Application to the Minister of Transport pursuant to Part 9 of the Civil Aviation Act 1990

Air New Zealand Limited

Qantas Airways Limited

APPLICATION TO THE MINISTER OF TRANSPORT UNDER PART 9 F THE CIVIL AVIATION ACT 1990

1. Executive Summary

Background

1.1 The Tasman is an intensely competitive market, due in part to its geographic location, time zone and liberal aviation policies. The high level of competition results from the competitive strategies of:

- Emirates (operating as a full service carrier (or **FSA**) pursuant to fifth freedom rights); and
- low cost carriers such as Virgin Blue (operating on the Tasman and Pacific Island routes as "Pacific Blue")[1], (**LCCs**),

and also from the number of carriers (and hence capacity) deployed on the Tasman.

1.2 The lower cost airlines – Emirates (which, despite being an FSA, has a marginal cost model for the Tasman, arising from its position as a fifth freedom carrier on these routes) and Virgin Blue (which employs a low cost point to point model) – effectively set fare levels on the Tasman, with intense competition occurring for price sensitive travellers (or "marginal" passengers). Competition for marginal passengers is not confined to those customers and extends to all passengers. The fare levels set to attract the marginal passenger are available throughout the market.

1.3 The conduct and business models of Emirates and Virgin Blue keep Air NZ and Qantas on constant competitive alert.[2]

1.4 This competitive environment has resulted in significant excess capacity on the Tasman, driven by the growth of Virgin Blue and Emirates, as well as by Air NZ and Qantas as they strive to maintain comparable network offerings. Indeed, there are currently an estimated 6,300 empty one-way seats flown across the Tasman every day (with 5,200 of those empty seats on the main Tasman routes).

1.5 Air NZ and Qantas both recognise that to continue their competitive stance on the Tasman they must secure cost reductions, increase load factors and improve their

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[1] Unless the context requires otherwise, the term "Virgin Blue" is used to describe the Virgin Blue/Pacific Blue operations.
[2] As the Virgin Blue CEO stated: "… make no mistake, Virgin Blue will continue to use innovation and "out of the box" thinking to stay at the forefront of competition". ("Virgin Blue woos business travellers with 'Velocity', powered by Virgin Blue – The world's next generation loyalty program", Media Release, 15 November 2005.)

revenue per ASK (available seat kilometre)[3] performance. The Parties have already undertaken a range of initiatives (for example, Air NZ's Tasman Express strategy and Qantas' subsidiary Jetstar) and have achieved material, but insufficient, cost reductions.

Tasman Networks Agreement

1.6 Certain collaborative arrangements are being entered into between Air NZ and Qantas pursuant to a Tasman Networks Agreement (**TNA**). It is conditional upon authorisation being granted by the New Zealand Minister for Transport under Part 9 of the Civil Aviation Act 1990 (NZ) and by the Australian Competition and Consumer Commission (**ACCC**) under the Trade Practices Act 1974 (Cth).

1.7 The TNA between Air NZ and Qantas is necessary to further reduce cost by removing some of the existing surplus capacity, thereby improving load factors whilst still maintaining connectivity with the rest of their networks. This will have no impact on existing low fares and can only viably be achieved via the TNA.

1.8 The agreement delivers the following unique efficiency gains:

- the cost savings associated with the better matching of supply to demand, allowing for the removal of some surplus capacity; and
- a more efficient use of the remaining capacity, in terms of increased load factors and better schedule spread, whilst meeting current and forecast demand.

1.9 As network airlines, neither Air NZ nor Qantas would choose to unilaterally remove the surplus capacity that will exit the Tasman as a result of the TNA. On a unilateral basis, such a decision (say by Air NZ) creates a serious risk that Air NZ's schedule would be considered inferior to its competitors' and passengers would "spill" to those competitors. This would have material negative consequences for Air NZ on the Tasman and across its wider network.

1.10 There will be no scope for damage to the Tasman competitive process arising from the TNA because there are no barriers to the expansion of either Virgin Blue or Emirates, or other fifth freedom carriers. These carriers have the incentive to expand (or enter) if the Parties attempt to raise fares above the competitive level.

[3] Revenue per ASK is essentially the average revenue per seat, expressed in cents, generated by a flight for each kilometre travelled.

1.11 Furthermore, there are substantial benefits from the TNA:

- cost savings from the removal of some surplus capacity, which will enhance the scope for sustainably low fares for consumers;
- reduction of wingtip flying, leading to a better spread of departure times;
- reduced waiting times for connecting passengers and an enhanced 'seamless' service;
- greater flexibility for consumers to change itineraries;
- increased benefits for each Party's respective frequent flyer members – members will be able to earn and redeem points on all services carrying the code of the operator of the relevant frequent flyer programme;
- the strengthening of New Zealand's national network carrier;
- environmental benefits due to reduced fuel burn and carbon emissions;
- more direct flight options; and
- increased likelihood of new direct routes.

1.12 The need to reduce cost to compete more effectively with lower cost operators is not unique to New Zealand. It is a reality which has led airlines worldwide to seek efficiencies through codesharing. For example, Air NZ and United.

1.13 The TNA is a natural and necessary response by network carriers such as Air NZ and Qantas to the intense competitive environment that exists on the Tasman.

1.14 In October 2004 the Australian Competition Tribunal (**ACT**) authorised a proposed alliance between Qantas and Air NZ in relation to all flights into, within and out of New Zealand (the **Previous Proposed Alliance**). The ACT found that the Previous Proposed Alliance resulted in a net public benefit, primarily due to the limited barriers to entry and expansion on Tasman routes and the competition the Previous Proposed Alliance would face, in particular, from Emirates and Virgin Blue.

1.15 The ACT had the benefit of engaging in a de novo hearing able to receive and give full weight to up to date evidence delivered in person by witnesses who underwent direct cross-examination. Furthermore, the case before the ACT was largely focused on a consideration of the impact of the Previous Proposed Alliance on the Tasman market. By comparison, the New Zealand High Court was called on to cover a range of additional markets, including domestic New Zealand and Auckland - Los Angeles and despite being presented with a range of updating evidence determined that its jurisdiction was limited to an appeal 'on the record'.

1.16 On that basis, the Parties believe that the ACT's findings are more helpful to a consideration of the current application.

2. The Application

This section summarises the Application and the Minister of Transport's jurisdiction under the Civil Aviation Act to authorise arrangements such as the TNA.

2.1 This is an application by Air New Zealand Limited (**Air New Zealand, Air NZ** or **NZ**) and Qantas Airways Limited (**Qantas** or **QF**) (collectively, the **Parties**) for authorisation by the Minister of Transport (the **Minister**) under section 88 of the Civil Aviation Act 1990 (the **CAA**) of the Tasman Networks Agreement, attached as Appendix 1. To address the structural anomaly described in section 11 below, the Parties also request that the Minister issue a Commission Regime pursuant to section 89 of the CAA.

2.2 The TNA is very different from the Previous Proposed Alliance between Air NZ and Qantas. The Previous Proposed Alliance included an equity component and applied to routes beyond the Tasman, such as domestic New Zealand and Auckland-US routes.

2.3 By contrast, the TNA involves a free sale codeshare[4] which relates solely to the Tasman market. The Parties will continue to compete on all other routes. This codeshare is supported by a similarly geographically limited revenue and pricing arrangement. The TNA is discussed in detail on page 9.

2.4 Under Section 88(2) of the CAA, the Minister may:

> …from time to time specifically authorise all or any provisions of a contract, arrangement, or understanding made between 2 or more persons in respect of international carriage by air and related to such carriage so far as the provisions relate, whether directly or indirectly, to the fixing of tariffs, the application of tariffs, or the fixing of capacity, or any combination thereof.

2.5 The TNA is clearly a contract falling within the above description and thus capable of authorisation by the Minister.

2.6 An authorisation operates as an exemption from the application of the relevant provisions of the Commerce Act. The Minister of Transport's power to authorise such arrangements reflects:

- the unique nature of the aviation industry and in particular its underlying international characteristics;

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[4] A "free sale" codeshare arrangement is one in which the marketing carrier does not assume the risk of ticket sales. This is to be contrasted with a "block space codeshare arrangement", under which the marketing carrier assumes the risk associated with the sale of a particular block of allocated seats.

- the need for speed and flexibility in approving international airline arrangements; and

- the Ministry's competence in developing and administering New Zealand aviation policy, in particular, the familiarity with New Zealand's obligations under international aviation agreements and the requirement of the Minister to consider the effects on international comity between New Zealand and other states.

2.7 In terms of the exercise of the Minister's discretion under section 88 of the CAA, this application includes information considered relevant by previous Ministers, and follows the form used by Air NZ in respect of its previous applications for authorisation for the Tripartite Alliance between Air NZ, Ansett and Singapore Airlines; and the Alliance Expansion Agreement with United Airlines. This application also contains information consistent with the Parties' separate application to the Australian Competition and Consumer Commission (the **ACCC**).

2.8 As set out in further detail in section 9 below, the TNA does not breach any of the provisions in section 88 of the CAA which limit the Minister's discretion to grant an authorisation.[5] The TNA falls within the Minister's jurisdiction under section 88 of the CAA.[6]

2.9 Pursuant to Part 9 of the CAA, Air NZ and Qantas hereby apply to the Minister for authorisation of the TNA and the issue of a Commission Regime (the **Application**).

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[5] Irrespective of the factors set out in s 88(4), the Minister is empowered to nevertheless grant authorisation on comity grounds.
[6] The previous alliance proposal between the Parties included a domestic New Zealand and equity component, which precluded an application under the CAA because these components fell outside the Minister of Transport's jurisdiction. It also applied to Auckland – US and Australia – US.

3. The Parties and the Transaction

(a) **Air New Zealand**

3.1 Air NZ was incorporated in New Zealand in 1940 and is New Zealand's only designated international airline and largest domestic airline. The main business of Air NZ and its subsidiaries (the **Air NZ Group**) is the air transportation of passengers and freight.

3.2 The Air NZ Group operates international services to Australia, the Pacific Islands, North America, Asia and the United Kingdom. Its Tasman services are branded Air New Zealand and Freedom Air.

3.3 A copy of Air NZ's annual report for the year ending 30 June 2005, and interim report for 2006, can be obtained from http://www.airnz.co.nz/aboutus/investorcentre/publications/annualreports/default.htm.

(b) **Qantas**

3.4 Qantas was incorporated in Queensland in 1920 and is Australia's largest international and domestic airline. The main business of Qantas and its subsidiaries (the **Qantas Group**) is the transportation of passengers and air freight.

3.5 The Qantas Group's flying businesses are grouped under two major brands: Qantas, and Jetstar, both of which operate on Tasman routes.

3.6 A copy of Qantas' annual report for the year ending 30 June 2005, and interim report for 2006, can be obtained from http://www.qantas.com.au/info/about/investors/annualReports.

(c) **The Transaction**

3.7 The TNA is an agreement between Air NZ and Qantas to co-operate in respect of any flight operated on the "Tasman Networks" by any member of the Air NZ Group and the Qantas Group respectively (TNA, clause 2.1). It involves a free sale codeshare, supported by revenue/pricing arrangements.

3.8 Under the TNA, the term "Tasman Networks" is defined to include the scheduled passenger networks of each of the Air NZ Group and the Qantas Group on any of the

Tasman sectors[7], or routes which depart from within New Zealand and arrive within Australia, and vice versa. The TNA specifically excludes sectors solely within New Zealand or Australia, and sectors between New Zealand or Australia and any other country.

3.9 The TNA involves the co-ordination of activities between the Qantas Group and the Air NZ Group on the Tasman Networks, to the extent reasonably possible, in the following areas:

- scheduling and planning of flights (including the allocation of capacity);
- the pricing of passenger services;
- frequent flyer programmes – members will be able to earn and redeem points on all services carrying the code of the operator of the relevant frequent flyer programme;
- processing of passengers and baggage at airports;
- minimum inflight service offering;
- codesharing; and
- cargo services (as determined from time to time).

3.10 The TNA includes a revenue allocation (rather than a profit allocation) model (the **TNA Model**). The allocation of revenue between the Parties will occur on a quarterly basis and will be a function of two elements:

- the revenue performance of each airline (expressed as revenue per ASK), which is calculated from a base period of the 12 months to December 2005; and
- each airline's proportionate share of the capacity actually deployed on the Tasman Networks.

3.11 Flights operated by Jetstar or Freedom Air will not automatically form part of the codeshare arrangements, but may be introduced at a later date. However, these

[7] A "sector" is a non-stop (excluding technical stops where no passengers or cargo are picked up or dropped off) flight leg between two points.

airlines are included in the co-operation under the TNA and their revenue on the Tasman will be subject to the TNA Model from the outset.

3.12 Management of the Tasman Networks will be undertaken by a Committee in accordance with certain governance principles set out in the TNA. The Committee will initially comprise six members, with three members appointed by each Party. The Committee's role will be to oversee the operation of the TNA and its functions will include (but are not limited to):

- setting strategic objectives for the Tasman Networks, including as to scheduling, pricing, passenger processing, codesharing, frequent flyer programmes, lounge and check-in facilities at airports included in the Tasman Networks, co-ordinating in-flight product standards and price marketing (the **Activities**);
- ensuring optimisation of the Tasman Networks schedule;
- ensuring coordination between each of the Parties with respect to the Activities; and
- assuming responsibility for decisions that have a material impact on the base Revenue per ASK, including aircraft type and configuration changes and all capacity additions, reductions and deployments.

3.13 The Committee will meet at least once every calendar month by teleconference and all decisions of the Committee must be unanimous of all members attending. A quorum requires no less than one member appointed by each of the Parties.

3.14 A Working Group will also be established to take responsibility for the day-to-day operation of the TNA and to provide operational support to the Committee. The Working Group will comprise eight members, with four appointed by each Party. The Working Group will meet at least once a week by teleconference and all decisions of the Working Group must be unanimous of all members attending.

3.15 In accordance with the Networks Plan (as defined in the TNA), the Working Group will manage all commercial aspects of the Tasman Networks, including pricing and revenue management, sales strategies and network capacity and scheduling.

3.16 Further details can be found in the TNA at Appendix 1.

4. Overview and reasons

4.1 The Tasman is one of the most competitive aviation operating environments. The high level of competition results from the competitive strategies of carriers such as Emirates and Virgin Blue and also from the number of carriers (and hence capacity) deployed on the Tasman. This competitive environment has resulted in significant surplus capacity on the Tasman, driven by the growth of Virgin Blue and Emirates, as well as by Air NZ and Qantas as they strive to maintain comparable network offerings. Indeed, there are currently an estimated 6,300 empty one-way seats flown across the Tasman every day (with 5,200 of those empty seats on the main Tasman routes).

4.2 Its geographic location, time zone and the liberal aviation environment have all contributed to the competitive characteristics of this market.

4.3 In the Tasman context, the Parties face a number of challenges, namely:

- the presence of significant fifth freedom carriers, in particular Emirates, who have the ability and commercial incentive to price on a marginally costed basis (see Appendix 2 for a discussion of the cost advantages inherent in fifth freedom operations);
- the presence of Virgin Blue – a low cost, innovative and opportunistic carrier;
- the absence of any barriers to entry or expansion;
- the capability and readiness of carriers such as Emirates and Virgin Blue to expand; and
- the fact the vast majority of the passengers travelling on Tasman services are price sensitive.

4.4 The aviation industry is vitally important to New Zealand. New Zealand needs a strong locally based airline to provide critical international, domestic and regional links between markets and with trading partners on a commercially sustainable basis. This is particularly important for a country of New Zealand's size and geographical isolation. Air NZ's network, which is designed to carry passengers to, from and within New Zealand, means it is far more incentivised to promote New Zealand as a destination than any other carrier, which means a strong and secure Air NZ is vital to promoting New Zealand as a tourist destination offshore. Indeed, in 2005, Air NZ carried [Confidential] tourists to New Zealand.

4.5 The New Zealand Government, recognising the vital importance of Air NZ to New Zealand and particularly its tourism industry and transport infrastructure, agreed to the NZ$885 million re-capitalisation of Air NZ in 2001 to secure its ongoing viability.

4.6 The TNA acknowledges the practical reality that to continue their competitive stance on the Tasman routes both Air NZ and Qantas need to continually secure any available cost reduction initiatives and improve their revenue per ASK performance. The TNA will enable the Parties to reduce costs by removing some of the surplus capacity on the Tasman from their respective networks whilst still maintaining connectivity and sufficient capacity to meet demand (at current and forecast levels). The TNA contributes to Air NZ's financial security by addressing the issues Air NZ faces on a core part of its network, and will also contribute to Air NZ's ability to expand its network as appropriate.

4.7 Air NZ's management team has undertaken a range of initiatives to address the issues on the Tasman and has made substantial progress. In addition to the launch of "Tasman Express", a key initiative is currently underway to place Air NZ's entire A320 fleet into a single operating group to service the Tasman and Pacific Islands for both Freedom and Air New Zealand brands. By leveraging the relative strengths of the Freedom Air and Air NZ business models, Air NZ aims to lower its short-haul costs by approximately 10 percent on a cost-per-seat basis.[8]

4.8 Likewise, Qantas has announced several initiatives, including a revised fare structure and the deployment of its lower cost subsidiary Jetstar onto certain, predominantly leisure, routes.

4.9 However, notwithstanding these and other initiatives, returns on this core route group remain well short of an appropriate return on capital.

4.10 The business models of FSAs work in such a way that any removal of capacity on a route must be considered in light of the broader network impacts. The consequences of a network airline unilaterally removing capacity from a market, such as the Tasman, would be to cede competitive advantage to the competing airline's network while effectively marginalising its own network. The effect of this would be reduced passenger appeal and loss of market share on the wider network. For that reason, Air NZ and Qantas each have strong incentives not to remove surplus capacity even when the outcome would be continued higher costs. In particular:

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[8] http://www.freedomair.co.nz/en/about-us/news/short-haul.jsp.

- (**Removal of capacity would undermine competitive network advantage**) When faced with a choice between network airlines (such as Air NZ and Qantas), consumers (particularly business passengers) are more likely to choose the network airline that offers more destinations and frequencies. Air NZ and Qantas compete on this basis on the Tasman (and throughout their networks).

- (**Each Airline Aims to Maximise Revenue**) A related point is that all airlines want to have a schedule that maximises revenues. Both Air NZ and Qantas face the same market characteristics and, hence, make similar decisions when it comes to setting schedules for routes including the Tasman. As a result, Air NZ and Qantas have historically scheduled flights at approximately the same time.

- (**Lower Costs**) Airlines have economic incentives to optimise aircraft use and produce a schedule with efficient crewing costs. On the major Tasman city pairs, aircraft can be used for four sectors (for example two return flights Auckland to Melbourne) if the pattern starts at 6.30am and finishes around midnight. Both Air NZ and Qantas seek to gain this increased utilisation by starting flights at around 6.30am. Absent the TNA, removing a flight would have two effects: first, it may have a negative effect on aircraft utilisation and hence on unit costs, and second, for the reasons outlined above, it would mean ceding a schedule advantage to the other network airline. Accordingly, this is highly unlikely to be a viable commercial option for either Air NZ or Qantas.

4.11 For example, if Air NZ decided to reduce capacity unilaterally, this would simply spill customers to its network competitor, Qantas. In turn, this would have an impact on Air NZ's wider network, coupled with a reduction in Air NZ's "city presence". The exact same logic applies to any reduction unilaterally considered by Qantas. The net result is generally larger increases in capacity than warranted by market demand (as network airlines respond to each other) or the retention of surplus capacity, neither of which is cost effective.

4.12 Labour and aircraft ownership costs are the largest two controllable costs for airlines and therefore any meaningful cost reduction must inevitably address them. The TNA allows both Air NZ and Qantas to reduce cost, principally by removing some of the surplus capacity on the Tasman. The cost savings are discussed in further detail in section 7 and Confidential Appendix 1. By operating collectively, the Parties can utilise their combined fleets to operate a joint schedule to service the various Tasman routes more efficiently. There are two distinct efficiency gains:

- the cost savings associated with better matching supply to demand, allowing the removal of some of the surplus capacity; and
- a more efficient use of remaining capacity, in terms of increased load factors and a better schedule spread,

whilst meeting current and forecast demand.

4.13 These identifiable cost savings are solely attributable to the joint decision making which is facilitated by the TNA.

4.14 The TNA provides for the Parties to agree tariffs and allocate revenues on the Tasman. These provisions are a necessary and fundamental part of the TNA. In broad terms, the tariff setting and TNA Model align the individual incentives of each airline to act in the interests of both airlines so as to ensure that the full benefits of the TNA are realised.

4.15 Absent these provisions, each airline would have the ability and incentive to act opportunistically to further its own interests at the expense of the TNA. Such opportunistic behaviour would rapidly lead to a breakdown of the TNA. That would lead, self evidently, to the benefits of the TNA not being achieved.

4.16 The Minister of Transport has authorised a number of similar arrangements between airlines pursuant to section 88(2) of the CAA. These include:

- Tripartite Alliance between Air NZ, Singapore Airlines and Ansett – approved February 1998;
- Alliance Expansion Agreement between Air NZ and United – approved February 2002; and
- Qantas/British Airways Restated Joint Services Agreement – approved December 2003.

4.17 The Minister will be aware that the Parties proposed an earlier alliance which related to, inter alia, <u>all</u> flights into, within and out of New Zealand. The Previous Proposed Alliance involved Qantas taking an equity stake in Air NZ and also included cooperation in domestic New Zealand. In light of these two features, the Parties elected to apply for authorisation under the Commerce Act given that the CAA did not confer jurisdiction to authorise the equity stake or arrangements within domestic New Zealand. In October

2004, the Australian Competition Tribunal (the **ACT**) authorised the Previous Proposed Alliance.[9]

4.18 In New Zealand, the Commerce Commission declined to authorise the Previous Proposed Alliance and the Parties appealed to the New Zealand High Court. In its consideration of the Parties' appeal from the Commerce Commission's decision, the New Zealand High Court received up-dating evidence. However, it determined that its jurisdiction was limited to an appeal 'on the record' and therefore it had to be convinced on the basis of the information before it that the Commerce Commission was wrong to reach its decision. The High Court gave only very limited consideration to the updating evidence filed with it, and was called upon to consider a range of additional markets including Auckland-Los Angeles and domestic New Zealand.

4.19 By comparison, the ACT reached its decision to grant the Authorisation of the Previous Proposed Alliance on the basis of a hearing "de novo" that focused its attention on the Tasman routes. It specifically distinguished the different appeal procedures in New Zealand and in Australia by reference to its own ability to take account of the substantial and material up-dating evidence.[10] Unlike the High Court in New Zealand, the ACT was able to reach a decision having full regard to the impact of Emirates and Virgin Blue on the Tasman. Critically, the ACT concluded that the Previous Proposed Alliance would need to compete heavily for the all-important marginal passenger, and "this natural interplay of responsiveness to market forces of supply and demand will not be likely to produce any anti-competitive detriment".[11] The ACT found that the Previous Proposed Alliance resulted in a net public benefit, primarily due to the limited barriers to entry and expansion on Tasman routes and the competition the Parties would face from Emirates and Virgin Blue in particular.

4.20 The ACT made the following key findings with respect to Tasman air passenger services and these findings remain accurate:

(a) (**Price sensitivity**) A significant demand characteristic of Tasman origin/destination passengers is price sensitivity, as evidenced by the recent

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[9] The ACT consists of a President and such number of Deputy Presidents and other members as are appointed by the Australian Governor-General. A presidential member must be a judge of the Federal Court. Other members must have knowledge of or experience in industry, commerce, economics, law or public administration. The ACT for the Previous Proposed Alliance comprised Justice Goldberg (also the President of the ACT), Mr G Latta and Professor D Round (a professor of economics at the University of South Australia and also the Director of the University's Centre for Regulation & Market Analysis).

[10] As the ACT stated when comparing its task with that of the High Court: "That task was significantly different to the task we faced in considering all relevant evidence afresh without the need to assess the Commission's determination for error."

[11] ACT Decision, para. 445.

success of online internet bookings of cheap fares and the continued prevalence of discounted fares.[12] This has not changed.

(b) (**No barriers**) There are no significant barriers to expansion on Tasman routes facing Virgin Blue or Emirates.[13] This has not changed.

(c) (**Emirates**) The ability of fifth freedom carriers, including Emirates, to engage in marginal cost pricing on the Tasman services (see Appendix 2) allows them to target price-sensitive, Tasman origin/destination passengers and, in so doing, provide a competitive constraint on the Parties. This constraining effect would extend to routes other than those where the fifth freedom carriers directly operate.[14] This has not changed.

(d) (**Virgin Blue**) Virgin Blue acts as a pricing constraint on the routes it serves as well as on some routes it does not serve. This is primarily because it poses a threat to other airlines that it will enter routes if fares are artificially high.[15] This has not changed.

(e) (**Mavericks**) Virgin Blue and Emirates both have the ability to play the role of a "maverick" in the market, thereby keeping the Parties on a "continual competitive alert, both proactively and reactively".[16] This has not changed.

(f) (**Sufficient excess capacity**) Although there might be a tendency for the Parties to reduce capacity, there was sufficient excess capacity available to compensate for any reduction.[17] This has not changed – indeed, Tasman-wide load factors are lower today than at the time of the Previous Proposed Alliance meaning there is even greater excess capacity.

(g) (**Alliance constrained**) Even though the Previous Proposed Alliance would, in the short-run, command a high share of the Tasman air passenger services market, there would be little scope for any significant long-run damage to the competitive process. If the Alliance were to go ahead, there would not be any barriers to significant entry nor would there be any barriers to effective expansion by either or both of Virgin Blue or Emirates. Thus, the ACT expected that the Previous

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[12] ACT Decision, at para. 399.
[13] ACT Decision, para. 327.
[14] ACT Decision, at para. 399 & 401.
[15] ACT Decision, at para. 355.
[16] ACT Decision, at para. 423.
[17] ACT Decision, para. 498.

Proposed Alliance would be promptly and competitively constrained should it seek to raise fares.[18] This has not changed.

(h) (**Market shares not conclusive**) The ACT was not dissuaded from its conclusions by the fact that, as at the time of the hearing, the Parties had a relatively high share on the Tasman. The ACT said the combined market share of the Parties as at the time of the hearing does not reveal the full picture of competition for the marginal customer.[19] This has not changed.

4.21 The Parties remain fundamentally constrained as to price and the levels of service they offer by the conduct of competing airlines and, in particular, Emirates and Virgin Blue, whose conduct and business models necessitate the Parties remain on continual competitive alert. For the reasons set out in 4.17 – 4.19, and given the TNA only affects the Tasman, the Parties believe that the ACT's findings are more helpful to a consideration of the current Application than those of the New Zealand High Court. Accordingly, in determining this Application, substantial weight should be given to the ACT's findings.

4.22 In summary, New Zealand's size, geographical isolation and the importance to the economy of the tourism industry mean that a sustainable national carrier is vital. Co-operation in respect of Tasman services represents the most efficient way for the Parties to address the challenges they face in the highly competitive Tasman market. The high level of competition on the Tasman that will continue under the TNA ensures there will be no detrimental impact on the public. To the contrary, the TNA will realise significant cost savings for Air NZ (and Qantas) and, given the New Zealand Government's shareholding, the enhanced profitability of Air NZ will ultimately flow through to the New Zealand taxpayer, by way of increased dividends to the Crown or reduced risk of shareholders being called upon to inject more equity. Additional public benefits include:

- sustainably low prices;
- reduction of wingtip flying leading to a better schedule spread;
- reduced waiting times for connecting passengers and enhanced 'seamless' services;

[18] ACT Decision, at para. 419 & 445.
[19] ACT Decision, at para. 429.

- greater flexibility for consumers to change itineraries;

- frequent flyer programmes – a wider range of benefits for each party's respective frequent flyer members. Members will be able to earn and redeem points on all services carrying the code of the operator of the relevant frequent flyer programme;

- environmental benefits due to reduced fuel burn and carbon emissions; and

- increased likelihood of new direct routes and destinations.

4.23 Finally, the TNA does not breach any of the provisions in section 88 of the CAA which limit the Minister's discretion to grant an authorisation. The TNA does not:

- prejudice compliance with any relevant convention, agreement or arrangement to which the New Zealand Government is a party;

- make provision for enforcement through fines or market pressures;

- breach a commission regime;

- unjustifiably discriminate between consumers of air services in relation to the access they have to competitive tariffs;

- in so far as it relates to tariffs, exclude any supplier of international carriage by air from participating in the market; or

- prevent any party from seeking approval under section 90 of the CAA.

4.24 Accordingly, the Minister should exercise his discretion to authorise the TNA.

5. The Tasman is highly competitive with surplus capacity

(a) <u>Competition on the Tasman generally</u>

This section outlines the high level of competition on the Tasman by reference to the extent of recent capacity growth and the number of carriers operating on the Tasman.

5.1 There are currently eight independent airlines providing air services on the Tasman routes: [20]

- Air NZ and Freedom Air;
- Qantas and Jetstar;
- Emirates;
- Virgin Blue;
- Aerolineas Argentinas;
- Garuda Indonesia;
- Lan Chile; and
- Royal Brunei.

5.2 Figure 1 below illustrates the capacity growth the Tasman has undergone in recent years. This capacity growth has not been accompanied by similar growth in passenger numbers, resulting in an escalation in the level of surplus capacity. The recent small dip in the annual trend between June and December 2005 reflects the suspension of services by Thai Airways and is minor when compared to the extent of capacity growth since 2003. The apparent reduction in capacity in early 2006 simply reflects seasonality and is consistent with earlier years.

[20] Thai withdrew in December 2005. It is not included in the figures used in this application but remains a potential entrant.

Figure 1 Tasman Capacity Growth: All Carriers (Services between AKL-WLG-CHC and BNE-SYD-MEL)

5.3 Despite decisions by Polynesian Airlines[21], Malaysia Airlines, and most recently, Thai Airways in December 2005 to suspend their services on the Tasman (the latter two in favour of direct services ex New Zealand), there continues to be a surplus of capacity relative to demand on the Tasman. The withdrawal of these airlines from the Tasman routes highlights the limited barriers to exit and re-entry facing carriers in the Tasman market.

5.4 As set out in Figure 2, overall load factors on the key nine Tasman routes – a key measure of efficiency – have fallen over the same period.

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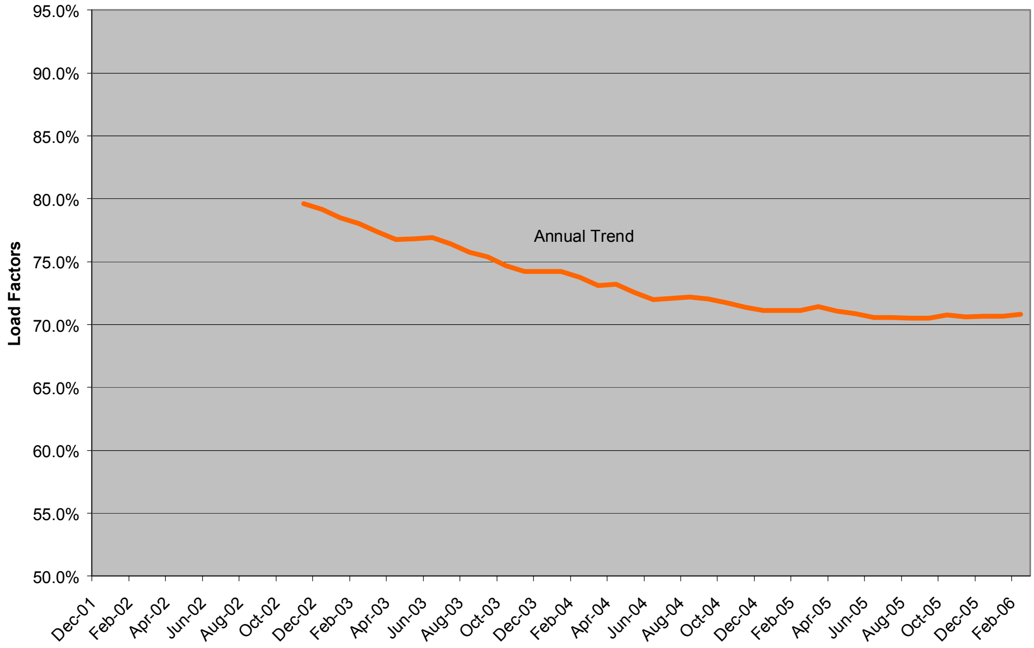
21 Which is managed by Virgin Blue.

Figure 2 Tasman Load Factors: All Carriers (Services between AKL-WLG-CHC and BNE-SYD-MEL) – Air NZ Estimate



5.5 Air NZ estimates there are currently 6,300 empty one-way seats per day on the Tasman. This equates to the equivalent of almost 11 empty A320 aircraft per day on the Tasman, each operating two return trips.

5.6 This high level of competition on the Tasman was considered by the ACT in 2004 in its assessment of the Previous Proposed Alliance between the Parties, seeking authorisation for capacity and pricing co-ordination on routes including the Tasman. As noted above, the ACT heard substantial evidence from industry participants and concluded that the level of competition on the Tasman and ability for others to expand meant there was no scope for sustainable price increases on the Tasman. The ACT said:

> Thus, in the absence of barriers to expansion for Virgin Blue and Emirates, and given the capacity available to Virgin Blue and Emirates, **we expect that the Alliance will be promptly and competitively constrained should it seek to raise fares**. Such a fare increase would likely be welcomed by the two newer carriers, as it would provide them with the opportunity to increase their market shares without having to lower their own fares, advertise more heavily, or otherwise engage in expensive brand and product differentiation. **We do not expect that the Alliance would be so**

commercially inept as to present Virgin Blue and Emirates with such a golden opportunity to expand at its expense.[22] (Emphasis added)

[22] ACT Decision, para. 445.

(b) **Emirates**

This section backgrounds Emirates, describes the 'marginally costed' pricing model it deploys on the Tasman, and outlines its long-term intention to operate on the Tasman.

5.7 Emirates, a Dubai-based airline wholly owned by the Dubai government of the United Arab Emirates, was launched in 1985 as a two aircraft airline serving destinations in Pakistan and India. Now, as one of the world's leading airlines, Emirates profitably operates a large modern fleet of 88 Boeing and Airbus jets. At the Dubai Air Show in late November 2005, Emirates announced an order for 42 Boeing 777 jets worth US$9.7 billion at list prices (at the time the largest-ever order for the Boeing 777 family of aircraft), with an option to buy 20 more. In announcing the order, Emirates' Chairman said, "We are investing in more new aircraft to meet escalating demand for Emirates' services from our customers across the globe. This new order will support the airline's growth".

5.8 Emirates currently has 127 wide body aircraft on order, including 43 passenger and two cargo A380s.[23] Ten A380s are expected to enter Emirates' fleet between April 2007 and December 2007 alone.

5.9 Since its launch and particularly in the recent past, Emirates has undertaken significant investments in new aircraft and expanded its routes. The ACT found that Emirates "is a rapidly expanding, high quality international airline … creating a global network, including Australia and New Zealand, from its Dubai hub and specialises in top end services". This growth has continued since the ACT's determination, during a period in which other network carriers have needed to reduce their networks, consolidate their operations and minimise their costs. Emirates' stated global expansion strategy is to become the world's largest global mega-carrier.

5.10 Emirates is currently one of the most profitable airlines in the world and has substantial financial resources at its disposal and significant global strength. As the ACT, which had the benefit of direct evidence from Emirates' Area Manager for Australia, Mr Eddie Lim, acknowledged, "(u)nlike the Applicants, as a comparatively young airline, it is not burdened by legacy costs".[24]

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[23] In 2003, Emirates announced orders for 71 aircraft valued at US$19 billion, at the time the biggest aircraft order in civil aviation history. Emirates current aircraft order book stands at 127, with a total value of US$35 billion. Its 45 A380s on order are more than any other carrier. Two of these A380s are dedicated freighters. See www.ameinfo.com and www.emirates.com.
[24] ACT Decision, para. 361.

5.11 In a press release on 15 November 2005, Emirates announced net profits of US$251 million for the first six months of the financial year to 30 September 2005.[25] Emirates is not required to pay corporate tax in the UAE.

5.12 Emirates entered the Tasman market in August 2003. The ACT found, based on the evidence from the airline, that it only took Emirates eight months from the commencement of its Tasman services to operate the services profitably. As recently as January 2006, Emirates stated that "The state of the business in New Zealand is absolutely superb".[26]

5.13 Emirates' current total capacity share on Tasman routes is 12.23%.[27] On the Tasman routes that Emirates flies, it has achieved the following share of capacity:

- 28.2% on Auckland to Brisbane (daily B777-300ER);
- 16.7% on Auckland to Melbourne (daily A340-500);
- 13.2% on Auckland to Sydney (daily B777-300); and
- 21.5% on Christchurch to Sydney (daily A340-500).[28]

5.14 Emirates also has an aircraft on the ground in Melbourne which it can readily deploy across the Tasman, without any changes to its current Dubai – Melbourne service.

5.15 As set out in Appendix 3, it is economically viable for fifth freedom carriers such as Emirates to fly the Tasman on a marginally costed basis. This is because the flights enable it to improve aircraft utilisation by flying a Tasman leg when its aircraft would otherwise be sitting idle in Australia, as well as providing additional "through traffic" for its services to/from Dubai. This was acknowledged by the ACT:

> Operating the trans-Tasman leg is economically rational for an FFC [fifth freedom carrier] if it can generate sufficient traffic on the trans-Tasman leg to cover the marginal costs of that additional leg. The main marginal costs of operating a flight are personnel costs, fuel costs, landing charges and fees for the use of airport facilities. Therefore, generally it is more profitable for FFCs to be flying trans-Tasman routes than for their aircraft to remain on the ground in Australia or New Zealand.[29]

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[25] Emirates Press Release: Emirates posts half-year profits of US$251 million, 15 November 2005.
[26] Chris Lethbridge, Emirates, New Zealand Herald, 9 January 2006, C14.
[27] Based on scheduled services as at 01.01.06 for the week commencing 20.02.06. (All capacity figures from Qantas.) Emirates' stated intention to introduce A380 aircraft on its routes serving New Zealand will increase the number of seats further (see, "Emirates moves in on Tasman routes", The Age, 1 April 2005).
[28] Based on scheduled services as at 01.01.06 for the week commencing 20.02.06.
[29] ACT Decision, para. 44.

…

> As Emirates prices its trans-Tasman operations on an incremental cost basis, it is unlikely that it will stop flying trans-Tasman routes because it is more profitable for Emirates to be flying trans-Tasman routes than for its aircraft to remain on the ground in Australia.[30]

5.16 The nature and scale of Emirates' operations on the Tasman makes the effect of its presence very different from a 'typical' fifth freedom carrier that uses Tasman routes as a way of utilising otherwise idle aircraft and to "top up" the wider network service. Its sheer size and Australasian presence means it derives significant economies of scale in terms of promotion of its brand and Dubai. Although it utilises fifth freedom bilateral rights, the Tasman is a major route in its own right for Emirates:

- Emirates operates substantially more capacity across the Tasman than is warranted by the demand for its wider services to and beyond the UAE.

- Emirates itself has clearly stated its intention to establish a significant long-term presence in Australasian markets. In a press release on 5 October 2003, Emirates' Executive Vice-President, Ghaith Al Ghaith stated with reference to the Tasman:

  > These flights are a demonstration of our commitment not only to our Australian and New Zealand customers but also to our determination to become a serious player on the Tasman route. We are here to stay.

- Emirates has combined with Air Tahiti Nui to provide around-the-world fares from New Zealand for all three classes of travel.[31] A sample itinerary could see a passenger flying Auckland-Papeete-Los Angeles-Paris-Dubai-Melbourne-Auckland.

- In early November 2005, Emirates approached the Australian Government to express its desire to double its current operating capacity into and out of Australia from 42 to 84 flights per week. Additional services to Australia would increase the scope for Emirates to strategically deploy additional capacity across the Tasman.

- In April 2007, Emirates will take delivery of the first of its 43 A380s and is reported to be intending to operate the 500+ seat A380 across the Tasman (although the

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[30] ACT Decision, para. 378.
[31] Emirates Press Release, 22 March 2006.

Parties expect initially only on services to Auckland due to current airport constraints at Christchurch).[32]

- Emirates' commitment to continuing to operate on the Tasman is highlighted by its promotion of its brand and of Dubai within Australasia and throughout its international network. It is also underscored by Emirates' promotion of the Emirates brand through association with significant organisations and events in both Australia and New Zealand, such as:

    - the "Emirates Team New Zealand" yachting syndicate (to which it has committed a reported NZ$30-40 million[33]);

    - races at the "Emirates" Melbourne Cup Carnival – Emirates is now the main sponsor for seven years from 2005;

    - a major sponsor of the Holden New Zealand Open golf tournament;

    - the Perth-based "Emirates Western Force" Super 14 Rugby team – Emirates is the principal, naming-rights sponsor until 2008;

    - the Sydney, Melbourne and West Australian Symphony Orchestras – which it has sponsored as Principal Partner since 2003;

    - official airline sponsor of the 2006 FIFA Soccer World Cup;

    - all International Cricket Council cricket umpires and referees until 2008 and sponsorship of the ICC Super Series (Australian team playing the rest of the world); and

    - "Premier Partner" of the Collingwood Football Club (AFL) until 2010.

- Emirates' entry into a frequent flyer programme with Virgin Blue (as discussed further at 6.34 below) and the fact it has its own lounge at Auckland Airport is further evidence of its long term intention to remain as an operator on the Tasman.

- Emirates' commitment to operating in the Australasian region is clearly evidenced in the attached Emirates document, "Here for the Long Haul".

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[32] See, http://www.travelbiz.com.au (4 April 2005) and also http://www.theage.com.au (1 April 2005).
[33] *The Independent Business Weekly*, 16 June 2004. "Emirates is believed to be putting up between $30 million and $40 million."

(c) **Virgin Blue**

This section provides a brief history of Virgin Blue and an outline of the low cost model it operates and its growth.

5.17 Pacific Blue is a wholly owned subsidiary of Virgin Blue. Virgin Blue currently operates a fleet of 50 Boeing 737 aircraft across 22 destinations in Australia, and serves six international destinations: New Zealand (Auckland, Wellington and Christchurch), Vanuatu, Fiji, Rarotonga, Samoa and Tonga. It is a well-funded company with “deep pockets”. In 2003, Virgin Blue undertook a successful initial public offering that gave it a market capitalisation of A$2.3 billion. As of 30 March 2006, its market capitalisation of NZD2.36b[34] was more than twice that of Air NZ (NZD1.16b). Virgin Blue’s access to significant financial resources as an ASX-listed company and through its ownership links with Richard Branson’s Virgin group of companies and the Patrick Corporation, provide it with strong financial backing.

5.18 In January 2004, Virgin Blue commenced flights between Brisbane and Christchurch (and now accounts for 34.4% of all seats operated on that sector). Since its initial entry in 2004, Virgin Blue has progressively expanded and as recently as 31 March 2006, it announced additional services from Christchurch and Auckland to Brisbane.[35] It has now achieved the following capacity shares (which are forecast to increase further from May when its additional Brisbane frequencies take effect):

- 34.4% on Christchurch – Brisbane;
- 19.9% on Christchurch – Melbourne;
- 10.7% on Christchurch – Sydney;
- 30.4% on Wellington – Brisbane;
- 7.6% on Auckland – Brisbane; and
- 25.5% on Auckland – Coolangatta.[36]

[34] 1 NZD = 0.85 AUD.
[35] NBR *Business Traveller* Friday 31 March 2006, reporting Pacific Blue’s launch of four new services from Auckland or Christchurch to Brisbane in May.
[36] Based on scheduled services as at 01.01.06 for the week commencing 20.02.06.

5.19 These are substantial shares achieved in a relatively short time. They are also significant when viewed in the context of the high level of constraint that lower cost airlines such as Virgin Blue impose on pricing, even where they have relatively low shares and even where they do not operate across all routes (discussed further in section 6(e)).

5.20 Virgin Blue's business model incorporates many of the typical LCC features, such as providing minimal base 'frills', implementing flexible labour arrangements, operating a single type of aircraft (the B737) and operating on routes and at times which maximise operating efficiency, whilst customising its product for the Australasian market.

5.21 In late November 2005, Virgin Blue re-defined this approach as part of the process of developing a "new world carrier" (**NWC**) model and predicted "the evolution of some LCCs into New World Carriers will expand the scope of competition with full service legacy carriers. NWCs will seek to leverage their low cost foundations and ability to add valuable new products to increasingly penetrate the lucrative business market to strengthen yields and profitability".[37] The key elements of the NWC model include:

- a low cost base, driven by high asset and people productivity;
- an ability to develop valuable new products on a profitable pay-per-use basis;
- competition based on customer segments, as opposed to the traditional route-by-route competition of LCCs (in other words, continuing to broaden the range of passengers to which their services appeal); and
- innovative development of "many of the trappings" that afford legacy carriers healthy yields, with a "barely perceptible" impact on costs.[38]

5.22 The development of the NWC is consistent with the ACT's view of Virgin Blue's forward-looking strategies:

> We recognise that Pacific Blue does not satisfy the needs of all time-sensitive passengers, but we have formed the view that it is likely that it will be successful in acquiring more business travellers as

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[37] "Virgin Blue announces birth of "New World Carrier" in CAPA Report" Media Release, 30 November 2005.
[38] Virgin Blue Press Release, 30 November 2005.

it continues to target the corporate market and to increase frequencies on existing routes and eventually enter the Auckland routes.[39]

5.23 Virgin Blue's commitment to ensuring these developments have a "barely perceptible" impact on costs is reflected in its announced costs per ASK for the 12 months ended 30 September 2005. Excluding fuel costs, costs per ASK were 6.03 Australian cents relative to 6.22 Australian cents for the previous 12 months (or a 3.0% decline).

5.24 In line with the stated NWC philosophy, Virgin Blue introduced a number of strategic and valuable innovations during 2005, including:

- Blue Plus fares in March – April 2005. Designed for business travellers, passengers who book a Blue Plus fare and can no longer travel for any reason are given the option of obtaining either a refund or a credit. In addition, all Blue Plus fare holders can take advantage of new priority check-in counters, free entry to Virgin Blue lounges (the Blue Rooms) in Brisbane, Sydney and Melbourne, and forward aircraft seating (subject to availability).

- A commitment to a faster check-in process realised through the roll-out of Blue-Check self check-in kiosks in airports across Australia and the introduction of "Web Check-in Facilities" from 1 October 2005. The web check service allows passengers to check-in, print a boarding pass, select seats and arrange for check-in of luggage before they get to the airport.

- A codeshare arrangement with Virgin Atlantic, announced in August 2005.

- Introduction of a new Application Program Interface that will allow Virgin Blue to codeshare with any international carrier.

- The introduction of "DigEplayer" personal video units on certain domestic flights from April 2006. These personal "video on demand" units will be available on a pay-for-use basis of $15 for the duration of the flight and feature unlimited access to 10 preloaded feature length movies, other short programmes and music.

- The introduction of a competitive frequent flyer programme, "Velocity".

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[39] ACT Decision, para. 354.

5.25 While not all of these initiatives are available on Tasman services, they are all available in domestic Australia, and the Parties expect that those innovations not already part of Virgin Blue's Tasman offering will be introduced as demand requires.

5.26 "Velocity" was launched in November 2005, in conjunction with launch partners National Australia Bank, Emirates, Virgin Atlantic and Europcar. In so doing, Virgin Blue highlighted its ambition to ensure the programme will be cost neutral, in line with its cost containment philosophy[40] and confirmed its commitment "to our original charter to drive competition by offering a high quality product at consistently lower fares."[41]

5.27 By increasing the airline's appeal to the business traveller, Virgin Blue has further increased the level of constraint it imposes on the Parties beyond that existing at the time of the Previous Proposed Alliance. This increase in appeal, together with a general trend in business travel on short-haul routes like the Tasman towards forgoing a higher level of service or broader schedules for the price and value offered by a LCC, means Virgin Blue remains a serious, long-run source of commercial rivalry for the Parties.

5.28 Virgin Blue remains in an extremely strong position to enter new and expand on existing Tasman city pairs:

- Virgin Blue and Pacific Blue each have highly recognisable, well-established brands in both Australia and New Zealand;

- Virgin Blue/Pacific Blue's brand in New Zealand has been further strengthened by its ex-New Zealand services to Samoa, via a joint venture with the Samoan Government;

- Virgin Blue has access to sufficient aircraft and financial resources in its own right and through its ownership links with the wider Virgin group and Patrick Corporation;

- Virgin Blue faces no regulatory restrictions, or any problems gaining access to facilities (including terminal space, counter space and slots) at Wellington, Christchurch and Auckland Airports (or airports in Australia) for the purpose of providing Tasman services;

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[40] Peanuts, The Low Cost Airline Weekly, Issue #97, 22 November 2005 at p.22.
[41] Virgin Blue Press Release: "Virgin Blue woos business travellers with 'Velocity', powered by Virgin Blue – The world's next generation loyalty program", 15 November 2005.

- Pacific Blue (through Virgin Blue), has a large Australian domestic network to provide feeder traffic to its Tasman service; and

- Virgin Blue continues to implement a business model that fundamentally seeks to minimise costs and offer passengers low airfares. Many of the recent innovations adopted by Virgin Blue as part of the NWC model appear to be targeted towards improving the airline's appeal to the business traveller. However, these developments have been undertaken with a stated commitment by the airline that it will maintain its low fare offering, which is likely to broaden the base of passengers for whom Virgin Blue offers a legitimate alternative to the Parties' services.

5.29 Virgin Blue's rate of expansion on the Tasman has slowed more recently. However, this is simply a reflection of the high degree of surplus capacity and competition on the Tasman, which means deployment of capacity on Pacific Island routes has proven more profitable. Even so, Virgin Blue has steadily expanded over the past two years and now operates services on six Tasman sectors. Its recent announcement to expand its Auckland – Brisbane and Christchurch – Brisbane services demonstrates it remains poised to expand where it sees an opportunity. The critical facts are:

- Virgin Blue remains profitable;

- the lower cost airlines around the world such as easyJet, Southwest and Ryanair all report varying levels of profitability and growth rates from time to time, but history has proven that their model is sustainable, and that the constraint they impose on other carriers is real and ongoing; and

- Virgin Blue faces no barriers to expansion, or to entry or exit, which means it can deploy and redeploy aircraft quickly in response to market opportunities on the Tasman without incurring material sunk cost.

5.30 In short, the fact that Virgin Blue's rate of growth on the Tasman has slowed in no way reduces its ability to "cherry pick" or otherwise affects its ever-present ability to enter or expand and undermine any attempted price increase. Indeed, Virgin Blue's CEO recently said "… make no mistake, Virgin Blue will continue to use innovation and "out of the box" thinking to stay at the forefront of competition".[42]

[42] Virgin Blue Press Release, 15 November 2005.

(d) **Other Fifth Freedom Carriers**

5.31 In addition to Emirates and Virgin Blue, the Parties contend that the fifth freedom carriers currently offering services on the Tasman routes impose, and will continue to impose, a competitive constraint on Qantas and Air NZ. Furthermore, a large number of other carriers, in particular Singapore Airlines, have similar, unexercised rights and could elect to enter the Tasman market at any time, given there are no barriers to entry or expansion. Thai and Malaysia are two carriers who have operated on the Tasman in the past and, given the incentive, will do so again.

5.32 As with Emirates, the other fifth freedom carriers are an effective competitive constraint on the Parties' pricing conduct because they have the ability and incentive to price fifth freedom flights on the basis of marginal costs only. This means that in the face of fare increases by either of the Parties, fifth freedom carriers are able to offer an attractive alternative to the marginal passenger.

5.33 Furthermore, there are a large number of other international airlines with the necessary air service rights which currently operate services to Australia and which could operate Tasman services in response to the necessary incentives. They include Singapore Airlines, Air China, British Airways, United Airlines, Cathay Pacific, Thai International Airways, Malaysia Airlines, Polynesian Airlines and Virgin Atlantic.

5.34 This analysis is particularly powerful when applied to Singapore Airlines, a network carrier with a high quality service that operates a large number of weekly services between the east coast of Australia and Singapore and New Zealand and Singapore. Even though Singapore Airlines does not presently offer Tasman services, it is well understood that it is constantly seeking to increase its presence into and out of Australasia. The constant presence of Singapore Airlines on the fringes of the Tasman market is yet another constraint.

6. No price impact on consumers

This section further describes the high level of competition on the Tasman – in particular from Emirates and Virgin Blue, and the absence of barriers to entry or expansion – and why that ensures there will be no adverse price impacts from the TNA. It describes how competition for the 'marginal' passenger is fierce, and how Emirates and Virgin Blue impact pricing for all types of passengers on all Tasman routes as a result. This section also outlines how competitors' pricing and capacity decisions impact the prices Air NZ and Qantas offer into the market, through the operation of airline revenue management systems.

(a) **No barriers to entry or expansion**

This section outlines the ability of other airlines, in particular, Emirates and Virgin Blue, to enter and expand on the Tasman.

6.1 The Parties acknowledge they have historically had a high share of capacity on the Tasman. However, their combined share has fallen markedly over recent years – from 93.4% in 2000 to 76.6%[43] as of December 2005 – as competitors have expanded. It is forecast to reduce marginally under the TNA due to the removal of surplus capacity. However, as outlined below, it is the extent of competition for the *marginal* customer that determines overall pricing, not the level of combined share.

6.2 The entry and growth of airlines such as Emirates and Virgin Blue and the rapid expansion of total capacity on the Tasman (even when allowing for the departure of some other carriers) indicates the absence of barriers to entry or expansion on the Tasman.[44] There are no issues as to facilities, aircraft, branding, regulatory or otherwise. This fact was reflected in the ACT's decision, when it said "there are no significant barriers to entry or expansion on Tasman routes facing Virgin Blue, or indeed, for that matter, for Emirates to which we refer later."[45]

6.3 In terms of the ability to enter in the very short run:

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[43] Based on scheduled services as at 01.01.06 for the week commencing 20.02.06.

[44] In addition to the 10 carriers currently operating on the Tasman, a further 12 have the necessary rights, namely, Cathay, Malaysian Airlines, Singapore Airlines, United Airlines, British Airlines, Air China, Air France, Lufthansa, Continental, Delta, American Airlines, Air Macau and Mandarin Airlines. Etihad – the official airline of the UAE – also has bilateral rights.

[45] ACT Decision, para. 327.

- even without any scheduling changes, Emirates has an aircraft flying services from Dubai to Melbourne that could immediately be deployed across the Tasman on a marginal cost basis to increase its share at the expense of the Parties;

- Emirates operates widebody aircraft, meaning it already has significant capacity ‘head-room’ to carry additional passengers if needed;

- the deployment of the A380 will further increase Emirates’ ability to carry an expanded number of passengers on the Tasman. Even assuming it only operates its A380s on Tasman services to Auckland, in a 500 seat configuration, that A380 deployment will result in a 40-50% increase in Emirates’ capacity;

- Virgin Blue has aircraft deployed elsewhere that could be quickly redeployed to the Tasman if it were more profitable to do so; and

- Other fifth freedom carriers have the bilateral rights to fly across the Tasman in response to an incentive to do so.

(b) **The lower cost airlines drive pricing on the Tasman**

This section explains why the lower cost airlines, Emirates and Virgin Blue, drive pricing on the Tasman and why the Parties must respond in order to retain the critical "marginal" passengers.

6.4 Competition from the marginally costed Emirates and the low cost Virgin Blue, coupled with competition from the other fifth freedom airlines, means the Parties are, and will continue to be, effectively constrained on the Tasman so that there is no resulting substantial lessening of competition.

6.5 As the ACT accepted, Virgin Blue and Emirates keep the Parties on a continual competitive alert, both proactively and reactively.[46] It also accepted expert evidence that fares in airline markets were driven generally by the competition for customers at the margin (see explanation from 6.7 below) and therefore rival airlines do not need to appeal to all of the incumbents' passengers to exercise a competitive constraint on them.

6.6 Competition for these critical marginal passengers is provided by existing competitors introducing a new set of competitive strategies generally (for example, Virgin Blue), to which incumbent airlines are compelled to respond, other existing airlines seeking to fill spare capacity by marginal cost pricing (for example, Emirates), or new entrants (for example, other fifth freedom carriers).

6.7 This constraint at the margin occurs because an unsold seat on a flight represents revenue lost. Network airlines such as Air NZ and Qantas necessarily incur significant fixed costs, which represent a high proportion of total costs. Because the fixed costs will not fall as passengers and revenue are lost, the profitability of the network airlines can be significantly affected by a relatively small loss of paying passengers. Given the relatively low marginal cost associated with one seat on an aircraft, the resulting loss of profit on an empty seat is almost as much as the lost revenue. This means that airlines prefer to sell a seat at a very low fare rather than have that seat depart empty.

6.8 If the Parties were to raise fares above prevailing levels in an attempt to exploit their market position, Virgin Blue or Emirates would treat this as an invitation to keep their fares at their current level, in order to attract the customers at the margin who may be quite indifferent as to the airline with which they fly. Accordingly, the Parties must

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[46] ACT Decision, para. 423.

monitor and respond to both the actual and potential behaviour of Emirates, Virgin Blue and other carriers to ensure that the critical marginal customer is not lost. This will occur regardless of whether the TNA is implemented.

6.9 The ACT explained the pricing constraint imposed on Air NZ and Qantas in the following terms:

> We therefore expect that competition for passengers at the margin will be intense. Each percentage point of market share gained is worth a considerable amount of profit to the airlines. Further, because airlines cannot easily discriminate between passengers at the margin and committed passengers, the low fares offered by Virgin Blue and Emirates in their attempts to gain market share at the expense of the Alliance will flow through to all passengers in the market who wish to take advantage of them.[47]
>
> …
>
> In short, we believe that Virgin [Pacific] Blue and Emirates are well placed to act, and would act, in response to any attempt by the applicants to reduce capacity, increase fares or offer poorer quality or more limited trans-Tasman services.[48]
>
> …
>
> We query whether any airline would be prepared to raise its fares first in such a scenario, given the uncertainties as to whether its rivals would follow its lead, and the financial penalties that it would incur should no other airline increase its fares to the same level or at all. It should be clear to any airline that it is not optimal to raise ticket prices on a sustained basis in a market with the competitive characteristics of the trans-Tasman air passenger services market.[49]

6.10 The pricing constraint on the Parties, driven by competition for the marginal passenger, has an effect that extends beyond the fares offered to these passengers. The ACT explained this effect in the Qantas/Air NZ Decision as follows:[50]

> The competition for the customer at the margin does not stay with that customer, but those fares necessary to attract the marginal customers will be available to all buyers in the market. The competition for an extra 1% of market share has an advantage and benefit for all passengers who are within the same passenger profile as the marginal passengers. All customers have the ability to get the same advantage and benefit. Therefore, the competition for the marginal passenger spreads throughout the market.

6.11 This conclusion is not at all surprising when an assessment of Emirates' capacity and pricing approach is made. The cost advantage associated with being a fifth freedom

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[47] ACT Decision, para. 444.
[48] ACT Decision, para. 452.
[49] ACT Decision, para. 466.
[50] ACT Decision, para. 429.

carrier on the Tasman delivers Emirates a lower profitability threshold and significant pricing freedom relative to the Parties. As the ACT accepted, this enables Emirates to target price-sensitive Tasman passengers with low promotional fares while providing a full service long-haul product. This ensures its continued competitive presence on Tasman routes.[51] Emirates' continued ability to take advantage of its unique cost position in this regard was highlighted earlier in 2005 when the airline publicly claimed "…it only has to fill 40% of its seats to be profitable over the Tasman".[52]

6.12 It also means Emirates can offer extremely low promotional fares in an effort to attract price-sensitive passengers, which in turn affects passengers' expectations regarding the appropriate fare level across all airlines. The existence of websites that provide detailed comparisons of fares and increasing pervasiveness of the internet generally, means that consumers are becoming increasingly aware of the various fares offered in the market. If Emirates offers seats at a particularly low sale fare, Air NZ and Qantas must respond to that fare to reassure the public that the airlines are maintaining competitive offerings on the Tasman. If Air NZ and Qantas do not offer fares commensurate to those being offered by their competitors, they are likely to lose a substantial number of price sensitive passengers. It is the experience of both Air NZ and Qantas that such passengers tend to switch in significant numbers from one airline to another in response to cheaper airfares.

6.13 Emirates leverages its marginal costing advantage to sell approximately 87% of its seats in its low priced lead-in and tactical fare classes.[53] In contrast, Air NZ and Qantas, without the ability to deploy aircraft on a marginally costed basis, sell [Confidential]% and [Confidential]% of their seats in lead-in and tactical fare classes respectively. Not only does Emirates offer such a high proportion of total seats at its lead-in and tactical fares, it does so while paying travel agents a level of commission in excess of that which can be offered by airlines operating fully costed models on the Tasman.

6.14 Emirates' higher product specification, current high levels of surplus capacity, and its ability to price at close to marginal cost, mean that it is a formidable competitor.

6.15 In addition to the substantial constraint imposed by Emirates, Virgin Blue has also had, and continues to have, a major impact on the Parties' pricing. Virgin Blue's low cost structure allows it to sustainably carry traffic at lower average fares than Air NZ and

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[51] ACT Decision, para. 378.
[52] http://www.theage.com.au/news/Business/Emirates-moves-in-on-Tasman-routes/2005/03/31/1111862535379.html
[53] 6 months to December 2005. Air NZ estimate, based on data collated by travel agents.

Qantas, meaning the constraint it imposes is much greater than its market share alone might otherwise suggest.

6.16 LCCs such as Virgin Blue have had two major impacts on FSAs:

- First, by leveraging their simple business model and low cost base, they have materially contributed to significantly lower prices in the market: directly, by offering those prices themselves; and indirectly, by prompting the incumbent(s) to lower their price across all related routes in expectation of their entry.

- Second, they have introduced different pricing models that have permanently changed many of the pricing mechanisms traditionally employed by FSAs to "fence off" seats for time sensitive passengers. For example, the offering of low priced one way tickets by LCCs has removed the ability of FSAs to implement traditional conditions such as return tickets or Saturday night stayovers.

6.17 Virgin Blue's impact on pricing is evidenced by the market behaviour of Air NZ and Qantas. Air NZ's short-haul changes were primarily in response to the rise of the LCC model – Tasman Express was particularly directed at the anticipated entry of Virgin Blue (and more recently the expansion of Emirates). These "Express" initiatives – "everyday low fares" – have resulted in fare reductions across all routes (including routes where Air NZ is the only airline operating) and the removal and simplification of fare conditions.

6.18 Qantas has also simplified its fare structure on the Tasman in an environment where Virgin Blue had signalled an intention to expand its services to the Tasman. As the ACT accepted, the launch in Australia and now on the Tasman of Jetstar by Qantas was also a competitive response.

6.19 The Parties must limit the deployment of their lower cost subsidiaries, Freedom and Jetstar, due to the "cannibalising" impact that their widespread deployment would have on the network feed traffic their respective parent airlines rely upon.

(c) **Revenue management**

The following section outlines how Air NZ and Qantas revenue management systems adjust prices to take into account the pricing and capacity decisions of Emirates, Virgin Blue and other competitors.

6.20 Air NZ and Qantas actively monitor the pricing behaviour of fifth freedom carriers and Virgin Blue in order to ensure fares are competitive with other airlines. By way of illustration, Air NZ's pricing department sets a fare structure by reference to the competitive environment (that is, the current and projected prices and products offered by competitors) as well as route yield and revenue requirements.

6.21 Air NZ and Qantas operate revenue management systems that aim to maximise total revenue on a flight by matching, as closely as possible, a passenger's willingness to pay with the particular fare charged. Revenue management systems are designed to forecast how many tickets the airline will sell at each price available for a flight and allocate seats to the highest value fare types, or buckets, first. Once this allocation is made for the highest value fare type, the system works its way down in fare values allocating seats until all available seats are accounted for.

6.22 This forecasting of demand is generally based on historical information from an airline's revenue management database and involves sophisticated computerised forecasting and optimisation techniques which account for historical booking patterns, bookings on hand, and cyclical variations by season, day, and time of day.

6.23 While revenue management systems categorise fares from highest to lowest value and then forecast demand at each price point allocating seats from highest value to lowest, seats are generally booked by passengers in the reverse pattern. Discounted fares tend to be purchased first and closed off (that is, no further tickets are sold in respect of that fare class) prior to an airline determining whether the forecast demand for higher value seats will materialise.

6.24 The revenue management system is designed so that, at specific set dates prior to departure (referred to as data capture points or "DCPs"), the revenue management system will compare projected demand against actual forward sales and alter the allocation of seats. This is sometimes referred to as "re-optimisation". In the week leading up to departure, it is likely that this re-optimisation will occur daily. In addition, if at any time between these DCPs, actual forward bookings suggest that demand has moved above or below certain set parameters, the revenue management system will re-optimise at that point.

6.25 When fifth freedom carriers or Virgin Blue offer low fare seats on a route, this invariably results in forward bookings for Air NZ that are below what the airline forecast. Forward bookings falling below forecast load factors will reduce the probability of the Air NZ aircraft being filled, which, through the operation of the revenue management system as described above, will *automatically* see more seats being re-allocated toward the lower fare classes as the revenue management system creates more discounted seats on a flight.

6.26 In addition to these automatic reactions by the revenue management systems, the Parties must also maintain competitiveness more generally with the promotional fares of Emirates and Virgin Blue. The Parties generally react swiftly to the promotional fares of both Emirates and Virgin Blue offer to Tasman travellers. For example:

- Between 2 May and 15 May 2005, Emirates offered one way fares of $139 on the Auckland – Sydney, Auckland – Melbourne and Auckland - Brisbane routes and $129 on the Christchurch – Melbourne route for travel between 2 May and 30 June 2005. Air NZ immediately responded on 2 May by matching the Emirates offer.

- Between 14 and 19 June 2005, Pacific Blue offered one way fares of $129 on Auckland – Brisbane, Wellington – Brisbane, Christchurch – Brisbane and Christchurch – Sydney routes for travel between 26 July – 7 December 2005. Air NZ responded immediately on 14 June by matching the Pacific Blue offer.

- Between 25 July and 8 August 2005, Emirates offered one way fares of $129 on Auckland – Sydney, Auckland – Melbourne and Christchurch – Sydney routes for travel in August 2005. Air NZ responded to this promotion by matching Emirates (although Qantas had already responded prior to Air NZ’s response).

(d) **Impact of Increased Frequency**

This section outlines how some passengers may elect to purchase more flexible tickets to take advantage of the improved frequency of flights offered under the TNA

6.27 Under the TNA, Qantas and Air NZ will sell each other's flights as codeshares, thereby significantly increasing the number of flight frequencies each offers for sale on the Tasman routes. Furthermore, on most routes flight departure times will be adjusted to improve flight coverage throughout the day. This increased network would not be achievable by either Party acting alone.

6.28 Passengers who value flexibility, and are willing to pay more for the fare types that offer flexibility, will choose the carrier (or combination) that offers the most alternatives for changing flights. Those passengers who would have purchased a more restrictive fare absent the opportunity to change flights could choose to buy a higher fare that allows such flexibility when presented with a greater opportunity to change flights (as is the case with the Parties' services under the TNA). The consequence is that under the TNA, it is possible that more passengers will purchase tickets for the higher fare buckets than would otherwise be the case.

6.29 In these circumstances, there is a potential for an increase in the Parties' average fares to occur on account of passengers choosing to pay a higher fare because they perceive a higher value in an improved product offering. Average fares will only increase if passengers value the changes made and make their purchasing decisions accordingly, and there will be no ability for the Parties to charge prices higher than the competitive market price. If passengers do not value the changes, they will not choose to pay the higher fare.

6.30 The ACT considered and accepted these propositions and made the following finding in respect of whether a change in average fares for the Parties gave rise to competitive detriment:

> We therefore accept that there may, or probably will, be situations arising whereby the applicants might achieve higher average fares under the Alliance. Such a situation would occur where passengers who value flexibility will choose a carrier that offers the greatest alternatives for flexibility in relation to changing flights. This may result in passengers choosing flights which nevertheless require them to pay a higher price because they fall into a different fare bucket. In such circumstances we consider that, in this respect, there will be little, if any, detriment arising out of the

Alliance as it will be within the power of passengers to choose their own times to fly and the point of time at which they wish to book their tickets.[54]

[54] ACT Decision, para. 457.

(e) **<u>The pricing constraint on the Tasman applies to all types of passengers and across all routes</u>**

This section outlines why the constraint from Emirates and Virgin Blue applies across all Tasman routes and all passengers.

6.31 The impact of Emirates and Virgin Blue applies to all types of passengers and across all routes, even those on which they do not currently operate. This proposition was accepted by the ACT.

6.32 Emirates' business product is world renowned and Virgin Blue successfully attracts business travellers. Jon Marshall, Virgin Blue's global sales manager, reported in March 2004 that corporate-government travel accounts for 40 per cent of Virgin Blue's traffic. Virgin Blue suggests its low fares, reliability, increased frequencies on existing routes and the continued expansion of its network have all contributed to the carrier becoming increasingly attractive to business customers.

6.33 Even in respect of schedule advantages, one consequence of the introduction of one way fares has been that passengers can, and do, choose different carriers for each leg, according to price and schedule convenience.

6.34 Virgin Blue's commitment to attracting business passengers is further evidenced by its launch of its "Velocity" loyalty programme. At the launch, Virgin Blue CEO, Brett Godfrey, said "Velocity powered by Virgin Blue, is for all of our Guests and is also part of our strategy to broaden Virgin Blue's appeal to frequent travellers, and the corporate and Government sectors".

6.35 By increasing the airline's appeal to the business traveller through innovations such as "Velocity", Virgin Blue has increased the level of constraint it imposes on the Parties relative to that outlined in the ACT's determination. This increase in appeal, together with a general trend in business travel on short-haul routes like the Tasman towards foregoing a higher degree of service or broader schedules for the price and value offered by an LCC, means Virgin Blue remains a serious, long-run source of commercial rivalry for the Parties.

6.36 Further, the low barriers to expansion by Emirates and Virgin Blue onto new Tasman routes, and the fare expectations those carriers set in the Tasman market as a whole, means their presence impacts fare levels on *all* Tasman routes – not just those where they may be operating at a given time.

6.37 In summary, the Parties believe there is no scope to increase fares beyond competitive levels, and reiterate the conclusion of the ACT (referred to at 5.6 above) that it did not expect that the Alliance would be so “commercially inept” as to increase fares.

7. Benefits

This section outlines the benefits to New Zealand of authorising the TNA. The benefits include cost reductions from the removal of surplus capacity, the more efficient deployment of capacity, a better spread of departure times, greater itinerary flexibility, enhanced connectivity (reduced waiting times) for customers, improved frequent flyer benefits, international competitiveness and a strong flag carrier, reduced fuel burn and carbon emissions and greater scope for the introduction of new direct routes.

(a) **Increased efficiency via cost reductions**

7.1 By operating collectively, the Parties can utilise their combined fleets to more efficiently service the various Tasman routes. There are two distinct efficiency gains:

- the ongoing cost savings associated with exiting surplus capacity; and
- a more efficient use of remaining capacity, in terms of a better schedule spread and greater aircraft utilisation. By way of illustration, the Parties' Tasman load factors (which are a key measure of aircraft utilisation) are forecast to improve from approximately 72.7 today, to an estimated 75-76.5% by Year 3 of the TNA.

7.2 In terms of cost savings directly attributable to Air NZ, and hence New Zealand, the TNA allows the removal of some of the surplus capacity. The full detail of the cost savings to Air NZ in this regard are set out in Confidential Appendix 1.

7.3 Under the TNA each Party bears its own costs. Reductions in cost therefore flow straight to the individual airline's bottom line, meaning the ongoing incentive to reduce cost is maintained under the TNA.

(b) **Better schedule spread for consumers – removal of wingtip flying**

7.4 The TNA will result in scheduling efficiencies which reduce the level of "Wingtip" flying, resulting in a more even spread of flight times for consumers. Wingtip flying is detrimental because passengers who wish to fly during a scheduling gap must fly at an inconvenient time.

7.5 The removal of wingtip flying is directly related to the TNA. Where Qantas and Air NZ are in competition with each other on a route, each has a strong incentive to schedule flights at roughly the same times as its rival:

- the airlines will seek to operate their flights at those times when there is the greatest level of high yield traffic, in order to maximise their load factors and revenue; and

- each airline will seek to draw business away from the other.

7.6 On the Tasman, an additional factor contributing to the high level of existing wingtip flying is the logistical issues associated with maximising aircraft utilisation. By scheduling aircraft to leave New Zealand early in the morning it is possible to operate two return services per day. Although this is an attractive means by which to maximise utilisation when operating independently, it does mean that Air NZ and Qantas' departure times are closely aligned. Under the TNA, the Parties can achieve equivalent or better aircraft utilisation via other means, reducing the level of wingtip flying.

7.7 Absent the TNA, Air NZ and Qantas will continue to have the same incentives to schedule flights at roughly the same time. This changes under the TNA because the objective for the Parties co-operating (and allocating revenue) is to arrange the schedules such that optimum frequency is provided to consumers. As a result, consumers receive a greater choice of flight times and benefits will accrue to consumers who are presently unable to fly at a time convenient to them.

7.8 The combined management of the Tasman network is likely, on some routes, to replace two overlapping flights with one flight with greater capacity and to offer an additional flight at a new time. This benefit applies equally to connecting customers, who gain the benefit of a wider spread of connection options. Taking Auckland – Sydney for example, under the default schedule, the Parties will operate services at 0630, 0800 (using the larger B744) and 0930, rather than the current 0605, 0700 and two overlapping 0900 services.

7.9 The Parties have agreed the default departure schedule for the first Northern Summer Scheduling period under the TNA, although this can be amended by the Committee if needed in response to market conditions at the time. Appendix 3 graphically illustrates the improvement to the spread of departures under the TNA using the default schedule.

(c) **Connectivity/Seamless travel experience for consumers**

7.10 The TNA will enhance the product offering to consumers by providing for better connectivity and a more seamless travel experience in terms of baggage thru-checks, multiple boarding passes etc.

7.11 The TNA will reduce the waiting times for passengers connecting to Tasman services from domestic or other international points at the key Tasman ports for two principal reasons:

- Tasman codesharing – this means a Napier passenger travelling to Australia (for example) has a wider choice of "NZ" services to connect to for the Tasman leg, because all QF services will carry the NZ code. As a result, Napier residents travelling to Australia will have a far greater number of online connections across the Tasman, thus reducing connection times and having more flexibility when planning their itineraries; and

- Schedule co-ordination – this results in a better spread of Air NZ and Qantas departures, *further* reducing the waiting times for Napier (and other) travellers connecting to a Tasman service as described above.

7.12 Appendix 4 lists the 17 airports in New Zealand (and 55 in Australia) that do not currently have direct Air NZ or Qantas services to Australia (and New Zealand).

7.13 It is possible to estimate the number of consumers for whom reduced waiting times are possible by using the most recently available census figures (2001) as a proxy for the catchment areas of the 17 airports currently without direct Tasman services. As set out in Appendix 4, in 2001 there were 631,599 people living in the centres where these 17 airports are located, who will potentially benefit from reduced waiting times under the TNA to the extent they fly across the Tasman.

(d) **Greater flexibility for consumers to change itineraries**

7.14 The TNA will also provide for greater flexibility in relation to itinerary changes. For example, a passenger that has purchased a flexible Tasman airfare ticketed by Air NZ may be able to change their booking to a flight operated by either Qantas or Air NZ. This will provide passengers with a greater range of flight times to choose from in the event that they wish to change their itinerary.

(e) **Frequent flyer benefits**

7.15 Although Air NZ and Qantas will continue to have independent frequent flyer programmes, members will be able to earn and redeem points on all services carrying the code of the operator of the relevant frequent flyer programme.

7.16 For example, an Air NZ Airpoints member will be able to earn and redeem Airpoints Dollars on Tasman flights carrying the “NZ” designator code, whether the flight is operated by Air NZ or Qantas.

7.17 This will increase the number of flights on which earning and redemption opportunities are available to members.

(f) **International competitiveness and national interest**

7.18 The TNA enhances Air NZ’s financial position, and provides it with a sustainable base from which to continue to grow and develop its wider network. The platform created by a stable home network (domestic and short-haul international) will improve profitability and hence Air NZ investor confidence, which will better provide:

- a catalyst for growth into other markets as appropriate;
- the ability to take advantage of additional air service rights negotiated by the Government;
- the ability to justify investment in better product enabling Air NZ to compete more effectively with other long-haul carriers, particularly those operating on the routes to Asia;
- the ability to invest in new aircraft in order to match passenger growth – failing to grow means moving backwards relative to competitors; and
- the ability to maintain and replace its fleet as existing aircraft need to be retired.

7.19 The TNA contributes to Air NZ’s financial security by addressing the issues Air NZ faces on a core part of its home network. It is in the national interest that Air NZ is a strong and competitive international network carrier – the Government’s decision in 2001 to take a majority shareholding in Air NZ reflects this fact. Indeed, in 2005, the Air NZ Group carried [Confidential] tourists to New Zealand. A strong and secure Air NZ is vital to promoting New Zealand as a tourist destination offshore. Because Air NZ’s network is centred around New Zealand, it is far more incentivised to promote New Zealand as a destination than any other carrier.

(g) **Reduced fuel burn and carbon emissions**

7.20 The reduction in the level of surplus capacity under the TNA will reduce the fuel burn, and hence carbon emissions, of the Parties on the Tasman. The more efficient deployment of Air NZ capacity alone allows Air NZ to burn approximately 15.87m litres less fuel each year that it would do without the TNA. Carbon emissions will fall as a result.

7.21 The increased profitability resulting from the TNA also has the potential to further reduce fuel burn and carbon emissions because it affords the Parties greater scope to invest in more fuel efficient aircraft in the future.

(h) **Increased likelihood of additional direct flights/new destinations**

7.22 While the Parties are not currently forecasting any new direct routes, the incentives to provide new direct routes are greater under the TNA than where each airline acts independently. Absent the TNA, Air NZ's entry on to a new service would be likely to encourage Qantas to enter. (Given the importance of the Tasman market for both Air NZ and Qantas in terms of local and connecting traffic, it is most unlikely that either airline would permit the other airline a network advantage through being the sole operator on a particular direct route in the medium term.) The need for network airlines to match a competitor's new direct service in order to defend their wider network revenues is the key reason why many routes are not served direct where airlines compete, but could be served direct where they can co-operate.

7.23 The ability to consolidate demand and take advantage of feed traffic from both airlines' networks means the Parties have significantly more incentive to offer additional services with the TNA.

8. Cargo

Under the TNA there is provision to agree with respect to cargo. This section outlines the constraint imposed by competitors on the Parties. In particular, it explains the impact on cargo rates on the Tasman that Emirates – which operates an entirely wide-body fleet on the Tasman – has had, and will continue to have.

8.1 Under the TNA, the Parties agree that they may co-ordinate cargo services and agree cargo rates on the Tasman to the extent from time to time determined, in its discretion, by the Committee.

8.2 Given that a large proportion of total cargo is carried in the belly space of passenger aircraft, any impacts in respect of cargo are largely captured in the preceding analysis of passenger services. However, the Parties make the following specific points:

- In addition to the carriage of cargo on passenger services, the following competitors operate dedicated freighter services on the Tasman:
  - Singapore Airlines (B744F AKL-SYD-AKL – Saturday)
  - CV Cargolux (B744F MEL-AKL (one way) – Friday and Sunday)
  - HJ Asian Express DHL (B727F AKL-SYD-AKL – Monday, Tuesday, Wednesday, Thursday and Saturday)
- A disproportionate amount of freight is carried in the belly space of wide-body aircraft (because it can be containerised) – Air NZ and Qantas operate a mix of wide and narrow body aircraft on the Tasman, whereas Emirates operates solely wide-bodied aircraft. This is reflected in Emirates share of cargo on the Tasman, which is relatively higher than its share of passengers; and
- There has been a reduction in freight rates since the date of Emirates entry on the Tasman. In respect of freight forwarders' consolidations (the primary traffic segment) from New Zealand to Australia, since the date of Emirates' entry, market prices have fallen from between NZD [Confidential] per kilogram to approximately NZD [Confidential] per kilogram.

8.3 Finally, as is the case with passenger services, there are many suppliers of cargo services who are not capacity constrained and who would readily be able to respond to increased demand if faced with an attempt by the Parties to increase cargo rates.

9. No legal reasons for the Minister refusing to authorise the TNA

(a) **Introduction**

9.1 The Minister must exercise his discretion to authorise the TNA in terms of section 88 of the CAA. The only reasons for refusing to authorise the TNA are those set out in sections 88(3) and (4), which are discussed below.

(b) **No infringement of section 88(3)**

In considering whether to grant authorisation under subsection (2) of this section, the Minister must ensure that granting authorisation will not prejudice compliance with any relevant international convention, agreement or arrangement to which the Government of New Zealand is a party.

9.2 The Minister's authorisation of the TNA will not prejudice New Zealand's compliance with any relevant international conventions, agreements or arrangements. Conventions and agreements which may be relevant include:

- the Open Skies Air Service Agreement between Australia and New Zealand dated 8 August 2002;
- the Single Aviation Market Arrangements (**SAM**) between Australia and New Zealand dated 19 November 1996;
- the Multilateral Agreement on the Liberalization of International Air Transportation between New Zealand, the United States of America, Singapore and other parties (the **MALIAT**) that came into force on 21 December 2001; and
- bilateral agreements between New Zealand and other countries.

9.3 The Open Skies Air Service Agreement as negotiated by the MOT with Australia specifically addresses the issue of commercial agreements between airlines. Article 14 provides that:

> "The competition laws of each Party, as amended from time to time, shall apply to the operation of the airlines of both Parties. Where permitted under those laws, a Party or its competition authority may, however, unilaterally exempt commercial

agreements between airlines (including block-space, codeshare and other joint service agreements) from the application of its domestic competition law."

9.4 Authorisations of the type sought in this application are thus expressly contemplated by the Air Service Agreement between Australia and New Zealand.

9.5 The SAM arrangements mean the Tasman is one of the most liberal aviation environments in the world and reflect a desire on the part of the Australian and New Zealand parliaments to achieve an efficient, integrated Australasian aviation market. The TNA will generate benefits for the customers of both airlines and will deliver economic efficiencies to the benefit of the airlines themselves and their countries of origin. The combined impact of the SAM arrangements and the TNA will be to deliver the best possible consumer and economic outcomes.

9.6 Additionally, nothing in the TNA will prejudice compliance with the MALIAT or any bilateral agreements between New Zealand and other countries.

(c) **No infringement of section 88(4)**

9.7 Section 88(4) of the CAA details the concerns which the Minister is directed to consider in determining whether or not to exercise his discretion to authorise the TNA. The TNA does not materially impact on any of the matters raised by the provisions of section 88(4).

Authorisation shall not be given under this section to any provision of any contract, arrangement, or understanding that provides that any party to it may directly or indirectly enforce it through any form of action by way of fines or market pressures against any person, whether or not that person is a party to the contract, arrangement, or understanding (section 88(4)(a).

- The TNA makes no provision for either Party to directly or indirectly enforce it through any form of action by way of fines or market pressures against any person.

Authorisation shall not be given under this section to any provision of any contract, arrangement, or understanding that has the purpose or effect of breaching the terms of a commission regime issued under section 89 of this Act (section 88(4)(b).

- The Parties believe that the only commission regimes issued by the Minister which are currently in force under section 89 of the CAA are the Civil Aviation

(Passenger Agents' Commission Regime) Notice 1983 and the Civil Aviation (Cargo Agents' Commission Regime) Notice 1983. The TNA does not have the purpose or effect of breaching the terms of either of these commission regimes, or the commission regime the Parties are seeking with this Application.

Authorisation shall not be given under this section to any provision of any contract, arrangement, or understanding that unjustifiably discriminates between consumers of international air services in the access they have to competitive tariffs (section 88(4)(c).

- The TNA does not contain any provision which discriminates between consumers in the access they have to tariffs.

Authorisation shall not be given under this section to any provision of any contract, arrangement, or understanding that so far as it relates to tariffs, has the effect of excluding any supplier of international carriage by air from participating in the market to which it relates (section 88(4)(d).

- The TNA has no impact on the ability of any supplier of international carriage by air from participating in the market to which it relates.

Authorisation shall not be given under this section to any provision of any contract, arrangement, or understanding that has the purpose or effect of preventing any party from seeking approval, in terms of section 90 of this Act, for the purpose of selling international carriage by air at any other tariff so approved (section 88(4)(e).

- The Open Skies Air Service Agreement with Australia has removed any requirement that tariffs be filed with the aeronautical authorities of either Party. In any event, the TNA does not prevent any party from seeking the Minister's approval of any tariff under section 90 of the CAA.

Authorisation shall not be given under this section to any provision of any contract, arrangement, or understanding that prevents any party from withdrawing without penalty on reasonable notice from the contract, arrangement, or understanding (section 88(4)(f).

- With the exception of specific events that give rise to a right of earlier termination, the minimum term of the TNA is effectively four years (3 years with 12 months' notice to terminate).

- This is not an unreasonable period for an agreement of this nature. It reflects the time which it will take for the benefits envisaged by the agreement to be fully realised and the major level of commitment required from each of the participants. The term of the TNA reflects that. In respect of the Tripartite Alliance (with Singapore and Ansett), the Minister in that case found that a period of five and one-half years was acceptable. In respect of the Alliance Expansion Agreement with United, the Minister accepted that a period of five years (four years with 12 months' notice for termination) was acceptable.

10. International comity

10.1 If, contrary to the representations contained in this Application, the TNA is considered by the Minister to be in breach of any part of section 88(4), section 88(5) of the CAA empowers the Minister to authorise it nonetheless if refusal to do so would have an undesirable effect on international comity between New Zealand and another state.

10.2 The SAM arrangements mean the Tasman is one of the most liberal aviation environments in the world and reflect a desire on the part of the Australian and New Zealand Governments to achieve an efficient, integrated Australasian aviation market. The TNA will generate significant benefits for the customers of both airlines and will also deliver economic efficiencies to the benefit of the airlines themselves and to their countries of origin. The combined impact of the SAM arrangements and the TNA will be to deliver the best possible consumer and economic outcomes.

10.3 The fixing and application of tariffs and the co-ordination of capacity is necessary to achieve the benefits for the Parties and their respective home countries and is consistent with Article 14 of the Open Skies Air Services Agreement between Australia and New Zealand. Tariff fixing and co-ordination of capacity are essential elements of the TNA, which is itself an expression of international comity.

10.4 The TNA is consistent with the spirit of the SAM arrangements entered into by New Zealand and Australia.

10.5 International comity provides a distinct and compelling reason for the Minister to exercise his discretion in favour of authorising the TNA.

11. Commission Regime

(a) **<u>A one-off re-alignment</u>**

11.1 Schedule 10 of the TNA contains a Commission Regime as between the Parties. This Commission Regime is necessary to address an anomaly in order to capture the full benefits of the TNA.

11.2 An essential requirement for the full realisation of the TNA benefits is that, as far as possible, each Party's Tasman services are 'sold without preference' by airlines and their agents. That is, tickets are sold on the *service* that best meets the needs of the *passenger* – rather than on the basis of *which* Party actually *operates* that service.

11.3 To ensure that sales are made 'without preference' the Parties must address an anomaly that arises from the *basis for* payment as distinct from the actual *levels of* payment of incentive commissions to travel agents. Currently, in respect of Tasman routes:

- Air NZ pays incentives where it is the *operating* carrier; whereas
- Qantas pays incentives where it is the *marketing* carrier.

11.4 Unless the Parties align the basis on which they pay incentive commissions to be on either an operating or marketing basis, travel agents will have no incentive to book passengers on the "NZ" code on flights operated by Qantas, because they will receive no financial incentive for doing so. The flip side is that agents will receive commission from both Parties where passengers are booked on Qantas' "QF" code for travel on flights operated by Air NZ. If unaddressed, this anomaly would skew the distribution of passengers travelling on the various Tasman services, leading to significant flow on impacts in terms of the efficient operation of the Parties' Tasman services, and hence the benefits under the TNA.

11.5 The Commission Regime addresses this anomaly by ensuring that – on the Tasman – agent eligibility for incentive payments is based on whether or not the Party is the *marketing* carrier. It is important to note that the Commission Regime only impacts the *basis* on which an agent is paid. It does not impact the level of commissions or other incentives – each Party will continue to unilaterally determine those from time to time. No detriment results from the one-off alignment.

(b) **<u>Minister's Jurisdiction</u>**

11.6 Section 89 of the CAA allows the Minister to issue commission regimes.

11.7 "Commission regime'' is defined as:

> … a statement, expressed to apply to any specified international carriage by air, specifying the rates and bases of calculation of agency commissions (including any benefit, whether in monetary form or otherwise, supplied to an agent) to be allowed, charged, disbursed, given, offered, paid, provided, or retained, in relation to the international carriage by air to which it is expressed to apply, and the circumstances and conditions under and subject to which any such commission is to be allowed, charged, disbursed, given, offered, paid, provided, or retained; and different rates, bases, circumstances, and conditions may be specified in respect of all or any of the following:
>
> (a) International carriage by air provided by different airlines:
>
> (b) International carriage by air arranged by persons of different classes:
>
> (c) International carriage by air provided for persons of different classes

11.8 The Commission Regime in Schedule 10 falls within this definition. Because the Commission Regime is necessary to ensure the full realisation of the benefits that flow from the TNA (and there is no detriment), the Parties request that the Minister issues a Commission Regime in the form set out in Schedule 10.

12. Confidentiality

12.1 The Parties claim confidentiality for the "Confidential Annexures" to this Application and also the information highlighted in this Application and enclosed in square brackets (the **Confidential Information**) pursuant to section 9(2)(b) of the Official Information Act 1982. The Confidential Information is commercially sensitive and valuable information which is confidential to the Parties (vis a vis the public and also each other), and disclosure would be likely unreasonably to prejudice the commercial position of one, or both, of the Parties.

12.2 Furthermore, the Parties request they be notified of any request made under the Official Information Act for release of the Confidential Information, and that the Minster seeks their views as to whether the Confidential Information remains confidential and commercially sensitive at the time responses to such requests are being considered.

12.3 This request for confidentiality is not intended to constrain the Minister and the Ministry of Transport from disclosing information to other Government departments for the purpose of seeking relevant expert advice. However, the Parties request that the Minister ensure any such Departments maintain the same full confidentiality as requested above.

Appendix 1 TNA

Appendix 2 Fifth Freedom Carriers

Due to time zone and curfew constraints at their originating airports, many carriers operating pursuant to fifth freedom rights have idle time on the ground in New Zealand or Australia, while they wait for an appropriate time to depart.

As a result, fifth freedom carriers operate Tasman flights to improve aircraft utilisation and because Tasman traffic contributes to the loads on their wider services. Emirates, for example, can aggregate the demand from New Zealand and Australian residents for services to Dubai and beyond into a single service.

Operating the Tasman leg is economically rational for an fifth freedom carrier if it can generate sufficient traffic on the Tasman leg to cover the marginal costs of that additional leg – any revenue generated in excess of these marginal costs contributes to the substantial fixed costs associated with operating an aircraft, which is a very expensive unit of capital. Therefore, it is typically profitable for fifth freedom carriers to be flying Tasman routes, because the alternative is for their aircraft to remain idle on the ground in Australia or New Zealand.

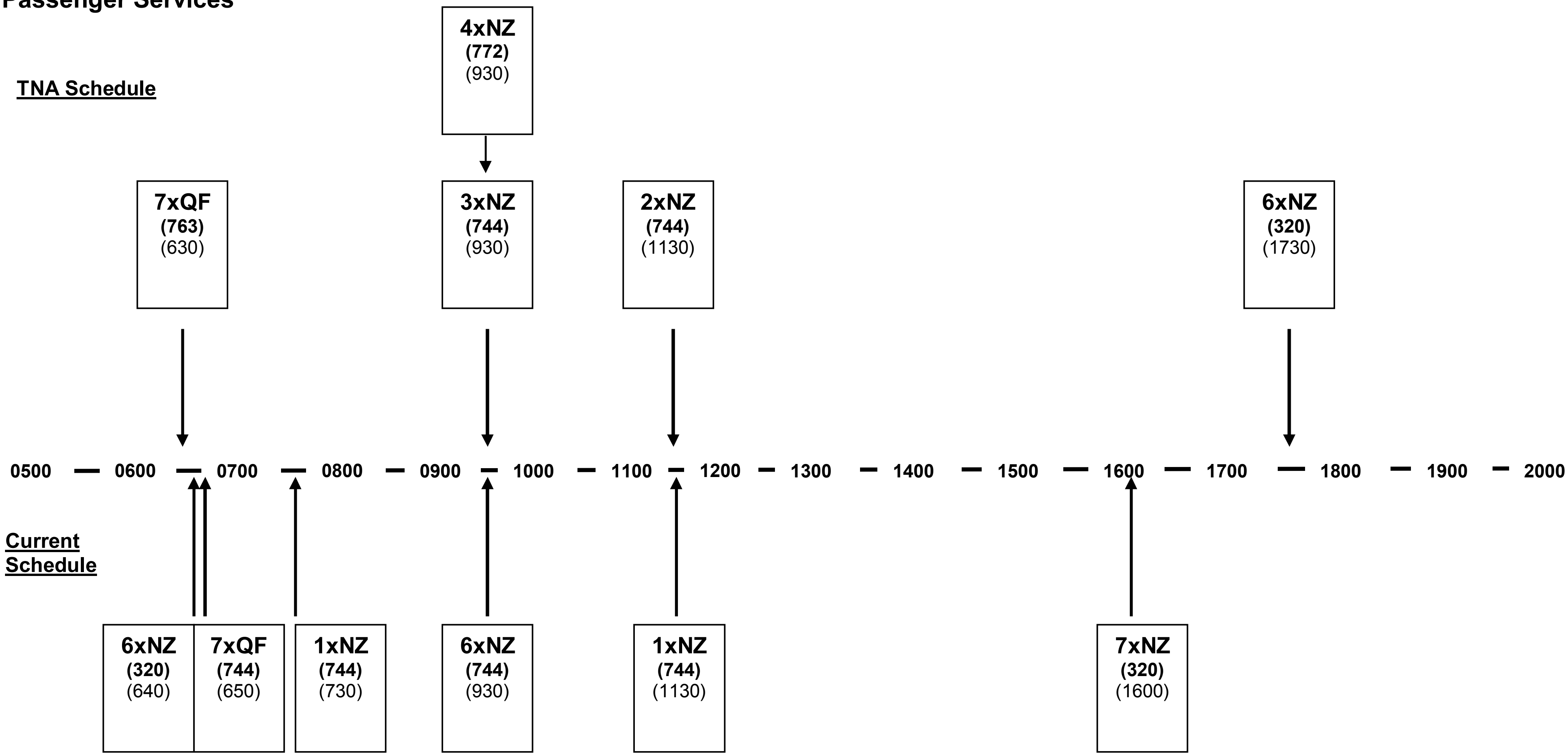
In summary, fifth freedom carriers are able to price at low levels because:

- the marginal costs of operating the flight are low; and
- they derive revenue from passengers travelling ‘beyond’ the Tasman.

Appendix 3 Schedule Spread

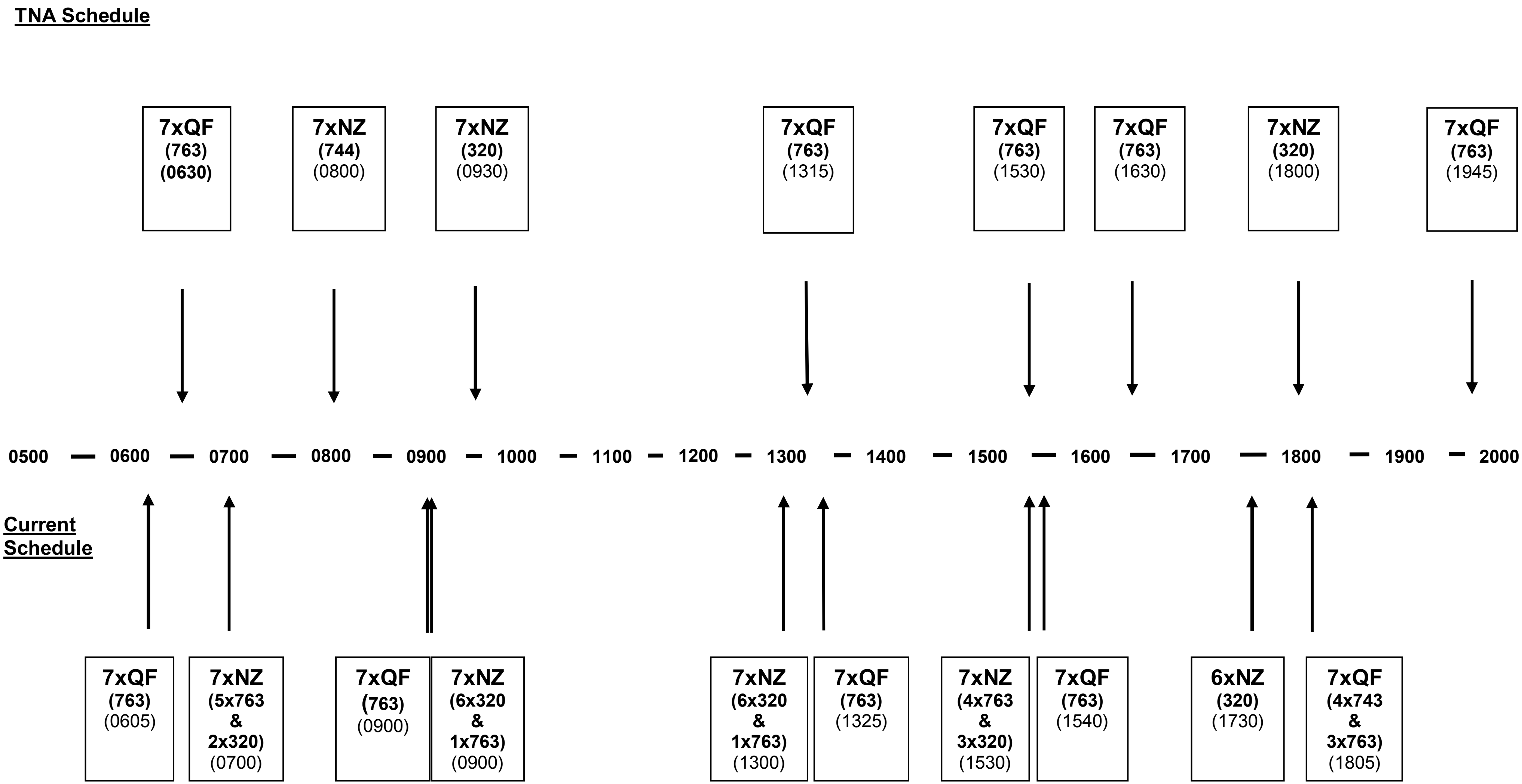
AKL-BNE

Passenger Services



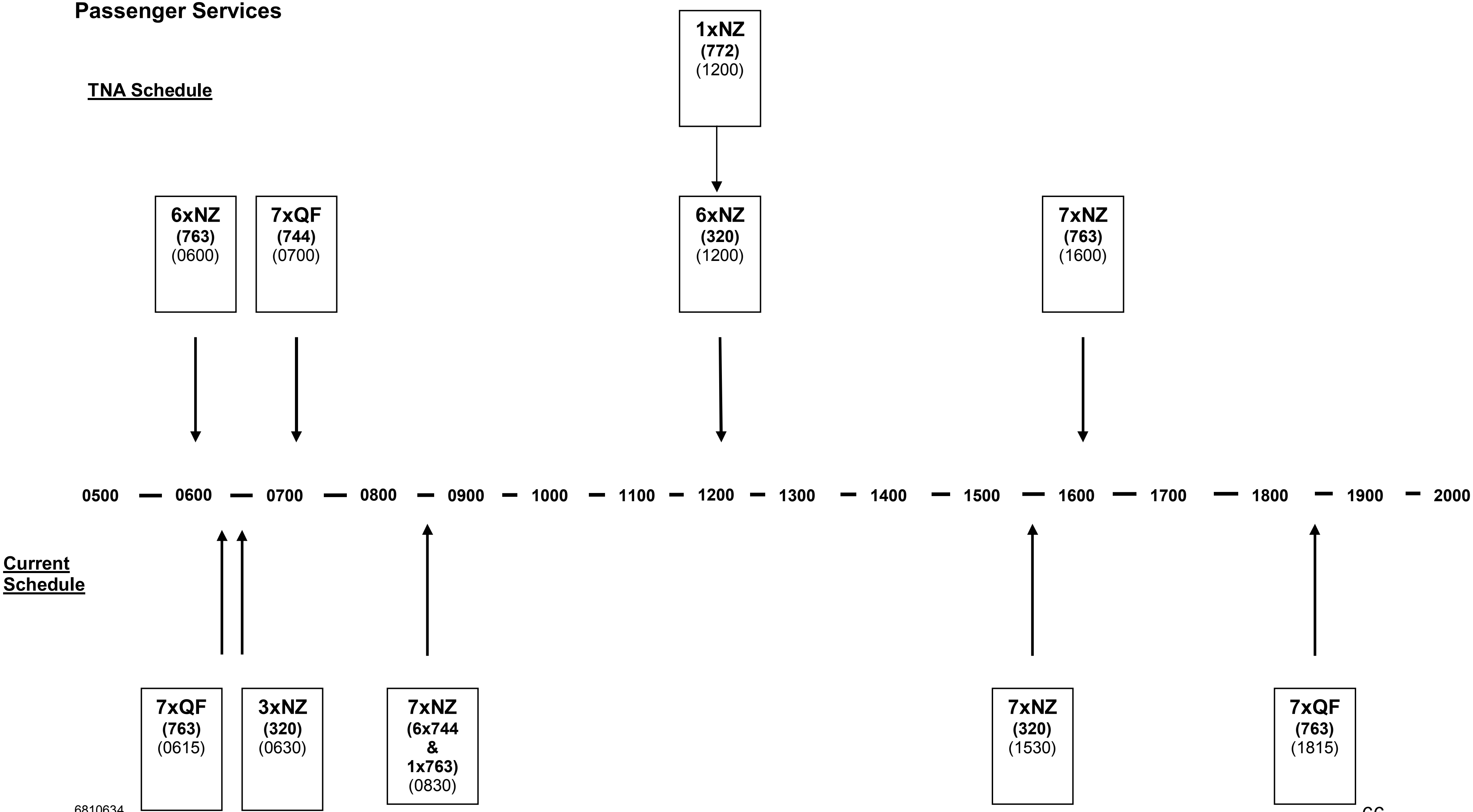
AKL-SYD

Passenger Services



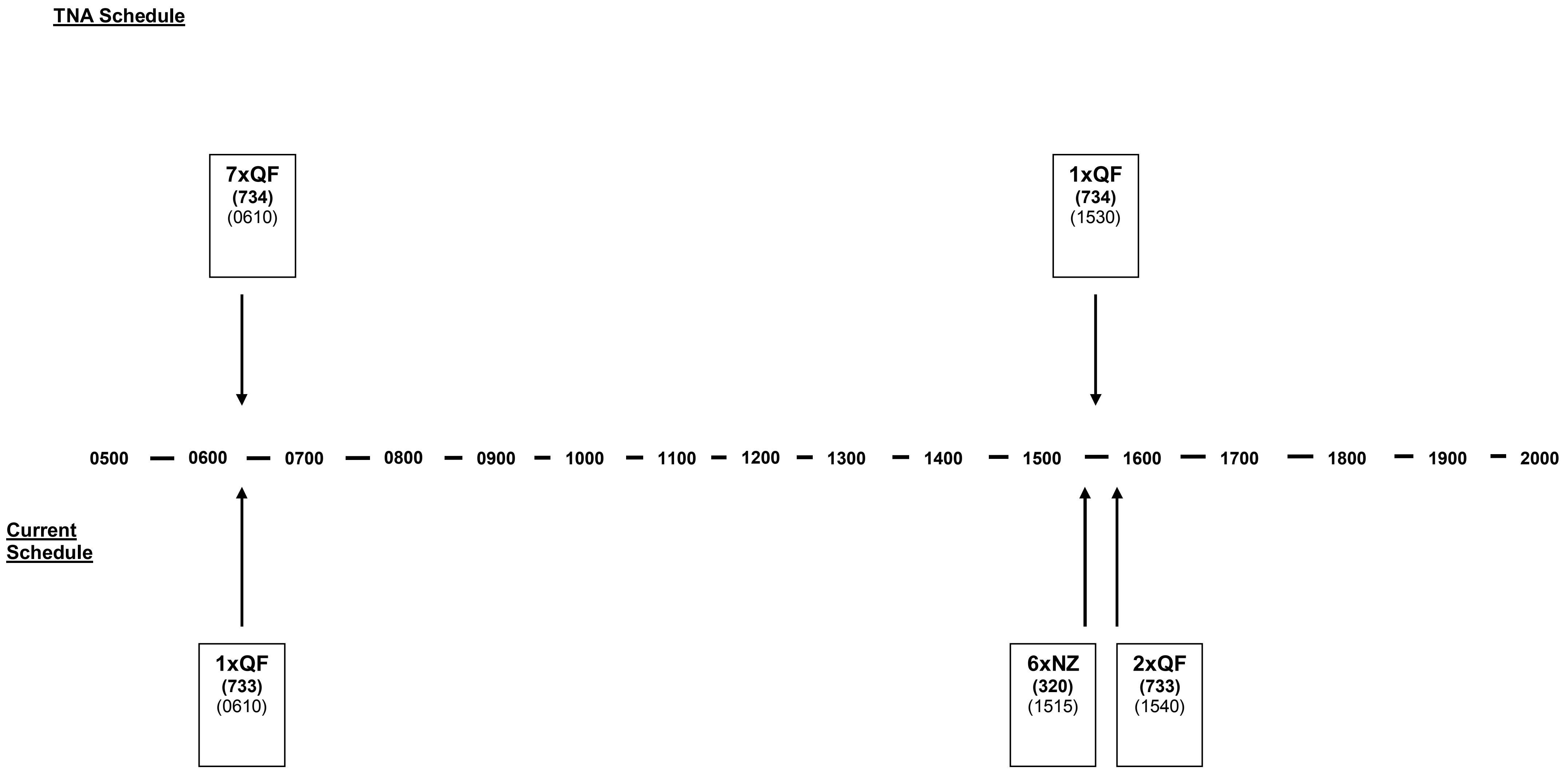
AKL-MEL

Passenger Services



WLG-BNE

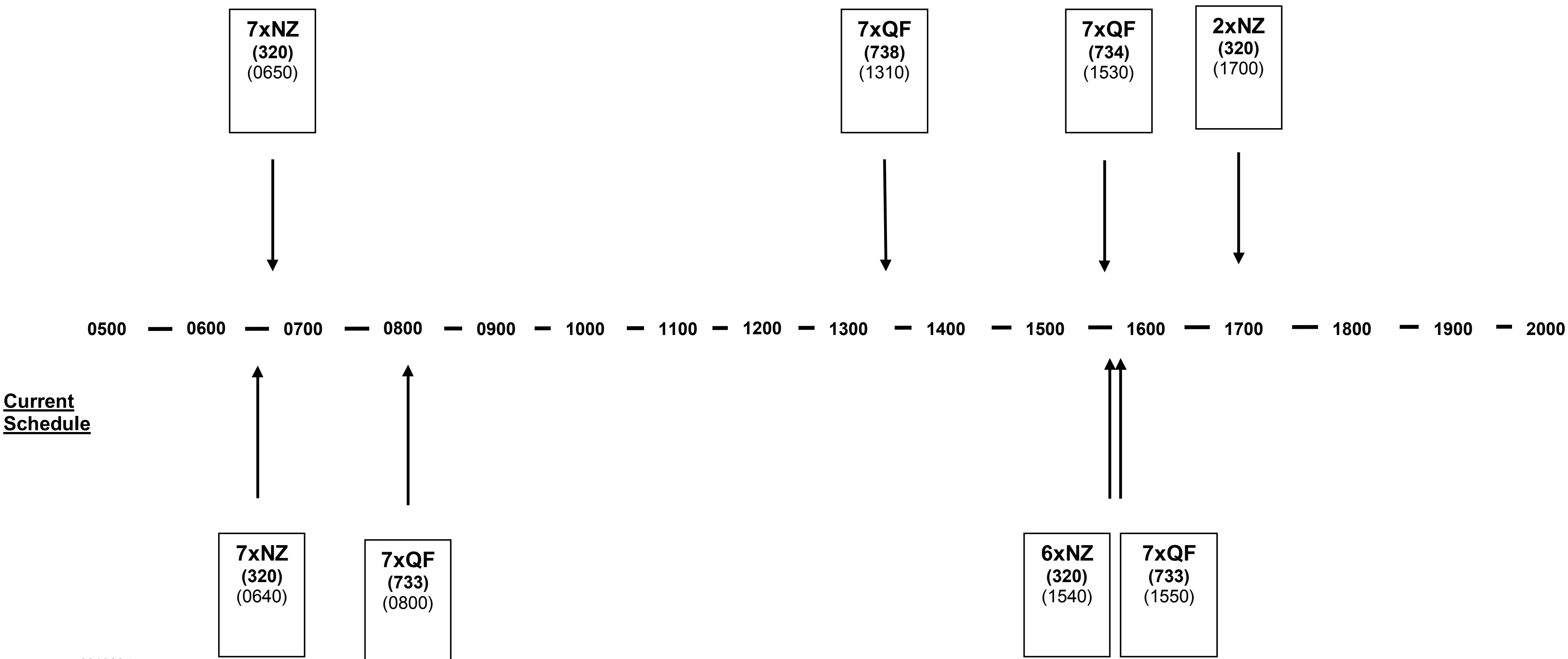
Passenger Services



WLG-SYD

Passenger Services

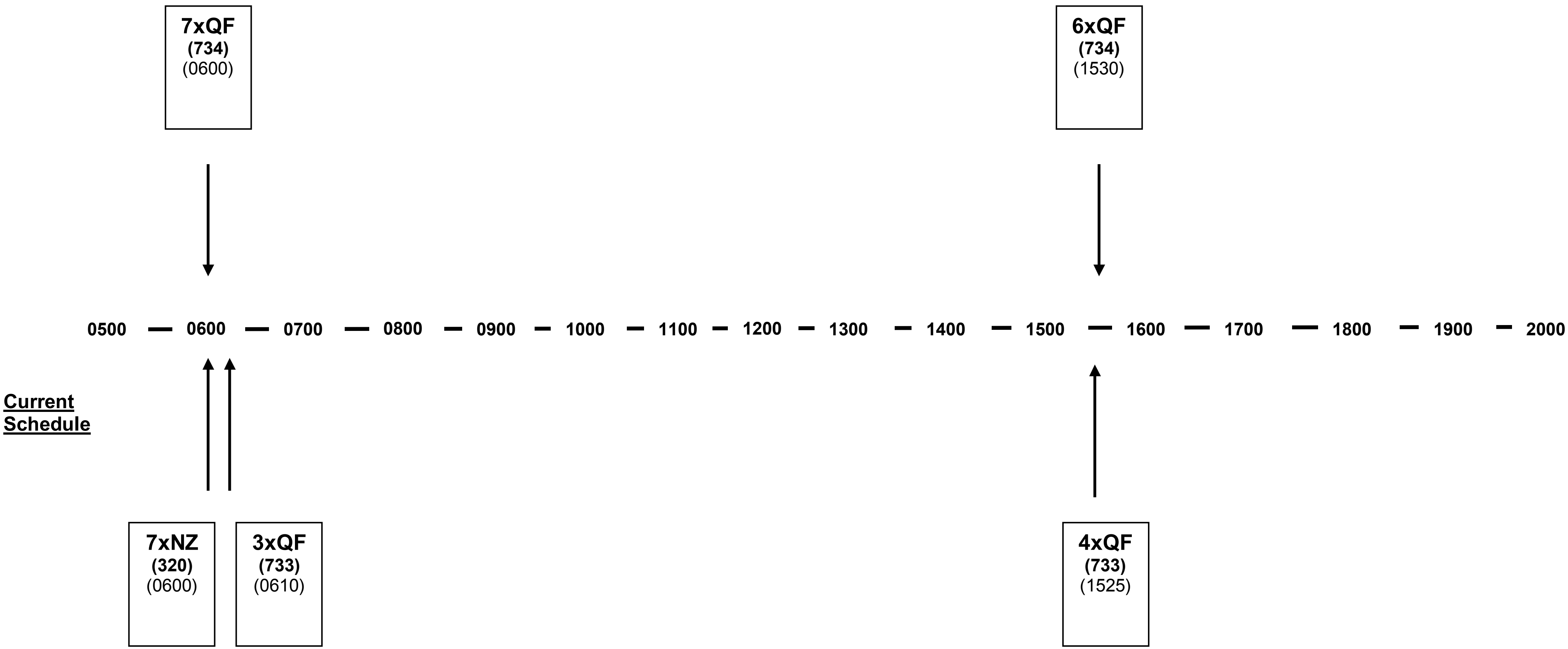
TNA Schedule



WLG-MEL

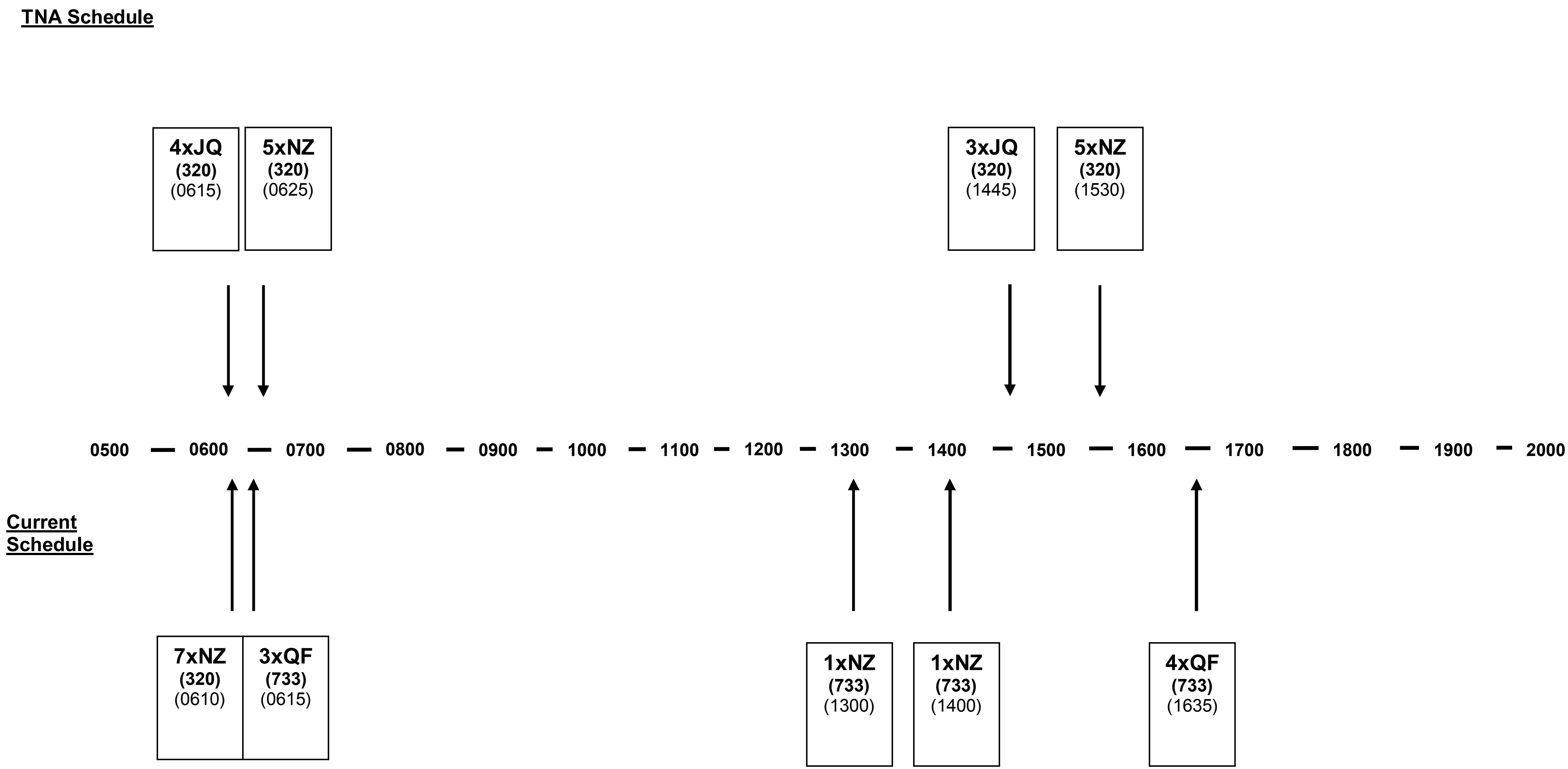
Passenger Services

TNA Schedule



CHC-BNE

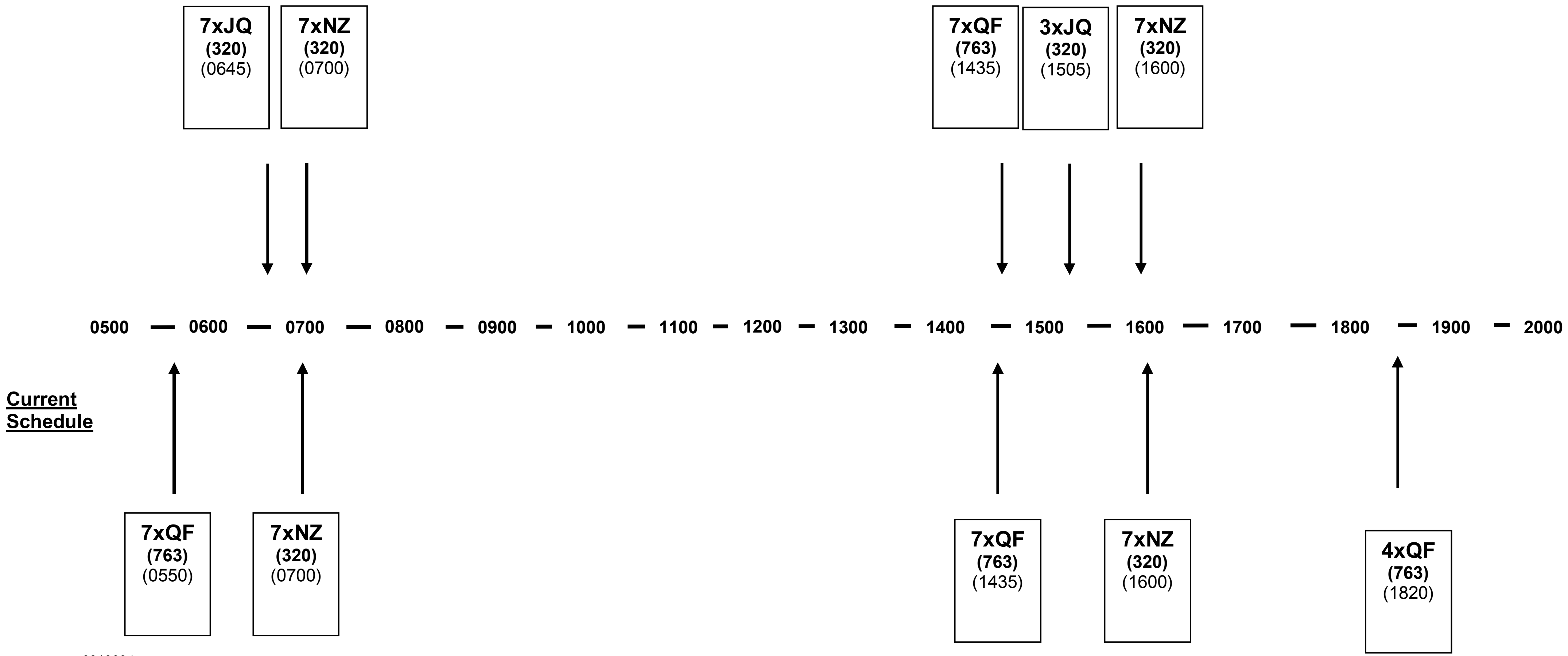
Passenger Services



CHC-SYD

Passenger Services

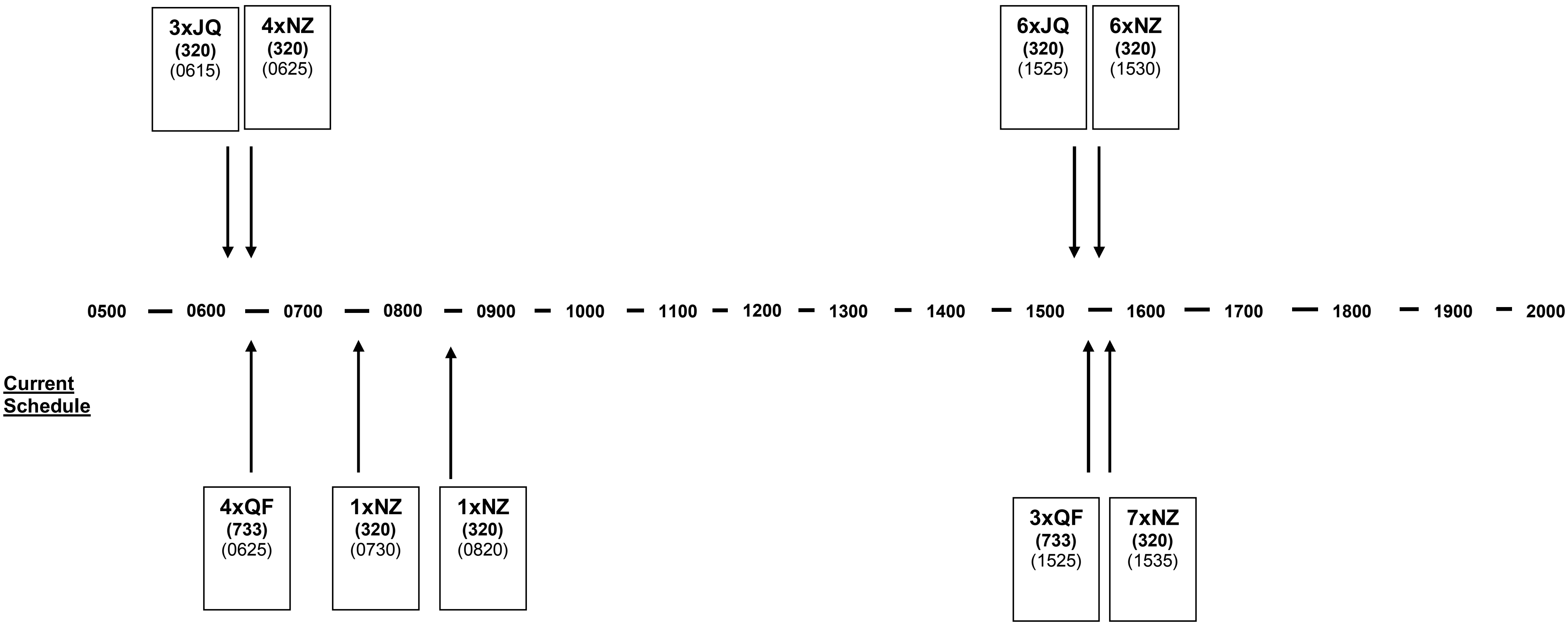
TNA Schedule



CHC-MEL

Passenger Services

TNA Schedule



Appendix 4 Potential for enhanced connectivity

New Zealand Airports and usually resident population[55]	Australian Airports
Blenheim – 26,550	Albury
Gisborne – 43,974	Alice Springs
Hokitika – 3,477	Armidale
Invercargill – 46,305	Ayers Roc
Kaitaia – 5,151	Ballina
Kerikeri – 4,854	Barcaldine
Napier – 54,537	Blackall
New Plymouth – 66,600	Blackwater
Rotorua – 64,473	Broome
Taupo – 31,521	Bundaberg
Tauranga – 90,906	Burnie
Timaru – 41,967	Canberra
Wanaka – 3,330	Chaleville
Wanganui – 43,266	Coffs Harbour
Westport – 3,783	Darwin
Whakatane – 32,814	Daydream Island
Whangarei – 68,091	Devonport
	Dubbo
	Emerald
	Gladstone
	Gold Coast
	Grafton
	Give
	Hamilton Island
	Hayman Island
	Hobart
	Horn Island
	Kalgoorlie
	Karratha
	Kempsey

[55] 2001 Census of Population and Dwellings.

Launceston
Long Island
Longreach
Lord Howe Island
Mackay
Maroochydore
Mildura
Moree
Mount Isa
Narrari
Newcastle
Newman
Paraburdoo
Port Hedland
Port Macquaries
Proserpine
Rockhampton
Roma
Shute Harbour
South Molle Island
Tamworth
Thursday Island
Tom Price
Townsville
Wagga Wagga
Weipa

Confidential Appendix 1

Cost savings to Air New Zealand

[Confidential to Air NZ]