to compete with Qantas and Air NZ on trans Tasman and other international routes.

6.8 In New Zealand, Air NZ operates Air New Zealand Destinations (events and tour packaging), Travel Centres (retail outlets), and Business Direct (a unit marketing business travel services). Air NZ reservations (Call centres) and electronic and internet bookings (retail via web and email).

6.9 In Australia, Qantas operates Qantas Holidays (its travel service packaging business), Call centres, retail agencies, and Qantas Business Travel (QBT - the dominant provider of business travel agency services (50%+ of the market) in Australia and also the dominant provider of travel agency services to the Australian Government).

6.10 In the New Zealand travel distribution services market, there are approximately 800 independent retail and inbound travel agencies in New Zealand, who are not owned or operated by Air NZ or Qantas. They employ in excess of 5,000 people, who will be directly detrimentally affected (excluding any multiplier effect), especially in provincial New Zealand. They also market the services of airlines, including other international airlines that compete with Qantas and Air NZ together with rental cars, hotels, accommodation, rail, coach and other services.

6.11 Travel agencies are located throughout New Zealand from Kaitaia to Invercargill. They make a significant contribution to the New Zealand economy and are an important part of the community of small town and rural New Zealand. The major brands are: Holiday Shoppe, United Travel, Flight Centre, House of Travel, Harvey World and Travel Smart. Their combined promotional spend is over $10million.

6.12 The Travel Distribution Services market is a very competitive business with an average net profit of less than 1% of sales. The industry is highly competitive and has demonstrated the ability to be profitable except where anti competitive practices result in arbitrary outcomes.

6.13 The specialists in the corporate travel market include: Atlantic Pacific Radius, Synergi Travel, Signature Travel, BTI New Zealand, BizTrav and Corporate Traveller.

6.14 The major wholesalers are: Gullivers Holidays, Tek Travel, Go International, Travel Plan, Infinity, Escape Holidays, Travel Arrangements, Air New Zealand Destinations, together with a number of niche operators. Together they produce over 1 million brochures and spend over $10 million dollars on promotion.

6.15 The major airfare consolidators are Gullivers, Tek Travel, Go International and First. These consolidators provide airfare distribution for all of the airlines including those who do not have their own representation in New Zealand.

6.16 Wholesalers, consolidators, retail and corporate travel agents handle the travel arrangements for the majority of outbound passengers, which in the year January to December 2002 totalled 1,292,979. The proposal to use QF Holidays will have a substantial detrimental effect on the New Zealand travel distribution services market.

6.17 The Bodus decision of 1996 concluded that at that time no one had a dominant position in the travel distribution market. Given that the industry did not make submissions on this issue that may or may not have been the true position, but since 1996 there have been substantial changes in the market.

- Air New Zealand (Air NZ)has gained a significant increase in business direct through their owned retail distribution.

- Air NZ has gained business through pricing, condition waiver and incentive and promotional practices on an increasingly sustained and systematic basis.

- Air NZ has consolidated its dominance in the New Zealand domestic market – 80%+ following the demise of Qantas New Zealand formerly Ansett New Zealand.

- Air NZ has made two substantial unilateral changes to the commission payments of all agents for domestic. Firstly, a reduction from 5% to 4% (1996), and secondly, to zero in 2002.

- Air NZ and Qantas together unilaterally reduced commission on the Trans Tasman from 9% down to 5%. (One day's difference in implementation).

- Air NZ and Qantas will not agree to have any voting representation from the Travel Agents onto the agent licensing governing body, i.e. IATA, to oversee or manage the distribution of travel services in New Zealand. Notwithstanding that the concept of equal representation of airlines/distribution services was recommended by the International Board of IATA.

6.18 Air NZ through its involvement with IATA Clearing House (BSP) is attempting to impose a requirement for travel agents to provide a bond sufficiently substantial that no airline operating in New Zealand or collecting money from New Zealand were to ever have any risk of agent default. They are looking for a collective bond of approximately $20 million.

6.19 Since 1996 travel agents have been faced with a series of major airline collapses including VBA's – Kiwi Air/Compass/Canada 3000 together with Qantas New Zealand, Ansett Australia and Swiss Air, which has left the travel distribution services as a creditor for in excess of $15 million. With the existing IATA Passenger Sales Agency Agreement unilaterally imposed upon the distribution services there is no redress opportunity. With the current travel agency licensing for IATA and its exemption from the Commerce Act there is no avenue to seek redress or obtain a balance in negotiation or competition.

6.20 Air NZ through its vertical integration has been involved with its direct customers in a series of exclusive practices including but not limited to direct discount pricing, special fares, condition waivers, benefit add-ons, capacity class breaks and fare matching waivers that are unavailable as of right to the distribution.

6.21 With the above changes in context with the current market practices we consider that in the travel distribution services market Air NZ has a dominant market position and from time to time uses this in a manner to preference its own retail distribution activities and drive business for its airline services markets. The requirement for Travel Agents to be able to service both domestic and international airline services, apply frequent flyer point redemptions and manage the class and capacity waivers required that only Air NZ can provide mean that Air NZ's dominance of domestic and international airline services means that Air NZ dominates the travel services distribution market at whim.

6.22 Air NZ has marketed its domestic services via its website for approximately 4 years at filed tariff prices equivalent to those advised to travel agents and sold through GDS's. In this period in spite of all promotions both direct to frequent flyer member and in general advertising Air NZ advised publicly that total bookings were still less than 4% of New Zealand sales. This changed in July 2002 when Air NZ introduced discount pricing to their website and promoted this on national television while it contemporaneously reduced travel agents commission to zero on filed fares which were higher than those promoted through Air NZ owned retail and the zero commission further required agents to levy service/booking fees. This unilaterally imposed differential has resulted, in less than 5 months, Air NZ moving to approximately 35% of its domestic travel services being received direct on their website together with a substantial gain of business through its other direct retail activities – Call Centres, Air NZ Travel Centres and its corporate division, Business Direct. All of this to the detriment of the existing Travel Services Distribution.

6.23 Air NZ's ability to control or influence the imposition of IATA regulations under which the travel distribution operates is evident. Where they wish to use the rules to their advantage they do, for example, while paying zero commission for the sale of domestic services they require travel agents undertake services for Air NZ customers at no charge – reference Pacesetter Travel Appendix B – even when pre-advised by the agent of what the agent's charges for services will be. When Air NZ does not wish to abide by IATA resolutions, e.g. payment of commission on international services, it together with Qantas redefined the Trans Tasman as a "domestic service" and unilaterally reduced the commission from 9% to 5%, as domestic services are exempt from IATA International provisions. There was not enough competition on those routes to enable any effective challenge to this unilateral halving of remuneration. Furthermore in moving the competition Air NZ in an effort to increase its market share on the Trans Tasman introduced their ARIS scheme, which uses confidential information from GDS's to determine market share under which Air NZ paid up to 11% for agents to preference Air NZ. This was more than double the base commission and has led to significant market distortion.

6.24 Currently Air NZ does not pay any commission or remuneration on any domestic travel booked/advised or ticketed. It has in place a scheme whereby travel agents may earn a little volume or loyalty payment. This scheme is called ARIS. The ARIS scheme operated by Air NZ currently pays agent distributors overrides on domestic air business but only for travel on competing routes. Travel on provincial routes gets no recognition under ARIS. Should the Alliance proposal proceed then Air NZ will be in complete control of which routes will be considered competing routes. In fact Air NZ would be in such a dominant position the airline would be able to cease ARIS payments for domestic travel. This would have the effect of bankruptcy in forcing the closure of most if not all non Air NZ and Qantas travel distributors in New Zealand. This is almost every travel distributor as Air NZ and Qantas services equate to between 70-80% of all airline sales for each and every travel distributor.

6.25 ARIS is Air NZ's incentive scheme to replace part or all of any remuneration paid by Air NZ for the distribution of travel services. To survive as a travel agent it is imperative that you meet the substantial targets on this scheme because Air NZ is responsible for more than 80% of all domestic services and approximately 48% of international. Any travel distribution outlet has bare shelves if it does not stock Air NZ. The scheme rewards for market share, growth and combined loyalty on all markets and has paid little or nothing for volume per se.

6.26 Barriers to Entry have increased significantly. The requirements for automation and technology are increasingly raising the cost as is the increased bonding requirement and the need to be a member of a reasonable sized distribution brand to have access to and share in volume payments and advertising support.

6.27 A further example of Air NZ using its dominant position and its vertical integration to favour its own distribution system is in the method of charging transaction fees. Currently fees charged by Business Direct (the Air NZ Corporate Agency) can be charged to corporate clients through the Air NZ-owned Travelcard billing system along with the corporate client's air travel costs and/or discounts on fees implemented by the airline. This in effect is a transfer payment from the airline. Fees charged by independent agencies must be collected from the corporate client separately from the ticket. Air NZ could resolve this problem for independent agencies by setting up a new 'ticketing' field for transaction fees but refuses to do so notwithstanding it does so for other independent agencies such as Airports and its own services such as insurance and miscellaneous charges.

6.28 Should the Alliance proposal proceed Air NZ would be in a position to further favour its own distribution service on a grand scale by offering corporate clients and Government bodies discounts and other inducements such as free Koru Club memberships as transaction fees in return for a commitment to booking exclusively through the airlines own distribution system. This it does on an adhoc basis to secure business today. These inducements are generally not available to businesses that choose to book through independent travel agents and experience indicates they will be increasingly unlikely to be available if this application is approved.

6.29 The QF/NZ Submission includes the provision that they will co-ordinate incentive programmes, treating all passengers as being equivalent [QF/NZ Submission, paragraph 26, page 19]. This indicates that agreements currently in place with the airlines for Government agencies and corporates will be under threat. Because of the competitive situation these agreements have provided significant cost savings for business travel and have included SLA's on airline performance.

Under the monopolistic environment proposed, it is doubtful these agreements would exist.

6.30 Equally important, Air NZ, who will be controlling the proposed JAO, has made no commitments to frequency/punctuality/competition pricing for business people. In fact it has indicated that the outcome of the JAO will be quite the opposite.

6.31 The proposal to use Qantas Holidays (QF Holidays) to attract additional visitors to New Zealand will ultimately have a substantial detrimental effect on the New Zealand travel distribution services market. Given the JAO application seeks authority for Air NZ to utilise various services including QF Holidays facilities to handle all their travel wholesaling and tour operating. The New Zealand wholesaling and tour operating employs in excess of 1,000 people and all these jobs will be at risk should the JAO be implemented. The modelling by NECG has indicated that proposal to use QF Holidays will indirectly add 2,500 jobs in New Zealand by the increased tourist numbers but it has not factored in any of the job losses direct and indirect in the travel industry in New Zealand that will inevitably occur with the applicants focus on expanding the activities of QF Holidays.

6.32 Approximately 10 years ago the outcome of preferential internal pricing and capacity treatment for QF Holidays by Qantas contributed to the collapse of the major independent travel wholesalers in Australia. This competition has never re-emerged. The same outcome will be seen in New Zealand where existing independent wholesalers will be cut out of the market, resulting in a substantial reduction of employment in the NZ travel industry.

6.33 QF Holidays operate differently to other wholesalers. Through a combination of internally managed preferential fares, promotional expenditure and exclusive capacity arrangements that cannot be matched in either price or capacity by any third party wholesaler. QF Holiday net profit is greater than the gross margin most wholesalers are given to operate with. If this position was allowed into

New Zealand independent wholesale and tour operation distribution, excluding minor niche marketers, would disappear.

6.34 Wholesale airfares (consolidation), as distinct to tour operations (airfares plus land), is a major part of the activity of the travel distribution wholesaler in New Zealand. This wholesale of airfares accounts for approximately 25% of all the international airfares sold in New Zealand. All major distribution chains operate wholesale airfare divisions which primarily act as a conduit and market distribution for the non-Air NZ and Qantas airlines. New Zealand is such a diverse geographic market with very small economies of scale all international airlines operating into New Zealand need independent services of a travel distribution network to market and distribute their product as they simply cannot compete on any remotely level footing with the dominant market player of Air NZ without an effective distribution and travel communications service which is provided by the independent travel agent and wholesaler. This facility deemed essential by the ACCC, reference decision A90408 13 May 2002 (Appendix D), for the effective operation of a competitive market place. If it was essential in Australia it must be even more essential in New Zealand to maintain a strong competitive, diverse and independent travel distribution service in New Zealand.

6.35 When you consider that QF Holidays will increase its market share in New Zealand, you can appreciate that any gain that QF Holidays makes in Australia will be at the expense of jobs and business in New Zealand and will add to the attractiveness of the proposed and often speculated float of QF Holidays in Australia, which will enrich Australians at the expense of New Zealanders.

6.36 The Alliance focus on the expansion of QF Holidays will lead to QF Holidays and Air NZ Destinations domination of the New Zealand travel industry as QF Holidays already does in Australia. If QF Holidays is facilitated into New Zealand under the guise of a JAO then ultimately travellers will have little choice and will be total price takers.

6.37 Air NZ officials have made public comment that their wish list is to have all point to point fares within and to/from New Zealand booked direct with Air NZ. The

NECG report clarifies their position that the future of the travel agents simply as a service provider of travel information for which the customer should pay direct. Implementation of the JAO would fulfil their wishes and lead to the demise of all but a few service providers of information in the industry. The travel distribution also facilitates sale and distribution of many other principals' products which add and make up the very reason for people to purchase an airfare. Travel agents facilitate and act as a co-ordinator of all consumers travel dreams. To expect a travel agency to sell only the dream at the end of the airfare is analogous to expecting supermarkets to give up on all their staple products such as milk, bread and survive only on selling foie gras. This is simply not a reality and there are no foie gras only shops in New Zealand, all businesses need staple products to survive. This is expected by the consumer. However Air NZ expect the travel agent to pay for simply accessing the airlines product availability whether a sale takes place or not. i.e. The travel agent of the future will pay for this information that the airline makes free to the consumer. Furthermore using its dominant position to eliminate all domestic commissions and then sell at an even lower price direct as Air NZ has done appears to be evidence of an abuse of a dominant market position to the ultimate detriment of the consumer.

6.38 There have been a number of contradictory statements as to the profitability of various routes. Air NZ has publicly indicated it is losing in excess of $200 million in its international routes, and Qantas has announced it is now making money on the Trans Tasman. Air NZ also is expecting a profit in the order of $250 million plus for the 2003 year, which by deduction indicates a profit in excess of $450 million on its Trans Tasman, domestic services and engineering. Given its domestic sales are less than $1 billion the decision to eliminate all commission to travel agents on the grounds of costs does require close scrutiny. As an outcome of this application by Air NZ and Qantas the parties to this submission will request the Commission to review a number of activities by Air NZ with regard to the distribution services market and the computerised information reservation services market and see if they should more correctly be viewed in terms of Section 36 and whether Sections 83 through 85 should apply.

6.39 Virgin Blue has already described the manner in which Qantas has sought competitive advantage through its vertical integration in the business travel agency sector in an effort to limit the success of the VBA in Australia.

> *" QBT has adopted a number of practices designed to limit the success of Virgin Blue in the business market. These include: the practice of not booking the best available fare on the day for business clients, often contrary to contractual arrangements, where these fares are offered by Virgin Blue; and the practice of including a global financial offer which bundles low cost services with preferential rates on overseas and business class travel which is only available through Qantas. This significantly impacts upon the ability of other airlines, both international (such as United Airlines and Air New Zealand) and regional carriers (such as REX) who cannot offer the same scope of services to compete " (Virgin Blue submission to NZ Commerce Commission, p11)*

6.40 Further examples of the manner in which Air NZ has employed its vertical integration to disadvantage their competitors in the travel services distribution sector are outlined in the following section of this Submission on the Computerised Information/Reservation Services Market.

6.41 Should the Alliance proposal proceed then Air NZ will have unfettered power to determine which routes will be considered competing routes. In fact, Air NZ would be in such a dominant position that it would be able to cease ARIS payments for domestic travel, Trans Tasman and international. i.e. There would be no incentive or requirement to compete.

6.42 Under the proposed Alliance, there would be no competitive pressure on Qantas to continue paying commissions to travel agents wherever Air NZ has ceased paying commission or decides to cease commission payments.

6.43 The proposed Alliance would be in a position to eliminate commission on sales for all airline services provided by the JAO, depriving independent travel agencies of between 70% and 80% of their revenue from airline commissions.

6.44 Air NZ has encouraged independent travel agents to introduce fees for providing their services including charges for making reservations and issuing tickets to customers to compensate for the loss of commissions. Air NZ has introduced some fees for their direct customers but at such a low level (below any reasonable cost) that they again are acting as a competitive constraint by cross-subsidising from other sectors of the company.

6.45 This would be a reasonable approach if the Air NZ/Qantas Alliance required its own wholesale and retail business to adopt the same approach – and to operate on the same arms-length basis as their independent competitors, receiving no special benefit because they are owned by the airlines.

6.46 In vertically integrated businesses, no guarantee can be provided that internal transfer pricing policies do not deliver benefits to 100% owned subsidiaries that are not available to their independent competitors. This submission and others made to the Commission contain information that suggests anti-competitive internal pricing practices exist today. Opportunities for an expansion of these practices would be created by the authorisation of restrictive trade practices by the Alliance.

6.47 For this reason, the Parties to this Submission believe that if the Alliance is to be authorised, the Applicants should be required to divest their wholesale and retail travel distribution businesses in New Zealand, close their Business Direct operations in the New Zealand business travel market and in Australia, and outsource their Call Centres and website fulfilment.

6.48 This would enable a truly competitive market to develop for the provision of wholesale and retail travel services in New Zealand which would deliver more benefits to consumers by way of choice, efficiency, and more comprehensive access than would be delivered by the operation of the Alliance as it is currently proposed.

7 COMPUTERISED INFORMATION/RESERVATION SERVICES MARKET

7.1 There are two types of computerised information and reservation systems that are relevant to the proposed Transaction:

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

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

7.2 Recently Air NZ has used its Carina system (CRS) to provide to its owned retail distribution (Business Direct/Travel Centres/Call Centres and Retail website) lower priced airfares and more capacity than is available through the GDS.

7.3 Until 1998 Air NZ, along with Qantas, owned the National Marketing Companies controlling Sabre (Fantasia) and Galileo through TIAS and they excluded 'last seat' availability in Amadeus as they did previously with System One. The ability for the Alliance to exclude capacity, manage classes and pricing in a GDS by biasing toward their own in-house system as Air New Zealand has done would normally constitute highly uncompetitive behaviour. The USA Administration is currently investigating US airlines for potential breaches of anti trust law by differential pricing. This potential for bias and unjustified abuse, even if inadvertent, is one reason why US Airlines stay out of almost all retail distribution.

7.4 The GDS provide airlines with access to data on travel agents forward bookings by route and by carrier and also carrier travelled. In New Zealand, Air NZ and Qantas use this data to set market share targets for overrides and other payments to agents. In short, it provides them with a tool to make it unattractive for agents to sell air travel on other carriers. The JAO agreement commits both

Air NZ and Qantas to preferencing their availability and reservations services on all CRS and GDS over all other suppliers which would be prima facie in breach of both the law and conduct in both Europe and USA with dire consequences.

7.5 GDS's provide airlines with an essential service by way of advising airlines worldwide of ticket numbers and flight and schedule changes. Current IATA mandates on BSP payments require agents to be a GDS subscriber to issue tickets through GDS software which advises BSP and the appropriate airline of the transaction and costs. It is virtually impossible to contemplate how a travel agent could manage two separate reservation systems to include Air NZ CRS interface (if accepted by Air NZ) and manage the accounting and administration of the transaction effectively.

7.6 Air NZ has also used the GDS to exert market power favouring its own distribution outlets to the disadvantage of other travel service distributors. The Air NZ GDS based fares available through travel agents are higher than those charged by Air NZ's own Travel Centres, its own corporate agency Business Direct, its call centres and relevant web booking site.

7.7 The option of booking through Air NZ's website to avoid the higher fares is not a practical solution for independent agencies and places them in a disadvantaged position in comparison to Air NZ's own distribution agencies who are not required to book through the website to avoid what amounts to a higher charge for the identical service with what Air NZ charges its owned retail distribution.

7.8 Air NZ has maintained that the fare differentials are based on differing costs. Yet there does not appear to be any cost brought into account for the web booking engine and associated administration that is an integral part of Air NZ's system. Global pricing for the product used is in the range of US$5-8 per booking.

7.9 The ability of Air NZ to publicly promote price differential by using its CRS to the exclusion of all travel agents has enabled Air NZ to dominate the New Zealand domestic airline market. When commissions were paid and Air NZ's CRS had the same prices as travel agents GDS it took four years for ANZ to get 4% of sales direct via the web and indications were that these were simply a transfer from Air NZ Call Centres. Since removing commissions and pricing higher in GDS in

July 2002, Air NZ has moved its direct market share to more than 50% in the period of six months. Internet bookings alone have gone from less than 5% of market to 35%. GDS data indicate that this has come directly from the travel agency distribution. This process is substantial affecting both the GDS market and the ability of agents to survive. The JAO threatens and envisages even greater dominance of the airlines CRS as it commits Air NZ to having a CRS compatible for interfacing with the QF CRS as to fares, conditions and capacity.

7.10 Under TIAS ownership Sabre (Fantasia) and Galileo induced New Zealand travel agents to sign 5 year contracts for the access to and distribution of GDS services. In 2001 TIAS completed the sell-back to Galileo and Sabre of all these travel agent contracts for the sum of approximately $160 million. This was the goodwill for the profitability of these contracts with agents. Air NZ booked $80 million extraordinary profit in its 2001 accounts. Subsequently Air NZ appears to have been using its market power to bypass the GDS and restraints of trade that were entered into with the sale by TIAS to provide discounted fares and services to its owned retail distribution which are not available to the travel industry via the GDS. At the same time travel agents are locked into longterm GDS contracts with no alternatives.

8 NEW ZEALAND DOMESTIC AIR SERVICE MARKET

8.1 The Commission has previously concluded that the Domestic Passenger Air Services Markets can be separated into three markets;

- Main trunk passenger air services;
- Provincial passenger air services; and
- Tourist passenger air services.

[Decision 278, paragraph 135, page 58]

We offer the following observations with reference to each of these categories.

Main Trunk Passenger Air Services (Main Trunk)

8.2 The Alliance proposal would place Air New Zealand in a dominant competitive position in the main trunk market. It would control all areas of pricing, scheduling, and capacity, retail and wholesale remuneration (if any) and distribution channels.

8.3 Under the Alliance proposal yield managers will be in a position to manipulate the loadings and the capacity available for smart and saver fares, by any combination of aircraft, route, departure times or departure dates. This will have the effect of increasing the average fare to the detriment of the traveller and with out any apparent change in published fares. The Alliance would not need to acknowledge publicly how much average fares have increased but would be able to increase costs to business travellers by employing a route management strategy which targets the services they frequently use.

8.4 The airline would be under no obligation to report unsatisfied customers who could not obtain either flights and/or appropriate pricing for the time slots desired. This will have a significant effect on the business traveller who represents up to 65% of main trunk services (Appendix E Table 37 NECG).

8.5 Origin Pacific provides some limited competition on Main Trunk routes. It has only been able to compete on NZ main trunk routes with Qantas Airways assistance. The NECG report concludes that in the future, the Alliance may impact on the ability of Origin Pacific to compete:

> *"A loss of code sharing is therefore likely to make expansion more difficult for Origin Pacific and indeed might even lead to some contraction." [NECG Report section 4.3, page 119].*

8.6 We suggest "contraction" may better read cessation. In either event, Origin Pacific has provided an essential service, introducing new provincial connections, and maintained price constraining pressure on provincial routes where it competes with Air Z Link airlines. It should not be penalised now for delivering these public benefits.

Provincial Passenger Air Services Market

8.7 The JOA proposal offers little prospect that the current competition between Origin Pacific and Air NZ Link airlines on regional routes will be sustained in the medium term in view of the two year limit to be placed on arrangements for passenger feed exchanges between Origin Pacific and Qantas.

8.8 The elimination of competition between Qantas and Air New Zealand or any other larger carrier on main trunk routes will deter new entrants from competing with Air NZ Link to provide regional air services to exchange passenger feed with the JAO network. This will create new opportunities for monopoly pricing of fares for travel on uncontested routes in regional New Zealand.

8.9 The QF/NZ submission further claims the growth of Origin Pacific in the past six years is evidence that barriers to entry have been low [*QF/NZ application, paragraph 188, page 62*]. The reality is that conditions will be different. If the Alliance proposal proceeds, Origin Pacific will lose its code sharing and financial underwriting arrangements with Qantas. It will then be in a disadvantaged if not in an impossible position.

9 TOURIST MARKET

9.1 The Tourist Market has two segments, New Zealand Tourist (Outbound) and International Tourist (Inbound).

9.2 The applicants claim that there is a high degree of demand-side substitutability…

> *"Consumers can, and do, choose from a variety of sun-seeking holiday destinations, which have broadly comparable prices". (Submission Para 147 Page 51)*

9.3 An analysis of New Zealand outbound travel statistics shows that this claim cannot be substantiated and this is supported by wholesale travel statistics.

9.4 Although the Australian experience may indicate that the Solomon Islands is a substitute for Fiji or the Barrier Reef, this is not the situation in New Zealand (Statistics NZ).

9.5 New Zealand Residents "Holiday" (as distinct to Visiting Friends and Relatives [VFR] and Corporate) departures by destinations 2001 year were:

Australia	286,554	Queensland 40% - 114,621
Fiji	45,363	
Cook Islands	14,774	
Bali	12,831	
Thailand	11,897	Phuket/Koh Samui – Approx 6,000
Norfolk Island	5,243	
New Caledonia	5,235	
Samoa	4,665	
Vanuatu	4,432	
Tonga	2,712	
Tahiti	2,543	

Note: Many VFR designated departures involve a portion of "Holiday" but are flagged by "Prime" purpose.

9.6 A limited degree of substitutability only exists between certain destinations based on the market segments travelling. From our experience this tends to be limited to between Islands of South-West Pacific and Queensland if safety is an issue, e.g. in the aftermath of the Fiji Coup and the Bali bombing.

Family Market Substitutability

9.7 In terms of family group travel, there is a relatively high degree of substitutability between Fiji, Vanuatu, Cook Islands, Gold Coast Australia.
This arises from similarities in:

- Flying time - 2½ - 4 hours
- Resort style accommodation with special facilities for children
- Overall price of family holiday
- Familiarity
- Destination as well as resorts/accommodation cater to children
- Low safety health risks
- Sun/beach/swimming

9.8 Substitutability with Asia is limited and usually only possible for families with older children.

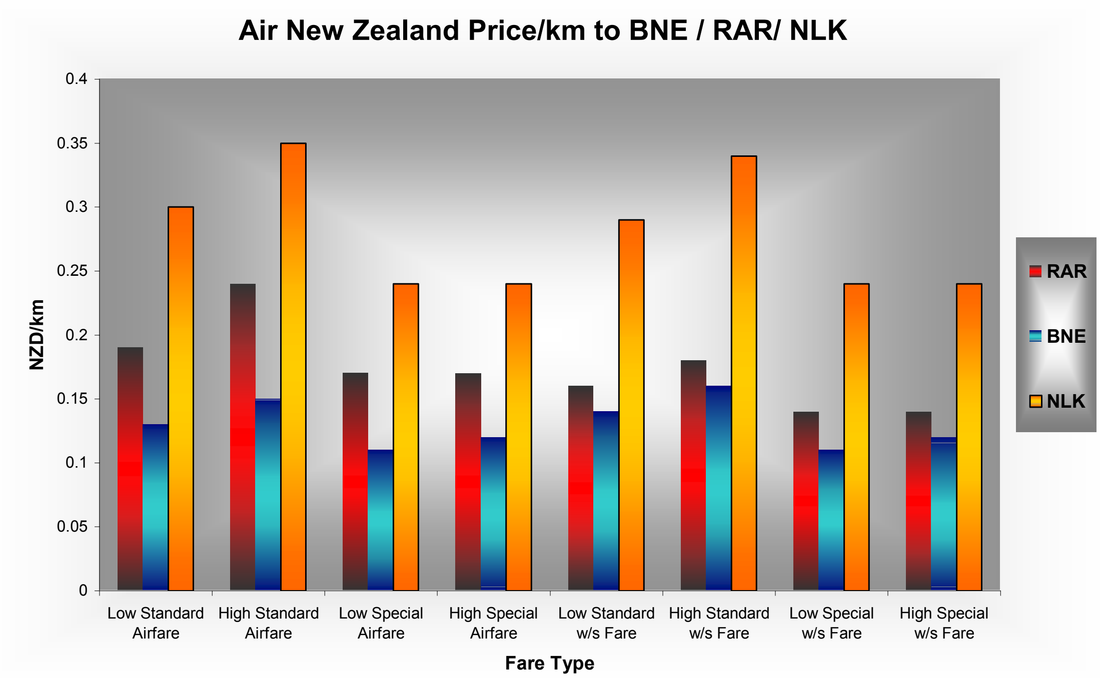
Couples Market Substitutability

9.9 For New Zealand "couples" travelling internationally, there is some level of substitutability between Australia (QSLD), The Pacific and Asia. Bali and Thailand (Phuket and Koh Samui) are the two main sun destinations in Asia. However, they attract only 19,000 travellers per annum and the quantum of any substitutability is limited, compared to the total of 184,000 travelling to Queensland and the Pacific where it is again limited often because the prime purpose is VFR and if the travel is to include visiting a friend then little or no substitutability exists. This is a fundamental reason why competition on these routes is essential. This pattern of demand is largely drive by considerations of:

- Cost and convenience of travel

- Standard of accommodation
- Beach quality
- Familiarity
- Varity available in Queensland and South Pacific
- Safety and health to a degree

9.10 The effect of monopoly pricing can already be demonstrated on the Rarotonga and Norfolk Island route. The following Graph shows the comparison with the Brisbane route which has more competition.



10 INBOUND TOURIST MARKET

10.1 The current state of the inbound tourism market to New Zealand was illustrated recently in the following:

"New Zealand's inbound tourism industry is on a roll. Figures issued by Statistics New Zealand this week show that overseas visitors increased by 10.8% in December compared with December 2001 and last year the country attracted more than two million short-term visitors. Our tourism is extremely impressive compared with Australia and the rest of the world and this trend is expected to continue."… "the end of United Airways (sic) operations and the proposed creation of Air Monopoly, the link between Air New Zealand and Qantas, is the industry's biggest concern" (Brian Gaynor, NZ Herald – February 8-9, 2003).

10.2 Against this background, questions must be raised about the validity of the Applicants' claim that their proposed Alliance will bring in an additional 53,000 tourists over and above the current 135,000 growth New Zealand is experiencing. This would represent a gain of 188,000 or 9% which is just under the highest tourism growth rate in the world! Any logical analysis of this growth rate will conclude that it is overly optimistic at best, especially with the declining competitiveness of the NZ dollar and the global security issues and even if managed in some years it is unlikely to be sustainable over time – if it can be achieved at all.

10.3 The Applicants claim positive impacts on tourism will be generated by their Alliance in three principal ways:

(a) increased incentive to Qantas Holidays to market New Zealand in its products;

(b) improved effectiveness of promotion by national tourism bodies;

(c) new fares, network and loyalty programme integration.

10.4 The claims that authorisation of the proposed Strategic Alliance will incentivise Qantas Holidays to generate an additional 53,000 tourists to New Zealand per annum, a financial gain of $148 million p.a. to New Zealand, and an additional 2,500 jobs in New Zealand by Year 3 of its operation requires very critical examination.

10.5 Without the Alliance, Qantas Holidays is already heavily incentivised to generate additional tourism to New Zealand by the fact that Qantas itself currently operates international and both trans-Tasman and domestic New Zealand air services with excess capacity and all these services would benefit from this activity.

10.6 The ability of Qantas Holidays to generate additional international tourist traffic to New Zealand will be limited (in part) by the commitment of additional promotional funding to expand its capacity to offer and sell New Zealand tourism product. This has been estimated at $14.5 Million p.a., which represents approximately 30% of the total income QF will receive if it sells to an additional 53,000 customers. This is a cost benefit that is unlikely to be accepted and can only be regarded as a "best intentions promise" rather than a commitment. I If it is accepted as a public benefit, it will be almost impossible to measure it for validation purposes.

10.7 The proposed Transaction, per se, will not immediately generate additional revenue or cost savings to provide the funds for additional promotional expenditure. Additional promotional expenditure will come at the expense of other expenditures. Promotional expenditure – as one of the relatively small group of variable costs of airline operation – is always vulnerable to reduction when profits come under pressure. This claimed benefit must be regarded as an unenforceable promise and should be discounted.

10.8 Para 399(a) states that "*QF Holidays will have an increased incentive to market New Zealand in its products*". This statement only serves to highlight the fact that QF Holidays will begin to exert anti-competitive behaviour to the New Zealand travel wholesale market as there will be very limited, if any, competition to Air NZ and Qantas. QF Holidays will be able to effectively undercut all the inbound travel wholesalers in the New Zealand marketplace. In the NECG paper (p.149) they state that QF Holidays has achieved a 7.3% market share of the inbound holiday passengers to Australia. It should be noted that this is in light of the decline in the Australian inbound tourist market over the period 2000 to 2002 and emphasises that the airlines have little influence in the overall quantum of demand for a destination but can influence the choice of customers by price and promotion.

10.9 The applicants state (402 Submission) QF Holidays will increase "*tourist penetration from the regions where it's global footprint*" is strong. Para 403 indicates that the net gain to New Zealand under the QF Holidays initiatives would be 53,000 tourists per annum over and above the current growth. It should be noted that the logic behind this estimate of inbound traffic growth is based on the assumption that New Zealand is the same as the global market. It also assumes that the same strategies that QF Holidays uses to promote Australia can be used to promote New Zealand. This assumption is not consistent with historical trends of data benchmarking New Zealand against Australia and globally.

10.10 Tourism into New Zealand is already growing at a very high rate with the 2002 calendar year figures confirming this trend. Statistics New Zealand figures show annual tourist numbers topped two million for the first time (2,045,000), up 7 per cent on 2001. This represents a gain of 135,000 visitors.

10.11 Contrast this increase in New Zealand with Australia where for the second year running Australia has recorded an annual drop in international arrivals with 36,200 fewer visitors last year than in 2001 according to the Australian Bureau of Statistics. This represented a fall of 0.7% over the previous year. So the growth forecasts QF holidays lead us to believe that will come our way may not eventuate. *(NZ Herald 8/9 Feb 2003*)

10.12 New Zealand's performance as a tourist destination is not an exception as the World Tourism Organisation figures indicate that the number of international arrivals in 2002 increased by 3.1 per cent to almost 715 million; 22 million more than the previous year. Furthermore, Asia and the Pacific claimed the number two spot from the Americas in terms of total number of tourists. In light of this statistic, it has to be asked if indeed the strong global footprint, increased dual marketing activities and other benefits claimed for Qantas Holidays will make any difference to New Zealand visitor numbers.

10.13 QF Holidays sold packages to 1.115 million passengers in the year 2002 (NECG p. 147). Of these only 15% were related to the inbound market. 49% were Australian domestic and 36% the outbound market. Given that QF Holidays only sold 165,000 packages to the inbound market in 2002, a 50,000 rise to New Zealand would imply that QF Holidays will increase its inbound market by a minimum of 30% at a time when they are not growing the market for Australia! This is highly improbable given that New Zealand already enjoys dual destination promotion by wholesalers and inbound tourism operators.

10.14 It should also be noted that tourist facilities in New Zealand are already struggling to cope with the current demand and Tourism New Zealand have identified that they should be focussing on quality, not quantity. This is not hard to understand when you consider that New Zealand, with a population five times smaller than Australia, has nearly half (42%) the number of tourists as Australia does.

Additional Promotion

10.15 The applicants Para 410 on page 112 states "*the Alliance will have a positive impact on promotion levels therefore tourist numbers but NECG have not been able to model this*". As in the earlier section and the one following on will show, the joint marketing exercise of the Alliance is more likely to reduce the Applicants' marketing expenditure and not increase any tourist numbers at all.

10.16 Given it is proposed that the Alliance will present Australia and New Zealand as a dual market globally, we must deduce that the total spend on New Zealand will be less than each individual state in Australia. Any increase in promotion that QF Holidays undertakes on behalf of New Zealand will be more than counteracted by the Australian States who in reality will react to QF Holidays paradigm shift i.e. from sole Australia to Australasia promotion. As an example, Queensland's QTTC Sunlover Programme rivals QF Holidays in spend and global reach as do other States products.

10.17 As QF Holidays will be marketing Australia at the same time as New Zealand, major events in New Zealand will be impacted negatively given the capacity and capability will be in Australia where critical mass gives that market first priority, e.g. World Cup. Americas Cup gets almost no publicity in Australia.

Additional Promotional Effectiveness

10.18 The Applicants claim that additional promotional effectiveness will arise from the Transaction, which would enable them to co-operate in advertising retail sales in their home markets, and to introduce new products offshore – such as "streamlined" Australia/New Zealand itineraries in Asia based on the ability to triangulate a combination of Qantas and Air NZ flights. Both claims require critical examination.

10.19 There is no science to confirm that co-operative advertising by Qantas and Air NZ in their respective home markets will stimulate the market, especially when it is to be accompanied by the rationalisation of current home market advertising expenditure by the two airlines. Yet the Trans Tasman market of 2+ million passengers is dependent on $1.2 million from Australia and New Zealand. If promotion declines and areas rise, why would the market size increase?

10.20 Equally, there is no science to suggest that co-operative advertising by the two previously competing airlines will be more effective than their current brand-specific advertising. The reduction of competitive product and service offering arising from co-operation between Air NZ and Qantas – coupled with the blurring of brand identity in cooperative advertising - could, in fact, diminish its effectiveness from the consumer's perspective.

10.21 The submission states (Para 406 p.112) that both QF and NZ will undertake to promote each others countries in their respective markets. They claim this will save advertising expenditure and stimulate the market. The increased marketing to the Australian outbound market is in conflict with the assertions that there will be reduced expenditure and may not increase visitor numbers to New Zealand as the section on "Tourism impacts from new flights and new fares" shows that travel on the Tans Tasman route will actually drop as a result of new fares and products (*Necg p106-107)*. So the joint marketing exercise appears to be an exercise to save marketing expenditure

10.22 The NECG study advances an econometric model to calculate the increased visitor numbers to New Zealand based on increased marketing spend by QF Holidays. It should be noted that the studies were based on passenger numbers on the Applicants' airlines flights as opposed to the full range of airlines carrying visitors to New Zealand. So whilst the passenger numbers on NZ and QF may increase, they may in effect be taking passengers away from the other airlines that travel to New Zealand. If increased spend by NZ and QF increases their market share, it follows that the inbound traffic on these carriers will decline.

10.23 In terms of the Applicants' claim that the Transaction will improve the effectiveness of promotion by national tourism bodies, no evidence is provided in the submission to support this assertion.

10.24 It should be noted that the national tourism bodies of Australia and New Zealand (the Australian Tourism Commission (ATC) and the New Zealand Tourism Board (NZTB)) have been established by statute to promote international travel to their respective home nations and to optimise the benefits to their home nations from the expenditure of funds placed at their disposal.

10.25 Historically, there has been a reluctance on the part of the ATC and the NZTB to engage in joint dual-destination marketing activities, and only a limited amount of such activity has been undertaken by the two national tourism bodies.

10.26 It could be beneficial for the Commission to seek the views of these bodies as to the impact of an increase in joint dual destination promotion by their respective flag carriers, particularly if it involved any diversion of the Applicants current off-shore expenditures on mono-destination travel to Australia or New Zealand.

10.27 In the experience of the Parties to this Submission, benefits to New Zealand are most likely to be optimised by the single-minded promotion of New Zealand as a destination in most key offshore tourism origin markets.

10.28 Finally, the Commission must take into account the fact that promotional activity by airlines is but one of a number of influences on international tourism purchase decisions. Global economic trends, the state of the economy in origin markets; exchange rate changes; inherent destination appeal (such as safety security and hygiene, opportunities for eco-tourism and so on); local prices for travel, accommodation, entertainment, and other purchases are all likely to be more significant influences on consumer choice than promotional expenditure, together with events such as Americas Cup and World Cup.

New fares

10.29 There is no evidence on the nature of the new fares that might be provided by the Applicants as a result of the Transaction in the material available to the Parties to this submission.

10.30 However, logic suggests that fares capable of generating additional tourist traffic and benefits would be lower and not higher than current fares, and competition between the major suppliers of air travel is more likely to produce lower fares than co-ordination between them. Therefore to increase yield even if capacity drops it can only be NZ based passengers who will pay more on average than they do at present.

10.31 Absent comparable competition or the threat of comparable competition from other suppliers, co-ordination between in the provision of services and the setting of fares by previously competing major suppliers would seem more likely produce higher rather than lower fares.

10.32 The intention of the proposed Alliance to introduce fare increases and reduce capacity is confirmed by NECG modelling which indicates that price and capacity changes planned by the Applicants would reduce total visitors to New Zealand by 10,333 and to Australia by 10,771 by Year 3 of the Alliance operation (NECG Report, p 156).

New network services

10.33 Turning to the matter of new network services, the Applicants claim their proposal will produce benefits by enabling the introduction of new triangulated international services between New Zealand, Australia and other nations that Qantas is currently unable to offer, and the introduction of new Trans Tasman connections – between Auckland/Adelaide, Auckland/Hobart, Auckland/Canberra, Wellington, Canberra. The likely benefit from these new services requires critical examination.

10.34 The opportunity to offer a streamlined, triangulated Australia-New Zealand itinerary in Asian markets already exists for Air NZ as a stand-alone entity. The air services agreements between the Governments of New Zealand and of Australia, Japan, China (and Hong Kong), Korea, Thailand, Malaysia, Singapore, and the United States already grant fifth freedom rights that provide the New Zealand flag carrier with the opportunity to operate triangulated origin market – Australia – New Zealand – origin market itineraries. These opportunities are currently largely unexploited by Air NZ. Indeed, Air NZ has just announced its intention to withdraw from its only operative "triangulated" service beyond Australia by withdrawing from the Sydney/Los Angeles route in April.

10.35 Demand in Asia for dual destination travel through Australia and Australia is most likely to be limited by the short holiday breaks prevalent in many Asian nations and an unwillingness on the part of travellers to expend more of their time in transit between destinations.

10.36 In assessing benefits to New Zealand from the proposed triangulation of Qantas/Air NZ services, critical attention also needs to be focused on the form of that triangulation.

10.37 As outlined in the NECG report accompanying the Applicants' proposal, the new joint triangulated service would involve an itinerary with Qantas providing inbound travel to Australia from the origin market, domestic air travel within Australia, and trans-Tasman travel to New Zealand. Air NZ would provide air travel within New Zealand and back to the origin market.

10.38 The lion's share of a consumer's spending on air travel is captured by the Australian airline under such an arrangement. The same is likely to be true of a consumer's spending on other discretionary purchases, as Australian goods and service providers gain first opportunity to access the triangulated tourist dollar.

10.39 The feasibility of the joint triangulation arrangements proposed by Qantas and Air NZ requires testing with Governments in international markets beyond Australia.

10.40 Nations that have granted fifth freedom rights to a New Zealand flag carrier and not to an Australian flag carrier may well take exception to an arrangement that enables an Australian flag carrier to circumvent the current provisions of the bilateral air services agreement they have negotiated with Australia.

10.41 The only other new routes to be operated by the proposed Alliance are a new Auckland-Adelaide connection, new connections between Canberra and Auckland and Wellington, and the resurrection of connections between Auckland and

Hobart (previously operated by Air NZ on an uncontested basis). None of these destinations have volume tourist appeal. Current demand for AKL/ADE travel is less than 100 passengers per week and Canberra is a destination most people get out of, not visit. Hobart has been tried in the past and failed to sustain even one flight per week. Freedom has tested markets to Hamilton Island/ Newcastle/Maroochydore and failed to achieve sustainable volumes.

10.42 Any benefit derived from the introduction of joint airline operations by the Applicants on these new routes needs to be discounted by the degree to which they deter new entry to the trans-Tasman and New Zealand domestic markets by another supplier.

10.43 New entrants – particularly VBA entrants – traditionally exploit such gaps in existing network offerings to initiate operations in markets. The opening of four new doors by the incumbent airlines under new co-operative operating arrangements amounts to the closing of four possible entrances to potential rivals.

New schedule benefits

10.44 The Applicants claim that benefit will arise from the Transaction because it will enable them to offer a better spread of flights in their daily schedules, as co-operation and co-ordination eliminates the competitive pressure to shadow each other with flights concentrated in periods of peak demand. The potential for the Applicants to produce this benefit only exists in the absence of significant competition from other suppliers and is to the detriment of passengers who wish to travel at peak times and presupposes mechanical breakdowns and servicing issues will cease to be a competitive issue.

10.45 The applicants propose a window of competitive restraint against any new competitor. We believe this is a nonsense as all FSA airlines have some very low fares in existence with almost no availability of capacity until threatened by competition. The Alliance would not need to change an airfare to drive a new VBA out of business.

10.46 The development of significant competition to the operators of the proposed Joint Airline Organisation will see a return to the peak demand period schedule shadowing that is currently practised by Air NZ and Qantas.

New loyalty programme benefits

10.47 The loyalty programme integration proposed by the applicants is of some value to the travelling public of New Zealand, since it provides points redemption opportunities for air travel within Australia which do not currently exist. However is unlikely to be permitted by the "Alliance" rules of Star or One World as it strikes at the heart of the differences between the competitive attributes of the "Alliance".

10.48 The proposed loyalty programme integration, if legally or contractually permitted, is advantageous only to the small proportion of trans-Tasman New Zealand travellers who require air travel within Australia, beyond the Australian international ports served by Air NZ itself.

10.49 The majority of Air NZ loyalty programme members can expect some detriment to arise from the proposed loyalty programme intervention, as it will enable a substantially larger number of Australian loyalty programme members to begin competing for points redemption on Air NZ flights and for other privileges associated with loyalty programme membership.

10.50 As the terms of the proposed transaction require both Applicants to apply non-discriminatory processes in allocating seats for points redemption, the value of Air Points accrued by loyal customers of Air NZ will be eroded by the degree to which integration increases demand for points redemption by loyal customers of Qantas on Air NZ flights.

The Trans Tasman inbound visitor market

10.51 The single largest source of all categories of visitors (holiday/VFR/business) to New Zealand is Australia. The latest numbers available from Statistics New Zealand indicate that of the total two million visitors to New Zealand in the year 2002, over 600,000 or 31% were from Australia.

10.52 If indeed both QF and NZ are losing money on the Tasman, the Alliance will seek to remedy the situation. This controlling factor of a duopoly would result in one of two outcomes under the supply/demand rationale;

- The capacity on the Tasman is reduced which in turn increases the yield.
- The yield is increased forcing demand down resulting in a reduction in capacity.

10.54 The net result is that there will be less capacity on the Trans Tasman and fares will be higher. This is most likely mean that total visitors from Australia to New Zealand will reduce.

10.55 The experience of Kiwi Air proved that the Trans Tasman market is very price elastic. Even a 1% fall in visitor numbers from Australia will result in the loss of 6,320 visitors to New Zealand. Thus, the NECG forecast reduction of a 10,000 in tourist numbers to New Zealand from all parts of the world in the third year of Air NZ / Qantas alliance operation appears to be a significant under-estimate of the likely impact of new fares and capacity changes to be made by the Alliance.

The North American inbound tourism market

10.56 In the year ended 2002, there were 205,000 visitors from the United States. The United States constitutes 10% of New Zealand's tourism market. Visitor arrivals from the USA to New Zealand for the year ended 2002 were up 17,900 (10%) over 2001. This is in contrast to Australia where arrivals from the USA were down 3% for 2002 (Statistics New Zealand and Australian Tourist Commission). This contradicts the comments in the submission which states that QF Holidays has a strong "global footprint" in the USA.

10.57 On the 29th of March 2003, United Airlines will withdraw from the Auckland-Los Angeles route leaving it to be shared between NZ and QF. Should the Alliance eventuate, this route will have no competition on it. There is already high demand on this route and any further reduction in competition will only increase the fares which will continue to rise until the demand reduces to the level of supply.

10.58 An airline can make the same amount of money flying fewer passengers at a higher price. This is the likely outcome of the routes to the United States. There is a high demand on that sector and the airline will deem it suitable to continue to increase fares until demand falls to the level that they are prepared to supply. This is a better situation for the airline as the flow on cost reductions of a lighter schedule are substantial.

10.59 Given that United Airlines still flies the Trans Pacific to and from Australia, there will be no attempt to increase passenger traffic between the United States and New Zealand. Instead what will eventuate will be very high fare levels on this route and reduced capacity and an increased emphasis to compete with UA on the USA/SYD route, which will attract inbound visitors away from New Zealand.

Other inbound tourism factors

10.60 ***Sydney as the main hub for New Zealand:*** In the long term if the Alliance eventuates and evolves, Australasia as a region globally could have only one hub that of Sydney with all other airports 'feeding' domestically to it.

10.61 *Star Alliance vs. One World:* Positioning of the Alliance in the broader framework of global airline alliances is critical to extracting a best return from the prime long haul markets of Asia and North America.

10.62 The most likely scenario under the Alliance proposal is that Air NZ will be required to quit their Star Alliance membership and join the One World alliance to be consistent with Qantas. A large number of potential visitors to NZ will be lost to NZ. This will have a significant impact on the 5 year incremental tourism value to New Zealand of $645 million. It is entirely possible and plausible that it could be $<645>.

10.63 The STAR Alliance status to which Air NZ belongs, and the One World Alliance in which Qantas participates each have dominance in different global continents. A move by Air NZ away from the STAR Alliance and into One World with Qantas will negatively impact the passenger traffic from North America and Asia.

10.64 Premium category visitors from the USA will be disadvantaged in the future with the likelihood of Air NZ quitting the Star Alliance and the recent reductions in service announced by United Air, also a Star Alliance member. The use of air points is of major importance to visitors from the USA and they will not be able to redeem them on routes to New Zealand.

10.65 The increased value from tourism of $645M claimed to be generated by the proposed Alliance is overstated as it does not take into account the effect on air point's travellers.

10.66 The Applicants' dubious claim that the creation of their Alliance will stimulate trans-Tasman and New Zealand market entry by a VBA carrier does not fit comfortably with Tourism New Zealand's positioning of New Zealand as a destination of 'Premium" status.

10.67 Furthermore, a value based airline does keep competitors out of the marketplace by presenting the perception that those routes are low yield.

11 AIR NZ'S NEED FOR THE STRATEGIC ALLIANCE

11.1 Air New Zealand and Qantas Airways Limited have cited the major reasons for seeking a Strategic Alliance are that the ' VBA model will inevitably find its way onto the New Zealand domestic and trans-Tasman routes'*(Application, page 8)* ….. and….. ' absent the Strategic Alliance, faces a lengthy war of attrition for supremacy of the New Zealand based networks (i.e. domestic and key international routes from New Zealand)' (*Application, page 9*) .Both these concerns appear to be significantly over-stated.

- Air NZ already operates a VBA – Trans Tasman and South Pacific – Freedom.
- Qantas already operates a VBA and VBA+ - Jetair and Australian Airlines, domestically and internationally.

Can Air NZ survive without the JAO?

11.2 Air NZ's claim that it is not well-placed to win an inevitable war of attrition with Qantas if the proposed Alliance is not effected, requires careful, critical scrutiny, and cannot be accepted at face value.

11.3 During its history, Air New Zealand has shown the ability to survive in extremely adverse conditions. It has recorded profits at times when the airline industry as a whole has been operating at a substantial loss – the oil price crises of the 1970s, the Gulf War in the 1980s, and the post September 11 world travel depression.

11.4 In terms of the regional and main trunk air services markets of New Zealand, Air NZ has dominance in terms of capacity, network reach, regional feed, schedule frequency, and flag carrier brand loyalty. It also has the advantage of comprehensive, well-established direct and indirect distribution of its products throughout the country and internationally in all its major inbound markets.

11.5 Air NZ is in the best position to secure feed for its domestic operations from carriers belonging to the world's largest international alliance, the Star Alliance

Network and from the One World alliance carriers by virtue of its frequency and capacity.

11.6 Air NZ enjoys similar advantage in terms of the New Zealand international outbound travel market, in important sectors of the New Zealand international inbound market, and in most sectors of the international inbound market to the islands of the Southwest Pacific.

11.7 Air NZ has a history of seeing off reasonably established rivals in its home market like SPANZ, Mount Cook, Newman Air, Ansett New Zealand and Trans-Tasman (QF/NZ) operation – as well as new entrants like Kiwi International.

11.8 It has brand strength, flag carrier loyalty, home ground advantage, and the most comprehensive direct and indirect air services sales and distribution networks in the country.

11.9 It is the dominant New Zealand provider of essential aviation support services – such as engineering, flight crew training facilities, and ground handling services.

11.10 Air NZ is well equipped to defend itself against competition in most sectors of the New Zealand air services market.

11.11 In its regional New Zealand operations, Air NZ has largely completed a rejuvenation of its operating fleet, phasing out old Bandeirante and Metroliner aircraft in favour of 19-seater SAAB and Beech 1900D aircraft, and expanding its relatively young fleet of 66-seat ATR 72 aircraft.

11.12 In its main trunk New Zealand jet operations, Air NZ recently completed its conversion from ageing Boeing 737-200 aircraft to new and more efficient Boeing 737-300 aircraft. It has also converted its domestic jet fleet to a new one-class, "defrilled" Express Class service to reduce operating costs and deliver profit on lower fares which show signs of stimulating market growth.

11.13 In the trans-Tasman market, Air NZ has re-shaped its operations to improve their competitiveness in extremely difficult trading conditions. It has introduced new smaller capacity B737-300 aircraft to gain advantage by offering higher frequency services. It has seen off budget airline start-ups by launching its own VBA budget-fare airline Freedom. It has survived against irrational competition from Asian carriers offering extremely low fares for Tasman travel by employing idle capacity from their network operations through Australia and New Zealand. It has maintained a major share of the market against competition from a better-resourced Qantas.

11.14 In terms of future operation in the trans-Tasman and short-haul Pacific markets, Air NZ recently concluded negotiations to acquire new, larger capacity Airbus A320 aircraft and new abilities to match or better its competition and at lower lease and operating costs than its existing fleet.

11.15 In terms of long haul international markets, Air NZ is the only carrier providing direct service between the high-value tourism market of Japan and New Zealand.

11.16 The recent withdrawal of United Airlines from the trans-Pacific operations between New Zealand and North America means there is no US-based competition on this important route, or for air travel services between Europe and the South Pacific over the United States.

11.17 United Airline's withdrawal from New Zealand should generate particular advantage for Air NZ which is a partner with United and Lufthansa in the Star Alliance Network. Air NZ can expect to gain feed traffic from these powerful Star partners in North America and Europe if it continues as a stand-alone New Zealand-designated international carrier and the only Star Alliance Network partner on the trans-Pacific routes to New Zealand and the Southwest Pacific

Islands. Air NZ has now become a strategically significant player in the Star Alliance being the only feed to South West Pacific and Australia from USA.

11.18 The Applicants claim that failure to authorise their proposals will inevitably lead to a war of attrition between them – a war that Air NZ is not well placed to win. We suggest that history does not support these claims.

11.19 Over the last 30 years Qantas has had numerous opportunities to compete in the NZ domestic market and has consistently refused to do so in part on the basis that: -

- Air NZ has such effective dominance, political and nationalistic support that effective competition at a profitable level is unlikely;
- Even the option of taking over the established operation of its failed franchisee Tasman Pacific for virtually nothing was unattractive; and
- The pursuit of an Alliance with Air New Zealand was more attractive than entry in strength to the New Zealand market in competition with Air NZ.

The question must be asked : Why would any prudent Board of Directors at Qantas decide to lose more money on a war of attrition in New Zealand when other more profitable opportunities and more significant challenges exist in other parts of the world?

11.20 It is alleged one of the critical issues confronting Air NZ is its current lack of an airline partner in Australia. Australia is generating 33% of New Zealand's overseas visitors and is the destination for 51% of New Zealanders travelling overseas. Air NZ alleges that the ability to exchange feed with a significant Australian domestic carrier is important to Air NZ's future viability. We dispute their allegation as 70% of Australian population is in four main centres, which Air NZ serves directly – Sydney, Melbourne, Brisbane. There is no need for access to the Australian hinterland. Our experience in the New Zealand market is that people from the country and outlying centres travel less and spend less than those from major cities. The MEL/SYD/BNE markets therefore, provide in excess of 70% of the travel market to New Zealand.

11.21 CER. Both Australia and New Zealand are signatories to CER, Gatt and strong advocates for WTO. If either party were to wage a ware of attrition they would invite the invocation of anti-dumping actions which incorporate substantial damage penalties.

Air NZ re-entry to Australia via Freedom

11.22 Air NZ could re-enter the Australian domestic market on a selective basis in its own right via its existing low-cost, low-fare subsidiary Freedom. In fact, this was Air NZ's preferred mode of entry before the Australian Government suspended scheduled development of the Australia-New Zealand Single Aviation Market Agreement, before the prospect of acquisition of a stake in Ansett Australia was identified, and was prepared to do so in the face of comprehensive and well-established competition from both Qantas and Ansett. This would be an appropriate vehicle to compete for limited volume markets.

11.23 Freedom's capacity to provide Air NZ with a highly competitive Australian re-entry vehicle appears to have been recognised by both Qantas and its current main rival in the Australian domestic market, Virgin Blue. Qantas seeks to neutralise this threat through the JAO. Virgin Blue seeks the divestment of Freedom by Air NZ as the price of achieving the JAO for the very reason that while Freedom operates as a flexible VBA on the Tasman, there is no economic room for a second VBA airline.

Air NZ partnership in Australia with Virgin Blue

11.24 A further option could see Air NZ moving into partnership with Australia's second largest domestic airline, Virgin Blue. Air NZ has indicated that it has made efforts to explore this option and that progress has been impeded by Virgin Blue's unwillingness to invest in changes to its operation that would facilitate interlining with Air NZ. However, this appears to be more a matter of who would gain most benefit and who would bear the cost rather than an insuperable hurdle.

11.25 Furthermore, Virgin Blue may be more interested in partnership with Air NZ now that it is being confronted with the full scope and nature of the JAO planned by Air NZ and Qantas. At this point the shareholders of Virgin Blue appear more interested in maximising their shareholder value through an IPO than in crossing the Tasman to enter New Zealand and face the competition of a further airline or two.

Air NZ re-entry to Australia with interested foreign carrier partners

11.26 The fact that Australia is now a significant gap in the STAR alliance network means there are other STAR members with common cause in ensuring that they have adequate passenger feed exchange arrangements in Australia. One or a number of them could be more interested in partnering Air NZ in an Australian re-entry now the details of the proposed Qantas/Air NZ alliance are known.

11.27 In short, it would be a mistake to conclude that the Alliance is the only viable option for Air NZ. It is necessary to determine just how rigorous Air NZ has really been in its efforts to identify other options, and whether other options exist which could secure the survival of the New Zealand carrier in the face of a "war of attrition" by Qantas.

11.28 In reality the obligations of good governance on the Qantas Board would prima facie preclude a war of attrition to fight for either NZ domestic supremacy or on the Tasman where currently Air NZ has the operating efficiency domination even if Qantas by virtual of its weight of numbers has a slight edge in customer numbers.

11.29 The balance of public benefits and competitive detriments could be more fairly and effectively struck by options other than the JAO proposed by Air NZ and

Qantas. The Commission is urged to explore this possibility in depth before authorising the current proposal.

Prospects for VBA entry to trans Tasman and NZ markets

11.30 Parties to this Submission do not share the Applicants' view that their alliance will encourage new entry to the trans Tasman and New Zealand domestic markets by a VBA carrier.

11.31 An Air NZ/Qantas Alliance would have major incumbent advantages at the three major airports in the trans Tasman and New Zealand – Sydney, Auckland and Christchurch. Peak time landing slots are in short supply at Sydney and Auckland. Gates and check-in facilities are under pressure at Sydney, Auckland and Christchurch. Peak time air traffic control delays are frequently experienced at Wellington.

11.32 Unlike Australia, New Zealand has no established systems securing access to essential aviation services for new entrants or to counter advantage enjoyed by a major, well-established incumbent like Air NZ. There are also very limited opportunities for new entrants to challenge airport company pricing of services where they are monopoly suppliers.

11.33 By virtue of scale and resources, the proposed Alliance will have a superior ability to recover from any service disruptions caused by these pressures – particularly compared to a new entrant VBA carrier which must keep its aircraft utilisation high and turnaround times to a minimum to succeed.

11.34 As has been pointed out, Air NZ has already developed an efficient VBA of its own which contributed to the demise of the VBA trans Tasman entrant Kiwi International. It has currently stationed Freedom to guard the most convenient point of entry to the trans Tasman and New Zealand markets for Virgin Blue.

11.35 Despite early displays of enthusiasm from Virgin Blue, and since the failure of Kiwi International, no VBA operator has demonstrated real commitment to enter the trans Tasman and New Zealand market while Qantas and the Air NZ/Freedom group are engaged in stiff competition. The attractiveness of both these markets will not be enhanced if the incumbent major competitors are authorised to co-ordinate their activities, including the activities of Air NZ's VBA Freedom.

11.36 It would also unlikely if not impossible for a new entry VBA carrier to replicate the services operated by Air NZ on key domestic tourism routes because their standard operating model is not suited to the demands of this sector of the market. Air NZ operates aircraft that are particularly suited to carrying groups of coach size (45+) on routes connecting the key tourism centres of Rotorua, Christchurch and Queenstown.

11.37 Thus Air NZ is able to offer a service on the key tourism routes that could not sustain two airlines but which are essential for all large suppliers of inbound passengers. This advantage was one of the factors that led to the demise of the Tasman Pacific "Qantas New Zealand" operation. It has, and will, ensure Air NZ continues to prosper in this arena.

11.38 The establishment of the proposed JAO by Air NZ and Qantas, without any constraint on Air NZ's ability to deploy Freedom anywhere it wishes in the New Zealand, trans-Tasman, and short-haul Pacific markets, is clearly a major deterrent to the entry of new VBA operators.

11.39 The joint Air NZ/QF strategy will be to ensure that the only VBA Airline on the Tasman is to be Freedom owned and operated under the JAO. To consider anything else is nonsensical when the NECG report indicates that VBA competition reduced prices by at least 20% over FSA competitive pricing and the VBA will take 20-30% market share. The 90% of the trans-Tasman markets which QF/NZ hold at present would reduce to approximately 65% for which QF/NZ would get an even lower yield than at present.

11.40 There is no evidence anywhere in the world that two VBA's can co-exist on routes on a sustainable basis. To the contrary there is evidence to demonstrate the failures. The successful VBA's to date – Ryan Air, Easy Jet, South West Airlines – fly almost exclusively routes uncontested by either VBA's or FSA's. Where an FSA is competing it primarily only uses one common airport in a city pair, ref. Appendix C.

12. RECOMMENDATIONS

12.1 In view of the substantial detriments likely to occur if the Alliance was allowed to proceed it is recommended that the proposal should not proceed.

12.2 If the Commission decides either against or for authorisation of the restrictive trade practices required to implement the proposed Air NZ / Qantas Alliance and JAO, it is recommended that the Commission initiate an investigation into possible anti-competitive practices (*cited in Sections 6 and 7 of this Submission*) that Air NZ has been pursuing in the travel services distribution market and if appropriate direct that Air NZ divest of its travel distribution services.

12.3 If the Commission decides that Qantas may purchase up to twenty two and a half percent of Air NZ, then conditions must be imposed on Qantas and Air NZ which prevent the two airlines from operating in the manner they propose in their application for approval for a JAO and ensure that true competition is embedded in all the relevant markets as defined by the Commission in Decision No. 278 – Bodas and the Commerce Act 1986 and subsequent amendments.