“Joint Business”

Submission on the application by Qantas and Air New Zealand for specific authorisation of a Tasman Networks Agreement pursuant to Part 9 of the Civil Aviation Act 1990

Wellington International Airport Limited

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INTRODUCTION

1 This submission is presented by Wellington International Airport Limited (*WIAL*). WIAL submits the Minister should reject the application by Qantas Airways Limited (*Qantas*) and Air New Zealand Limited (*Air NZ*) (together *the Airlines*) for authorisation of the Tasman Networks Agreement (*TNA*) pursuant to Part 9 of the Civil Aviation Act 1990 (*CAA*).

EXECUTIVE SUMMARY

2 The cartel proposal by the Airlines is unnecessary and extraordinary.

3 Competition policy in New Zealand and internationally emphasises that the presumption should be toward competition in the interests of consumers. As the Australian Treasurer, Peter Costello, said in commenting on the "code-share":

> *"It's (the competition aspects of the proposal) got to be considered, yes, because people forget the purpose of competition policy is to get lower prices."*

4 Competition law does not prohibit every merger or arrangement, but what is being proposed by the Airlines would not be contemplated, let alone approved, in any other industry. And if it were to be considered, every claim would be thoroughly examined by competition experts.

5 The Airlines have not been able to demonstrate any good reasons why the Minister should abandon consumers to the risks of an anticompetitive capacity-fixing and price-fixing agreement. Their diagnosis of "the problem" is demonstrably flawed and they rely upon a series of myths to promote their case to a public and Parliament that cannot be expected to be familiar with the details of airline economics.

6 The Airlines have generated a PR spin that the TNA is a usual "code-share", similar to previous code-shares entered into by the Airlines. In actuality, the TNA is more a cartel or merger than a code-share and is outside the scope of the Minister's authorisation discretion. Further, the TNA is lacking in any public benefits which dictates the Minister should decline to exercise his discretion in any event.

7 Like other businesses in the Wellington Region, WIAL has a direct interest in a sustainably prosperous travel industry on the Tasman. Our interests are aligned with Wellington residents and Wellington businesses, especially

travel oriented businesses. We receive no benefit whatsoever from an airline operating an empty aircraft. Nor would we suffer any detriment if, under the proposed arrangement, the volume of passengers were the same as the counter-factual scenarios (Tasman markets without an arrangement between Qantas and Air NZ). We simply do not believe that this will be the case.

8 Naturally, WIAL supports airlines in their objective to pursue a return on their investment. We simply can find no basis to believe that the "code-share" is required to achieve that objective. We can however see serious risks to consumers and businesses in New Zealand, and particularly in the Wellington region.

9 One reason for WIAL's objection to the Application before the Ministry of Transport (*MoT*) is that it is much more collusive than the type of agreement intended to be authorised pursuant to the CAA. The current application is for two airlines that dominate the relevant markets to jointly set schedules, supply, prices and several other matters, as well as share the revenues from their joint enterprise in pre-determined fashion. Our principal concern relates to market structures that will be in place for some time and how those structures will affect future decision making. We naturally have reservations about some of the announced schedule changes (particularly as they relate to Wellington), but we are even more concerned about future decisions that would take place under the TNA.

10 The words of the Airlines themselves in answering questions from the ACCC are quite telling:

> *"the Applicants* ***must effectively operate as a joint business****. In other words, they must have the ability to develop sales targets, forecast load factors, and to manage yields and share revenues as one. The ability to determine tariffs jointly is a critical part of this process." (emphasis added)*

11 This is not to be a broad framework agreement – it will involve weekly meetings of a joint working group on every detail of scheduling, capacity, pricing and marketing.

12 This is not what was intended when the Minister was given powers under s88 of the CAA.

13 The "code-share" proposal should be viewed in context of the Airlines' recent history. It is a last ditch attempt to have a collusive arrangement authorised outside the purview of the Commerce Commission (*the Commission*).

14 In our view, the outcome of decision making under the proposed arrangement will significantly disadvantage travellers compared to the decision making in a competitive environment where the most efficient producer with the best strategy fills gaps left by other players. That will flow on to numerous businesses and regional economies, including our own.

15 We expect that prices will rise very significantly and that seats in lower fare categories will become harder to secure, particularly at peak times. We expect reductions in capacity and higher prices to lead to a significant reduction in travellers on the Tasman.

16 We foresee no public benefits sufficient to outweigh those detriments. Indeed, many of the benefits purported by the Airlines are unproven or illusory. Insofar as any benefits exist, they accrue only to the Airlines and are not unique to the TNA. They could be secured without a cartel. Section 88 of the CAA requires the Minister to pay particular heed to the interests of consumers. It is not a "net public benefits test".

17 We do not accept that there are no or few viable alternatives for the Airlines. Senior executives of both companies have confirmed publicly that there are alternatives.

18 It is New Zealand consumers and New Zealand firms who will suffer most. This is not a case of two Australasian companies teaming up to take on the world. It is a case of two dominant companies colluding within their home markets. That collusion will put New Zealand's future economic success at risk. As the New Zealand Institute has recently pointed out, New Zealand is isolated and has few markets it can access in under three and a half hours. Australia is the only significant market.

19 It is of great importance that our air services to Australia remain accessible and affordable if our businesses are to thrive and retain and attract talented people. We simply cannot afford an airline cartel on the Tasman.

WHAT THE MINISTER MUST CONSIDER

20 The legal framework for the Minister's decision is discussed at the end of this submission. This is not because the legal framework is unimportant – on the contrary it puts boundaries on the Minister's power and sets criteria for any decision that will be fatal to the Airlines' application. But, if recent history is any guide, there will be another proposal from Qantas and Air NZ, perhaps another application, or perhaps next time a direct appeal for political favour. For this reason we discuss the substance of the TNA in some detail in this submission. In our view it remains a thoroughly bad idea still looking for a credible rationale.

21 In summary, Part 9 of the CAA defines the limits of the Minister's power, and what he must consider.

22 The Minister's power to authorise arrangements:

(a) relates only to provisions that relate to the fixing of tariffs or capacity. Some significant cartel features of the TNA fall outside the Minister's jurisdiction and cannot be authorised;

(b) is limited by a set of "negative conditions". The TNA offends at least one of these and for this reason alone cannot be authorised;

(c) must be exercised in the public interest. The Airlines were wrong to suggest the Minister has a "rubber stamp" role.

23 When weighing the public interest, the Minister must consider:

(a) the impact of the proposed cartel on competition;

(b) the evidential basis for the claimed benefits, whether these benefits are related to the aspects of the TNA that are within his jurisdiction, and whether they can be achieved by another means; and

(c) whether prices under the TNA will be in the interests of consumers. The Minister cannot reasonably conclude on the evidence provided by the Airlines that this test is met. Attached at **Schedule 2** is the only independent expert economic analysis made available, and LECG conclude prices will rise by at least 19% on routes out of Wellington. This submission demonstrates consumers will be significantly harmed.

24 This submission provides information relevant to the Minister's assessment of the public interest. It also demonstrates the Airlines' assertions in favour

of the TNA are without foundation, and at times misleading. On the record before him, the Minister cannot conclude the tariff and capacity fixing aspects of the TNA are in the public interest.

THE PROPOSAL IS CONTRARY TO NATIONAL OBJECTIVES

25 While WIAL naturally is concerned at the likely impact of the proposal on our own business – through reduced numbers of people travelling to and from Wellington – our objection is more fundamental and more general. That is, this proposal represents a real threat to New Zealand's future economic success.

26 New Zealand – and the New Zealand economy – are geographically isolated. Indeed, the recent OECD Economic Survey of New Zealand observed that New Zealand "is found to have the most remote position of all OECD countries". And that remoteness from the rest of the world, and especially our trading partners, still really matters.

27 The just-released New Zealand Institute Discussion Paper entitled "The Flight of the Kiwi" explains why:

> *A glance at a world map indicates a major reason why New Zealand's level of international economic activity is lower than in all other small, developed countries. New Zealand is the most physically distant developed country in the world relative to major markets.*
>
> *New Zealand's physical remoteness makes it more difficult to participate in the global economy. The cost and risk profile of international expansion is higher for New Zealand firms than for firms expanding from Europe because of the small scale and isolation of the New Zealand market. Indeed, there is substantial international evidence demonstrating that trade and investment flows reduce as the distance between two countries increases.*

28 The Discussion Paper shows, by graphic illustration, why it is so difficult for a firm to go global from a New Zealand base. Under the heading "Distance is not dead", New Zealand's remoteness is measured in terms of the shares of global output and population that can be accessed within a three and a half hour flight from various cities. This distance is chosen as the maximum that people can reasonably travel return in a day to support business activities (e.g. a trans-Tasman trip) or to return home for weekends:

> *On this measure, New Zealand is highly disadvantaged compared to major cities in Asia, Europe, and the US. New Zealand can access about 1% of global output within a three and a half hour flight compared to 26% of global output from Paris, 25% from Chicago, and 32% from Hong Kong.*

29 The Discussion Paper then goes on to state the challenge for this country, in the following terms:

> *Increasing New Zealand's level of international economic engagement is vital to New Zealand's future economic success. Going global from the end of the world may be difficult, but much improved outcomes are possible if business and government respond with deliberateness, ambition, and creativity.*

30 For New Zealand's State-owned airline to respond to that challenge with the TNA beggars belief.

31 The practical effect of the Airlines' proposal, if allowed, must be to remove all competition between the two major carriers flying the only route that brings other cities and other major markets within that three and a half hour flight. The reason for that proposal, as stated in the Airlines' application to the Minister, is to counter the "unfair" competition, and to remove the surplus capacity, that Emirates and Virgin Blue have brought to that route. The real purpose, it may fairly be assumed, is to deter Emirates, Virgin Blue and any potential competitors from flying those routes. The inevitable consequence for passengers seeking to fly those routes – whether to support business activities or to return home for weekends – will be reduced availability of seats (at convenient times) and increased air fares.

32 In other words, the TNA can only operate to increase New Zealand's geographic economic remoteness.

33 But, geographic remoteness is not the only challenge facing New Zealand's economic success. The report jointly produced last year by Ministry of Economic Development and The Treasury entitled "Growth Through Innovation" sought to measure New Zealand's performance in relation to other OECD countries against various key indicators of macroeconomic stability and performance. Those indicators which showed weakest performance were "labour productivity" and "innovation".

34 In particular, New Zealand's level of labour productivity is low by OECD standards and about 20% below Australia and Britain. Private sector R&D, too, is also very low.

35 While current poor performance in both those sectors may be due to a number of factors, in both cases New Zealand's distance from major world centres is important. For example, perceived availability of competent senior managers in New Zealand is below that in most other OECD countries. And, labour and skills shortages reflect our much smaller pool of talent. The report states bluntly that "… increasing the supply of skilled and

talented people should remain a priority for the government, education providers and employers". That will involve both attracting new talent to these shores and reversing the diaspora of educated and skilled New Zealanders (as Ireland has managed to do).

36 Again, however, improving this country's connectivity with the rest of the world – but especially other major world centres – will be crucial to this process. The kind of skilled and talented people which New Zealand vitally needs will simply not be prepared to become economic exiles to a remote part of the globe – especially one made more remote by a cartel created by the national carrier.

37 In the New Zealand Business Herald of 24 July, the Minister of Economic Development said that David Skilling, Chief Executive of New Zealand Institute and co-author of its most recent publication "The Flight of the Kiwi" was someone for whom his Ministerial door is always open. Similarly, it must be expected that proper Ministerial credence will be accorded the joint MED/Treasury report. Both documents say, unequivocally, that geographic remoteness presents a special challenge to New Zealand's future economic success.

38 We submit that any proposal which has the potential to exacerbate that remoteness must be rejected, for the sake of the nation's future economic success. Even if Air NZ, and its majority shareholder, will gain financially from authorisation and implementation of the TNA, the economic cost to the rest of the country would be too great.

PUTTING THE PROPOSAL IN PERSPECTIVE

39 Many people find it hard to keep their feet on the ground when it comes to thinking about airlines. The excitement of international travel and the idea of a "national" carrier distorts their perspective. And for some, a free upgrade or free flight is a temptation hard to resist.

40 So it is worth reviewing an example of the TNA using another industry. Below we use a hypothetical example of supermarkets to try to restore some of that perspective (with apologies to the supermarket chains).

Supermarkets to share customers

Today, New Zealand's two supermarket chains that control all major outlets announced plans to jointly set prices, product ranges, opening hours, service levels and store locations. They also agreed to jointly determine what they will pay suppliers and their payment terms. The supermarkets revealed that they had reached agreement and were now seeking approval from the Ministry of Economic Development to proceed.

"It is madness that we both have stores across the road from one another, and open pretty much the same hours and selling the same products", said a spokesman. The supermarkets have advised that their stores are on average only 20% full of people across the course of a week. "It makes sense to close some of the stores, reduce the number of lines carried and reduce opening hours to get efficiencies. Of course, those savings will be passed on to consumers". And when there is only one store, we will be able to offer customers longer trading hours, better service, a better product range and more access to our loyalty programme.

The two supermarket companies will set up a joint committee that will meet each week to decide what products will be offered, the price for each item, which stores will be closed, what hours the remaining stores will be open and how many check out and stocking staff will be rostered.

Responding to fears of price increases from the price-fixing arrangement, a spokesman said that there are thousands of convenience stores in New Zealand. In fact it is one of the most intensively competitive in the world and the major supermarkets cannot compete with small convenience store operators, often recently arrived in New Zealand, who do not properly cost their own time.

Acknowledging that not all towns have a convenience store, a spokesman said that people in those towns can take comfort from the fact that there are lots of convenience stores in Auckland. "If we put up prices, restrict discounted items or cut service in small towns, people will no doubt go to Auckland to shop."

While the total number of stores is expected to be reduced at least from more than 260 to 218, a spokesman for the supermarkets insisted that customers will in fact have more choice of store. "Customers will now be permitted to go to both supermarket chains instead of just one", he said.

Worried suppliers and staff were told to be at ease. There would be no job losses associated with store closures and the supermarkets assured suppliers that they would not seek to disadvantage them – they seek a simple one-off adjustment in the terms of trade.

The agreement was posted on the supermarkets' websites, but numerous sections were deleted, including those on price changes.

41 There is of course one major difference in this hypothetical analogy – the Government is not an 80% shareholder in either of the major supermarket chains.

SUMMARY OF AIRLINE MYTHS

42 The Airlines have relied heavily on ten myths when justifying this proposed cartel. The Minister must not accept these myths as gospel. He needs to ask whether these are true, and whether they justify New Zealand travellers facing a cartel in the various Tasman markets. The myths are:

i) The agreement is all about **the Tasman**.

ii) This is a **normal code-share**, just like all the others.

iii) Airlines **cannot make money** on the Tasman.

iv) There is an enormous amount of **excess capacity** on Tasman routes.

v) Qantas and Air NZ **can do nothing unilaterally**.

vi) The Tasman routes are **highly competitive**.

vii) **Virgin and Emirates** will constrain price increases arising from the cartel.

viii) **Other airlines will enter** the market or expand if prices are pushed too high.

ix) There are **no alternatives** to a cartel.

x) There are **major benefits** for customers that can only be provided under a code-share.

43 This submission exposes each of these assertions as myth. The Airlines have claimed their opponents have not fronted up with facts, and for this reason we make no apologies about the length of this submission. While the Airlines claim "excess capacity", we have provided data comparing the load factors on Tasman routes to others. While the Airlines refer vaguely to "network effects", we provide data on how they both unilaterally adjust capacity in the normal course of business. While the Airlines claim the Tasman is contested by 8 airlines, we break that down to the facts of what is actually happening.

44 Just a code-share? We have compared the usual features of a code-share and the TNA. Academic assertions about marginal customers containing a dominant cartel? We detail how Qantas and Air NZ very effectively price discriminate. Benefits of the TNA? We have provided the only independent

economic analysis of the TNA, and it is damning. Bluntly, it is the Airlines making assertions to the Minister, and they do not stack up.

45 Put simply, there is no major problem to be fixed in the Tasman markets. The Airlines have claimed there is overcapacity – up to 6,300 seats per day. But load factors are as good, if not better, than comparable international routes, implying this figure is PR spin directed at those unfamiliar with the industry's economics. There will always be spare seats. That is how the airline business works.

46 In any event, the Airlines propose to drop only a small proportion of these empty seats overall. They say that they will increase load factors only from 72.7% to somewhere between 75-76.5% over three years, something that can be easily achieved by other means. Again this exposes their spin – the cartel will still aim for 25% spare capacity. And it has to be asked why, if excess capacity is so bad, they have recently added seats, and plan to add more. This begs the question of the real purpose of the cartel.

47 The claim by the Airlines that capacity cannot be reduced unilaterally is patently false. They reduce capacity all the time, they have recently done so on the Tasman and they plan to do more during the course of this year, regardless of the code-share. The same is true of the claim that the Tasman markets are vigorously contested by 8 airlines, and that Virgin Blue and Emirates pose a threat to the market share of Qantas and Air NZ. Again, this begs the question of the real purpose of the cartel.

48 Once again Air NZ has put its survival at issue in selling a cartel with Qantas. But Air NZ is in good financial health – a fact that Ralph Norris identified as his greatest achievement in May this year. Perhaps this is why the assertions about financial crisis and losses have been left to the realms of PR and media, where they will receive less rigorous scrutiny. If the Tasman routes are not as profitable as Air NZ would like, the reasonable load factors and limited competition on the Tasman require that the Minister, and shareholders, demand to know why. Again, we need to know the real purpose of the cartel.

NATURE OF THE PROPOSAL

Overview

49 Qantas and Air NZ did not design and enter into the TNA with the objective of maximising the national welfare of New Zealand or Australia. The TNA is the latest manifestation of a strategy dating from 2002 to reduce competition in Tasman and New Zealand markets and generate anti-competitive profit. The nature of the 2002 proposal was fully exposed in Commerce Commission hearings and evidence. Public statements by executives of both Airlines have made it clear that this is a continuation of the same strategy. The usual public benefits associated with a code-share, such as increased global connectivity and the addition of new routes for airlines and their customers, are unsurprisingly absent.

50 In this section we highlight the fact that the TNA is much more significant than a standard code-share proposal. Air NZ and Qantas are committing to meet weekly to "manage all commercial… aspects of the Tasman Networks, including…pricing, capacity, scheduling, sales strategies… matters relating to competitor and tactical responses… customer service standards." This is, in substance, a cartel of the two dominant airlines on the Tasman.

51 The fact that the TNA is more properly described as a cartel than a code-share is relevant to the Minister's decision. Authorisation of a cartel would be a surprising use of Part 9 of the CAA. As discussed in the section on the Legal Framework below, the Minister is not compelled to authorise an application. The Minister must exercise his discretion in the public interest. The fact that public benefits of a code-share are absent or marginal, and that the public detriments of a cartel are very real, is what this decision is all about.

Normal code-share arrangements

52 Air NZ has emphasised that this proposal is "normal" and no different to the code-shares it has with other airlines, or to the code-share it had in the 1990s with Qantas on the Tasman. This is a significant part of its explanation as to why the MoT and Minister should approve it, and why it should not be examined by the Commerce Commission.

53 Both these assertions are totally incorrect. The proposal is completely abnormal. Our advice is that the code-shares from the 1990s excluded, for example, all pricing cooperation, all matters relating to competitor and tactical response, and all matters concerning travel agent commissions or incentives.

54 WIAL has taken advice from airline advisers, including those familiar with code-shares at first hand in Australasian markets. We now have a very good understanding of how those arrangements operate and have been able to prepare a reliable comparison between the TNA "Joint Business" proposal, and other code-shares.

55 It is important to be clear about two features of a normal code-share – what the Airlines agree about price, and what the Airlines agree about capacity and scheduling. On price there is normally no discussion or collusion. On capacity and scheduling, there is only very limited discussion.

56 Code-share arrangements have a well understood role. Airlines agree to carry each other's passengers to places they do not go. Air NZ has dozens of code-share agreements with airlines that offer different destinations. For example with the right code-share in place, a German can board a plane in Munich and disembark in Nelson having flown on Lufthansa tickets (and code) the whole way.

57 Code-shares can also be used to increase the appearance of frequencies and presence in a GDS screens where two airlines operate on the same route (particularly if they are both members of the same global alliance). However, this would not involve jointly fixing all prices, marketing, schedules or capacity.

58 There are a variety of types of code-shares, but few result in:

- Two airlines becoming effectively a "Joint Business" that operates "as one" (as the Airlines have said in their recent submissions to the ACCC);
- Collusion over retail prices of all the seats on an aircraft;
- Schedule collusion;
- Tactical response to competitors;
- Intimate sharing of detailed commercial information such as net fares, net revenue, pitches for new business and upcoming promotional fares in the market.

59 A summary of types of code-shares is provided below. In addition, an example of a joint-venture and the proposed TNA is included:

Aspects Jointly Managed & Agreed	TNA	JV Example	Air Share[1] (Old Tasman)	Seat Blocks[2] Eg: NZ/JL	Freesale[3] Eg: STAR
Frequency	X	X		X	
Aircraft Type	X	X			
Capacity	X	X			
Routes	X	X	X		
Available Seat Kilometres	X	X	X		
Retail Pricing	X	X			
Net revenue	X	X			
Revenue Risk Sharing	X	X			
Defined blocks of seats (limited)			X	X	
Freesale of seats (unlimited)	X	X			X
Wholesale price or pro-rate				X	X

1 Under the Air Share agreement of the 1990s, no money changed hands and each party allocated equal ASK's which were translated into seats on specific routes. This was the basis of the previous agreement between Air NZ and Qantas on the Tasman and used their seat allocations to compete independently of each other. On the Tasman in the 90's not all serves were part of Air Share – in fact, the number of services excluded grew over time. Most importantly, the schedule details were still independently set, except that every six months in the 50/50 division of ASKs was discussed to ensure a balance still existed and to ensure separation. This is a far cry from weekly price, schedule and capacity collusion.

2 Seat blocks may either be by way of ASK exchange (as per pre 1997 Tasman Air Share), or sold for a set price as with Air

NZ's agreement with JAL.

3 In a freesale environment the operating carrier keeps the revenue (less a cost of sale allocation) and on multi-sector/airline a SRP (Straight Rate Prorate as per the IATA Prorate Manual) of end to end fare applies.

60 Reciprocal freesale arrangements are common in larger alliances (like One World or STAR). The purpose of an alliance freesale code-share is principally network extension. Operations and scheduling are the prerogative of the operating carrier. Prices are set for end to end journeys and, where there is a multi-sector journey on more than one carrier, revenue is shared on a straight prorate basis (the airline gets a specified proportion of revenue according to the sector on which it carries the passenger). Also, they would not normally operate these arrangements on routes where they overlap without the approval of the two relevant anti-trust authorities.

61 Under a normal reciprocal freesale agreement – eg: Star Alliance - Air NZ would choose which flights of other airlines on which it would place its code. It would not have any direct influence as to the specifications of those operations (schedule, frequency, aircraft, timing) or the sales behaviour of the operating airline.

62 Under a block code-share, the operating carrier effectively sets a "wholesale" price for providing seats to the non-operating airline. The non-operating airline will obviously need to know what seats it can sell on what services, but the operating carrier does not collude with the non-operating airline on the price of the other seats on the aircraft. The code-share partner is generally able to set retail prices as it likes and both airlines are incentivised to sell as many of its seats as it can at the best price it can get, regardless of the interests of the other airline. Obviously if one of the parties feels hard done by generally or is being undercut, it may pull out of the arrangement and commence its own services. But that is all part of the competitive dynamic.

63 There are variations within the block seat arrangement. There are hard blocks where the non-operating airline must pay for the seats regardless of whether it is able to sell them (effectively chartering the seats). There are also "soft" block arrangements where the non-operating airline seeks to sell seats on a best endeavours basis, but there are no penalties for not selling them (and the operating carrier has the right to sell those seats if they are not sold).

64 The code-share between Air NZ and JAL is a hard block seat sale arrangement. The JCAB (Japan Civil Aviation Bureau) seeks to set upper and lower fare limits, however outside of this, the respective airlines must <u>independently</u> set their own fares, otherwise they are in breach of consumer laws.

65 Often within code-share arrangements, there are "carve outs" where cooperation is barred for reasons of competition law.

66 Those familiar with the local industry believe the TNA is more extensive than what they have ever seen and is more a joint venture (*Joint Business*) than a code-share. For example, the code-share between Air NZ and Qantas that operated in the 1990's on some Tasman routes provided for no price fixing or joint marketing (despite Air NZ's contention that this has been done before). Indeed, industry advisers tell of occasions when Qantas surprised Air NZ by advertising fares at levels that had never been offered before.

67 We understand that, even though the "air share" of the 1990s was far more limited in nature, it was only reluctantly approved at the time.

68 Code-share partners do not usually pool revenues. They do not insist on joint pricing, or collusion over scheduling and capacity. Instead each party continues to sell seats in accordance with its own market strategies, getting the benefit of whatever margin it can over the price it will have to pay to the carrier.

International comparison

69 The approach of the US regulators has been acknowledged by the MoT. In its report on the Alliance Expansion Agreement between Air NZ and United Airlines (2002) the Ministry noted that the US Department of Transportation (*USDOT*) imposed certain "carve outs" before granting anti-trust immunity (all such carve outs being incorporated into the New Zealand application). The provisions the USDOT refused to authorise were very similar to the most offensive aspects of the TNA:

> *The USDOT imposed a 'carve-out' so that anti-trust immunity is not extended to pricing, inventory or yield management co-ordination, or pooling of revenues…"*

70 Further, the USDOT did not allow the parties to meet and fix prices, again, in contrast to the meetings contemplated under the TNA:

> *The parties were also directed to withdraw from participation in any IATA tariff conference activities that discuss any proposed through fares, rates or charges applicable between the United States and New Zealand…*

71 Is the New Zealand MoT going to take a position diametrically opposed to the position of the USDOT, and authorise full blooded collusion? How does this square with the express requirements in the CAA to have regard to international relationships?

Qantas and Air NZ are proposing a cartel

72 The TNA provides for the Tasman routes to be operated jointly. A combined 8 person Working Group will meet every week to "manage all commercial… aspects of the Tasman Networks, including…pricing, capacity, scheduling, sales strategies… matters relating to competitor and tactical responses… customer service standards."

73 The Airlines will cease competing for Tasman passengers. All income will be shared in proportion to how many passengers each carried on the Tasman in 2005. However, all costs will be carried by the incurring airline. In other words, each $1.00 of revenue will be shared perhaps 65/45, while the airline that can run a cheaper service will keep 100% of the cost cut benefit.

74 The model encourages the two Airlines to chisel costs and capacity at the expense of passengers and growth opportunities. It will be in Air NZ's interests to announce "your service has been cancelled due to engineering requirements" as often as possible - they get the same revenue when the passengers have to rebook on a Qantas plane.

75 The TNA looks remarkably like a new mask for the Alliance that was rejected by the Commerce Commission as likely to cost New Zealand consumers up to $1bn.

76 Air NZ has stressed that the proposal is not a profit-share (as proposed under the Alliance rejected by the Commerce Commission in 2003). This is disingenuous. True, the Airlines remain responsible for their own costs but when their representatives must agree unanimously on virtually all the service aspects that determine cost, they have created a profit share in all but name.

77 At least under a full profit-share, both would be incentivised to invest. To the extent that TNA does leave them free to cut their own costs, they are both incentivised to spend as little as possible. For example, why not cut all tourism promotion. You only get a pre-determined share of revenue, so just leave it to the other party, and share the revenue.

Application of the Civil Aviation Act

78 The Airlines' application is far removed from what can be considered a code-share, and the arrangements contemplated by the CAA.

79 As noted above, significant features of the TNA cartel fall outside the scope of the Minister's power to authorise tariff and capacity arrangements. These include:

- The proposed revenue sharing arrangements.

- The fixing of prices for seats sold by the operating carrier.

- Fixing of capacity beyond what is needed to offer and agree blocks of seats.

80 These legal boundaries are discussed in the Legal Framework section, below.

ORIGINS OF THE TNA "CODE-SHARE"

The objective stays the same

81 There can be little doubt that the Airlines' application is an attempt to get an arrangement as close as possible to the Alliance (merger) that was proposed in 2002. Only this time, the proponents are seeking to do so without the approval of New Zealand competition authorities.

82 During the last alliance proceedings, former Air NZ CEO, Ralph Norris, was reported to have said that, if they failed to get approval, there was no plan B. They would go back to "Plan A" and try again.

83 Speaking on a desire for more mergers and consolidation among global airlines, Geoff Dixon, CEO of Qantas said recently:

> *"As you know, we attempted an equity partnership with Air New Zealand a few years ago, only to be knocked back by regulators. We are now trying again – minus the equity and with a narrower arrangement."*
>
> *Geoff Dixon, BTRE Conference, 14 June 2006*

84 The 2002 strategy was expansive and included other routes as well as those on the Tasman (such as domestic New Zealand).

85 The CAA does not allow the Minister to approve code-shares for domestic services, so that has been left out.

86 It is worth noting that the Airlines recently had the Australian Competition Tribunal extend the duration of its approval for its full Alliance proposal.

Its just the story that keeps changing

87 It's never easy to justify the formation of a cartel. Consumers (and regulators) are naturally sceptical of the underlying motives and the likely subsequent conduct: "Right, this better be good…". But, Air NZ and Qantas have struggled. In 2004[4], WIAL described the Alliance as "a thoroughly bad idea still searching for a credible rationale". Two years on, the Alliance has morphed into the code-share, but nothing has changed. The search for a credible rationale continues.

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4 In submissions to the High Court during the airlines' appeal of the Commerce Commission's rejection of the Alliance

88 The Minister should think hard about whether the Airlines' latest stated rationale lines up credibly with commercial and economic reality. If past experience is anything to go by, it will bear little relation. It is worthwhile to trace some of the previous iterations:

(a) First, the "death spiral" theory. Qantas was, apparently, about to execute an offensive on Air NZ's home patch, using its "deep pockets" to grind a financially vulnerable Air NZ into commercial oblivion. Hence the need for a cartel.

Ironically, Air NZ itself proved this to be a fallacy. Using good old-fashioned innovation and competitive drive, Air NZ launched a number of commercial initiatives which prompted a recovery of such significance that the death spiral scenario was rendered fanciful.

(b) Next, it was the "low cost carrier" (*LCC*) phenomenon. Pacific Blue was an LCC and so, by definition, had the capability to set price (very low) and single-handedly reduce Air NZ's profitability beyond sustainable levels. A cartel was needed to summons the commercial clout to survive this threat.

Again, Air NZ (and Pacific Blue to some extent) has shown this threat to have been massively over-stated. The Express model, combined with the advantages of incumbency and network reach, have meant that Pacific Blue has barely registered as a competitive threat. Thank goodness Qantas has remained a competitor!

(c) A low point for Airlines came when it was argued that the Alliance generated public benefits in that it economically stranded would-be overseas travellers, forcing them to spend their money at home – a boon for local business!

This argument reveals the ugly side of the cartel. In a nutshell, it is the reason for WIAL's opposition. A significant number of New Zealanders will be denied the consumer choices they would make were the suppliers of passenger air services required to operate in a competitive market.

(d) By the time the appeal came about, the emphasis has shifted to a new trump card. Emirates was cast as a player of such fearsome financial and commercial might that a cartel was required between Air NZ and Qantas to cope.

Unsurprisingly, the High Court did not accept that this 5th freedom player with its *occasional flights* at *odd times* on *select routes* was to be the ultimate constraint on a merged entity with overwhelming levels of market share and incumbency advantages on both sides of the Tasman.

(e) And, now, for the MoT, a variant of that old theme – this time it is "unfair" that the Commerce Commission should decide on the code-share because it cannot stop the unfair way Emirate competes.

(f) Plus, a new one – the environment. This code-share will remove "wasted" capacity, incrementally reducing the strain on the environment.

WIAL considers the "excess capacity" argument at length at paragraphs 139-180 below. In short, the Airlines have "spare capacity", which is rational, normal, efficient and, in fact, serves consumers very well.

So what are the real reasons?

89 Commonsense tells us there is only one *real* reason for this code-share – more profit. We have nothing at all against profit or a return on investment, but under our competition policy, companies are either disciplined by the market if that is possible, or by legislated processes where it is not. The cartel will be subject to neither.

90 It is important to understand that in 2002 when this strategy was conceived:

- Load factors were very high on the Tasman (even higher than today).
- The combined market share of the Airlines on the Tasman was even higher than today.
- Fares on the Tasman were much higher (about $1000-$1500 return was common for economy).
- Fuel prices were nothing like they are today.
- There was no Emirates or Pacific Blue on the Tasman routes.

91 In fact, none of the explanations now offered for the cartel existed when the strategy was conceived. That does create cause for scepticism about the strength of the arguments. But those that run Qantas and Air NZ are experienced, intelligent people. So why would the Airlines seek this anti-competitive arrangement?

Qantas

92 On Qantas' side, it is easy to see the attraction of the TNA - Air NZ pays them $98 million for assets worth only $50 million. In fact, bearing in mind the terms of the convertible notes and the lack of imputation credits associated with them, the value of the convertible notes could be considerably less, closer to $34 million (which makes it the $64 million question).

93 That is, there is a **transfer of at least $48 million** from Air NZ to Qantas, which is a transfer of $39 million from New Zealand taxpayers to Qantas (based on 80% government shareholding).

94 This is great for Qantas, but so much for cost savings for Air NZ and losses on the Tasman.

95 The Tasman represents only a small part of Qantas' business. As Geoff Dixon has said, "it is a small part of the puzzle in global terms". So it makes sense for Qantas to have it tied up in a neat arrangement that means no time or effort will be required on it for the foreseeable future. Qantas has bigger fish to fry and this arrangement leaves them free to focus in other areas.

96 Air NZ is no strategic threat to Qantas at all. It competes to some extent on the Pacific route, but it has no commercial interest to rock the boat on what is a very profitable route.

97 It does Qantas no harm to take Air NZ away from an arrangement with a larger scale competitor.

98 Finally, Qantas is always very keen to take actions that might hinder the growth of Emirates.

Air New Zealand

99 Air NZ's motivations are different, and it is obviously very motivated if it is willing to pay Qantas $48 million to be part of the deal.

100 In WIAL's view, there is a genuine anxiety among Air NZ executives that Qantas will "crush" Air NZ if they don't have a very intrusive agreement with them. There is a long tradition of this thinking – previously airlines like Continental and United were the bogeys, and Emirates plays this role today for other airlines. It is not necessarily bad or unusual for management to be anxious about competitors.

101 However, the anxiety is exaggerated and misplaced, and should certainly not be a cause for a revolutionary change in public policy. While Air NZ competes vigorously with Qantas it does not threaten its survival, and Qantas has demonstrated over a long period its willingness to operate in markets characterised by a dominant duopoly, particularly with parties it believes are no threat.

102 Of course, Air NZ has a strong interest in keeping any competitor out of its domestic market where it earns a very large slice of its profits (and effectively subsidises other routes). Qantas is a player in New Zealand domestic, but only on a very limited number of routes, with limited frequencies and with a reliability, product and brand proposition that does not compare to its Australian domestic operations. It pulled out of a code-share on regional routes more than two years ago and its share of the market has been falling.

103 There is no explicit deal about New Zealand domestic as far as we are aware, but clearly Air NZ will be motivated if it believes that a deal on the Tasman will discourage Qantas from competing more robustly in the New Zealand domestic market where high yields prevail.

104 This also applies to Air NZ's trans-Pacific routes to the US.

105 It is a indication of the value of the domestic (and US) routes that Air NZ is willing to:

- pay Qantas tens of millions of dollars;
- withdraw completely from a number of Tasman routes (such as WLG-MEL and WLG-BNE)
- allow Qantas to dominate capacity on WLG-SYD and AKL-SYD

106 Finally, it is very likely that Air NZ sees this arrangement as the first step back toward the full merger that was proposed in 2002 and rejected in 2003 and 2004. The fact that the parties now have approval from the ACT until 2010 (recently extended by agreement) makes this a very real danger.

107 We believe that Air NZ's anxiety is unfounded. In any case, the Minister should certainly not use an anachronistic loophole in the CAA to approve an arrangement on the Tasman that is motivated by:

- a desire to discourage competition on other high yielding routes;

- re-ignite a merger that was resoundingly rejected by the Commerce Commission and High Court as contrary to the interests of New Zealand consumers.

PROFITABILITY

"Losses" on the Tasman

108 Air NZ has said that it has been losing money on the Tasman. It has been very coy on providing details of those losses. It said that it has lost $35 million in the three years from 2003 to 2006 on Wellington routes. When pressed they have acknowledged that losses were greatest in 2004, when they were in the process of introducing new, larger aircraft and when Pacific Blue started up daily to Sydney (with some good introductory fares).

109 Things have changed considerably since 2004. There are no more introductory offers, and limited competition on most routes.

110 To some extent, Air NZ has itself to blame for losses. When Pacific Blue operated to Sydney (until May 2005), Air NZ was often cheaper than Pacific Blue, often by a considerable margin. In short, it over-reacted to a new competitor. It is consistently well below Qantas fares – for example in the first six months of 2006, Air NZ was an average of $52 cheaper than Qantas one way (lowest available fare) on the WLG-SYD route.

111 These days, Air NZ just says that it is losing "several" millions every year. Without more, this statement is meaningless:

(a) On its face, all we can take from that is that it must be more than $1 million.

(b) Compared to what? Compared to selling every seat? Stand alone costs? Marginal costs? How are common costs allocated?

(c) There are many ways for route profitability to be constructed and allocated between routes. We do not know for example, how profitable feeder traffic from domestic routes is factored in to these calculations (or whether it is factored in at all).

112 Without Air NZ and Qantas submitting detailed data and allowing it to be thoroughly examined by an independent party, the Minister cannot rely on claimed losses. No such data has been provided or examined by experts.

113 In the absence of that analysis, the question becomes, is the Tasman inherently unprofitable without a "Joint Business" cartel.

Is the Tasman inherently unprofitable?

114 It has to be regarded as surprising and worthy of enquiry that Qantas and Air NZ would be making losses on the Tasman when:

- They completely dominate most routes (including all those in and out of Wellington).
- Load factors are in normal ranges (as will be shown later in this submission).
- There is a good body of business customers on most routes (including those in and out of Wellington).
- They have been able to increase prices and avoid the discounting of 2004.
- Both Airlines have airlines that operate at costs 30% below those of historic costs. Jetstar has made much of this in Australia, and Air NZ has made this point in investor presentations about Freedom. Both Airlines are free to apply these low cost models on leisure routes that have lower yields.
- The Airlines are operating in home markets with high levels of brand loyalty.

115 As one former airline executive commented to us, most airlines in the world would "give their eye teeth" for those circumstances.

116 The fact is, we know that not everybody loses money on the Tasman. There are lots of indications that this is the case:

- Qantas is adding seats to its Tasman routes out of Wellington, specifically business class seats;
- Pacific Blue advise that they make money on the Tasman and in Wellington and would not be here if they did not;
- Jetstar is making money on the Tasman in and out of Christchurch, according to Qantas (see footnote on page 9, Airlines' response to ACCC on 13 June 2006).

117 Even if we accept that Air NZ is losing money, that does not seem at all inevitable in the absence of a code-share. Rob Fyfe, the CEO of Air NZ, has said that they could make the Tasman routes profitable by unilaterally withdrawing capacity or raising prices. Of course, the Airline submissions

say that they cannot withdraw capacity unilaterally (which we deal with later).

118 For example, an average price increase of $10 would result in an additional $34 million of revenue between the two Airlines ($18 million per annum for Air NZ and $16 million for Qantas). That $10 would represent between 1-4% price increase in most economy fares, and far less than that for business class. That 1-4% is far less than predicted under a cartel (the Commerce Commission predicted 16% on average, and LECG predicts a much higher figure).

119 Is a $10 average increase achievable for Air NZ without significant impact on market share? Almost certainly:

- A large body of business travellers have a lower price elasticity of demand (their choice of airline is affected by frequency, schedule, club membership, frequent flyer programmes (*FFP*) and corporate accounts)

- Air NZ consistently prices below Qantas in lower fare categories that are most price sensitive, and Qantas seems to have no problem achieving prices well above Air NZ or Pacific Blue.

- On most routes there is no competition at all, other than between Qantas and Air NZ.

- The dominant Airlines have successfully pushed through far more significant price increases (some fuel related) since early 2005 without significant adverse impact.

- The two "bogeys" used by Air NZ and Qantas, Emirates and Pacific Blue have followed price increases introduced by Qantas and Air NZ. Pacific Blue has made it clear on many occasions that given the opportunity, they would like to see higher yields on the Tasman. Their objective is to be good value and competitive on leisure routes, but not a deep discounter or to lead prices down.

120 As Rob Fyfe has commented, a price increase is certainly an option. And it seems it would need to be relatively small, and certainly far less problematic than a cartel with Qantas.

121 In its May 2006 update to investors, Air NZ confirmed that it had already made unilateral progress on costs:

"Higher utilisation of smaller aircraft and the exit of two A320s, following the consolidation of Freedom and Air New Zealand's A320s into one operating company, has removed more cost from the Tasman business."

122 If the objective is to make money and they genuinely believe that they will not over the next few years, then simple remedies seem at hand (apply lower cost product or increase price marginally).

123 If the objective is to make a case for a merger, then it obviously serves Air NZ's purpose to claim ongoing losses.

Collapse of Air NZ?

124 In an interview with Australian Financial Review Magazine, published in May this year, Ralph Norris was asked about his "greatest achievement". He answered:

Professionally, it's the turn around of Air New Zealand. When I joined as CEO in February 2002, it was a company on the verge of failure. To turn this around in 3 and a half years and see the airline become of the strongest in the world from a financial perspective, and have one of the youngest fleets of any airline in the world, that is an achievement. (May 2006)

125 In its May 2006 update, Air NZ expressed optimism about its profit performance and noted increases in yields (but finished with the usual warnings about what might happen if fuel prices keep rising – it is always handy to have a crisis just around the corner):

A combination of fare increases (in response to high fuel prices) and improved load factors in the premium cabins has meant that the yield improvement in the final quarter of this financial year has been better than expected.

The combination of higher yields and recent initiatives to reduce costs, in response to escalating fuel costs, has increased management's expectation that the original guidance issued during the 2005 results announcement in August 2005 could be achieved.

However, most analysts are now predicating high oil prices to continue into the coming financial year. Should this be the case then higher jet fuel prices are expected to impact heavily on the 2007 financial year profitability.

126 Air NZ recently confirmed it will make a pre-tax profit of about $140 million this year. Its accounts show that its short haul operations (which include the Tasman) make money. In fact, short haul yields rose 8.1% this year.

127 The airline's substantial additional fleet investment, overhaul of its long-haul product, launch of new international routes and, importantly, growth of market share on various Tasman routes are not the activities of an airline in terminal decline.

128 To put this issue to bed once and for all, the Airlines themselves have dismissed the idea that there is any issue about financial crisis or collapse. In their response to the ACCC on 4 July 2006, the Airlines say that they are not arguing that Air NZ is in any form of financial crisis or decline. Indeed, Qantas has bemoaned the fact that its high profits make it hard to get what it seeks in Australia.

129 On the record, the Airlines do not seek to make an argument that there is a current or impending financial crisis for either airline. It would be impossible to do so.

130 However, it appears that off the record in private meetings and public forums the Airlines are giving the impression that this is a matter of survival. Certainly that seems to be reason why some Ministers, MPs and others have been persuaded to support (or to not object) to the cartel.

131 The Minister should not make the same mistake. Any suggestion that this is required for the survival or growth of Air NZ should be completely put aside.

Fuel Costs

132 A great deal has been made of fuel costs as part of the un-official picture of financial crisis.

133 It is important to bear in mind that while costs have gone up:

- Airlines have a great deal of their fuel costs hedged (for exactly these reasons);
- Air NZ and Qantas have both increased fares markedly in response to fuel costs (but not only in response to fuel costs). These were initially identified as fuel levies or surcharges, but have mostly now been incorporated into advertised prices after pressure or prosecution by competition authorities.

134 At a speech to Wellington leaders organised by the Wellington Regional Strategy on 25 May, Rob Fyfe advised that Air NZ's fuel costs had gone up by $450 million. That is an impressive figure and was of course designed to create a sense of urgency and sympathy. However, that cost is being born principally by customers, not airlines.

135 On the Tasman, we estimate that Air NZ is collecting approximately $93.6 million in fuel surcharges. Bear in mind that fuel charges have also been applied to other markets and routes and, according to Air NZ, the Tasman represents 20% of revenues. A simple extrapolation from the Tasman would suggest that Air NZ is fully recovering any additional costs of fuel.

136 Qantas explained its approach as follows:

> *"What we're trying to do is get ourselves a cost base that will handle the current oil price and then allow us to reap the benefits when the price drops"*
>
> Geoff Dixon, quoted in the Herald Sun (Australia) 8 July 2006

137 That is a sensible commercial strategy, and puts the fuel issue into context – there are revenue offsets and cost savings being delivered, but the fuel price is another passing issue.

"EXCESS" CAPACITY

A false definition of "Excess"

138 The Airlines have relied heavily on the idea of "excess" capacity on the Tasman. There have been numerous emotive statements and images produced, targeted principally at decision makers and members of the public unfamiliar with normal industry economics.

139 In making their argument, they assume that every empty seat is "excess". They know that this is not the case and is in fact quite normal.

140 To make it more obvious to those outside the industry, it is only required to think of similar examples:

- If every seat on every bus were occupied from its originating point - it would be a disaster resulting in delays and queues.

- If every supermarket were full of customers all of the time - it would be a disaster resulting in food shortages and huge queues.

- If every piece of road were taken up by cars, it would be a disaster for congestion.

- And if every aircraft gate at an airport were fully occupied all of the time - airlines would scream blue murder.

141 It becomes an even more absurd point when you consider that the Airlines are saying that any spare capacity is excess, while in the electricity industry, the concern is that there is **not enough** spare capacity.

142 Spare capacity is not the same as "excess" capacity. As LECG points out in their report (attached at **Schedule 2**), spare capacity is essential to the efficiency of most industries and factored in as a cost of production.

143 Efficient levels of spare capacity vary from industry to industry – to determine efficient levels of spare capacity in the airline industry, it is best to look at norms.

144 If you listen to the Airlines, you might be misled into thinking that the norm is 100% seat occupancy.

145 Ian Thomas, from Centre for Asia Pacific Aviation, has said that for most routes the break even load factor is 60%. At 70% load factor, he says airlines make good money.

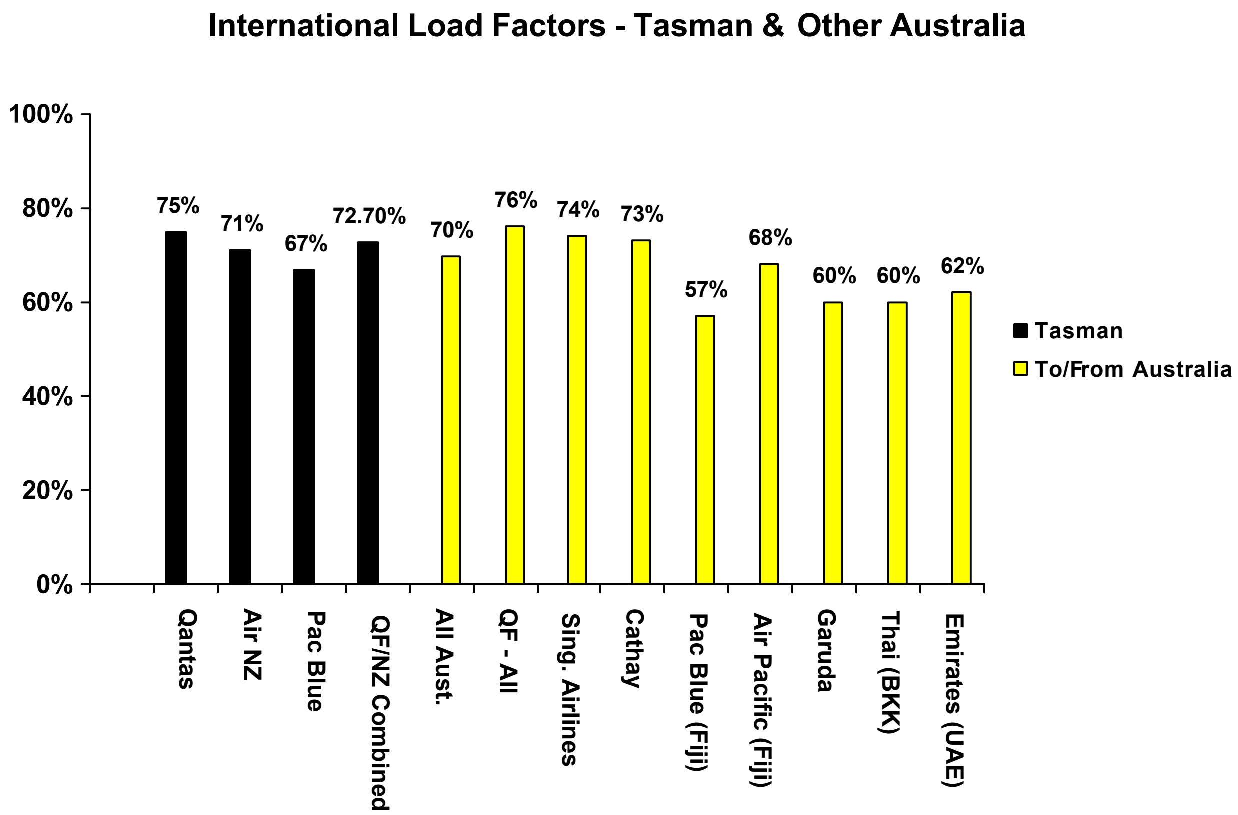
146 TRL reports that the world wide average load factor is 73.8% which is a ten year high (it was up from 73%). They source this from ICAO.

147 More detail on the norms in Australasia are provided below.

Load Factors on the Tasman are Normal

148 Load factors are simply the percentage of seats occupied. It is sometimes measured as Revenue Passenger Kilometres/Available Seat Kilometres when it is necessary to calculate an aggregate across routes of different lengths and capacity, but Passengers/Seats is equivalent when calculating load factor for a single route.

149 The Airlines say that load factors have fallen, which shows a problem with over-capacity. They quote numbers of empty seats and empty aircraft (equivalents) to suggest the same point. In fact, as industry participants know, empty seats need to be considered in the context of total seats. The CY2005 year data (the most recent full year publicly available) provides some interesting comparisons on international routes in and out of Australia. All figures are sourced from the Australian Bureau of Transport and Regional Economics, except the combined QF/Air NZ load factor which comes from the Airlines themselves in submissions to the ACCC.


International Load Factors - Tasman & Other Australia
100%
80%
60%
40%
20%
0%
75%
71%
67%
72.70%
70%
76%
74%
73%
57%
68%
60%
60%
62%
Qantas
Air NZ
Pac Blue
QF/NZ Combined
All Aust.
QF - All
Sing. Airlines
Cathay
Pac Blue (Fiji)
Air Pacific (Fiji)
Garuda
Thai (BKK)
Emirates (UAE)
Tasman
To/From Australia

150 There are certainly examples of very high load factors on constrained, high yielding routes. One of the reasons why many considered the Singapore Airlines application to fly Australia-USA very important was that United Airlines operates at 86% load factor and Qantas at 80% load factor. Yields are commensurately high and, as anybody in the travel industry will tell you, it is murder to get a seat. Similarly Qantas' service to South Africa operates at 82%. Not even these highly occupied services operate at anywhere 100%.

151 Occasionally members of the public or journalists observe that an aircraft on which they travel is "half empty". It is important to remember that to reach a load factor of 70%, there will be days when the aircraft is half empty and days on which there is not a spare seat. That happens because it is not possible to have customers spread their demand (unless a route is constrained, which is inimical to customer service).

152 There has never been a route commence on which airlines would plan on 100% occupancy.

153 Even in the New Zealand domestic market that is dominated (about 85%) by Air NZ, load factors for the Airlines over the course of a year tend to range between 60% and 80%, most commonly between 70% and 75%. In May 2006, Air NZ reported its Group load factor at 67% across all routes.

154 Only a market player with extreme expectations of load factor could suggest that the Airlines' Tasman load factors are at such an unacceptable level that an unprecedented anti-competitive arrangement should be authorised. Figures published by Air NZ suggest that they consider a seat load factor of 74% on the Tasman to be reasonable. More recently, they say 75% to 76.5%.

155 Despite protestations by the Airlines, there is clearly an accepted industry range of load factors, and that range is reflected in the recent load factors of the Airlines on the Tasman routes. Too low and capacity is withdrawn. Too high and customers are turned away on a regularity that is unacceptable to airlines operating a market. And of course, to operate a schedule across a season means that there may be periods when demand is below the average.

156 To think of it another way, we can examine the emotive "11 empty aircraft per day doing two rotations each", quoted publicly by the Airlines (of which 2 are in Wellington). There are lots of parallels:

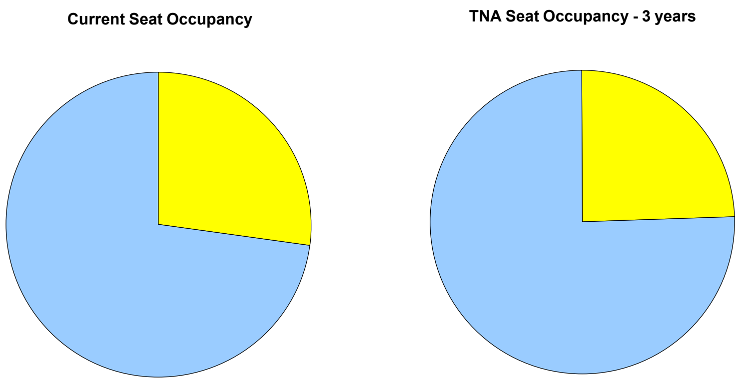
- There are eight 737-300s leaving Wellington empty every day on domestic trunk routes and coming back empty AND an additional 15 Q300s leaving Wellington empty every day and coming back empty. And yet the domestic market is a very profitable market for Air NZ.

- There are 84 empty A320s leaving Australia every day to places all over the world and coming back empty.

157 It sounds dramatic, but in the context of total capacity it is quite normal.

TNA is Completely Unnecessary

158 What will be changed by the agreement? In their recent submissions to the ACCC, the Airlines say that they intend ***over three years*** to go from 72.7% combined load factor to 75-76.5% combined load factor. That is, they currently leave 27.8% of seats empty and that is a disaster, but would consider it OK to leave 25% of seats empty three years into the TNA.



159 The real gain for the Airlines is collusion on price and service, and being one step closer to a more comprehensive deal to merge and collude. The Airlines are asking for the government to endorse a permanent but disguised subsidy from New Zealand consumers.

160 The "Joint Business" cartel (TNA) is totally unnecessary to achieve an increase in seat factor of just three points over three years. Over a three year period, the difference between 72.7% load factor and 76% load factor is nothing more than statistical "noise".

161 This could easily be achieved with some very mundane strategies:

- Holding capacity constant while passengers grow at 1-2% per annum (note: this would be well below historical average growth rates).

- Growing capacity at 3% per annum in response to a more normal 4.5% passenger growth rate.

- Reducing capacity by 1.3% per annum over three years. This is completely insignificant compared to ongoing changes.

Marginal Capacity

162 Qantas and Air NZ have made a great deal of the fact that Emirates and 5th Freedom carriers use "marginal capacity" to fly the Tasman. The Airlines blame excess capacity on this behaviour, and have even referred to it as "dumping".

163 Air NZ has even said that the Commerce Commission cannot deal with this "dumping", and that is why we need a "code-share" approved by the Minister . But when asked, the Commission confirmed it has never received a complaint and had no reason to initiate any action involving Emirates.

164 The Airlines say that Emirates services are marginal capacity because uses the downtime of an aircraft that flies a long haul service.

165 In fact, Qantas and Air NZ use marginal capacity just as the 5th Freedom carriers do. They fly 747 and 777 aircraft on routes that are more suited to narrow bodied and mid-sized wide bodied aircraft. This contributes significantly to the spare capacity on the Tasman. It may be quite commercially rational to do so, but if so, they can hardly criticise 5th Freedom carriers or seek relief in the form of an extraordinary departure from normal competition law.

166 Air NZ has traditionally used the aircraft that fly between Auckland and Los Angeles/London for this purpose. Wide bodied aircraft (747-400) are scheduled to arrive in Auckland from LAX early morning and are not scheduled to depart until late that same evening. Those aircraft are scheduled to:

- Arrive daily Auckland from LAX at 0515am & 0645.

- Operate a Tasman service (AKL-BNE), departing Auckland at 0930 (or 0640 on a Friday).

- Depart Brisbane at 1240 (or 0930 and 1240 on a Friday) arriving back in Auckland at around 1740 (and 1430 on a Friday), ready for a departure to LAX at 1945 or 2145.

167 There are similar services operating AKL-MEL-AKL six days per week.

168 This is no different to Emirates. Air NZ may leave a 744 on the ground some days, but Emirates also leaves its aircraft on the ground at some Australian cities rather than fly in the down time.

169 Under the proposed TNA, Air NZ proposes to continue using 747-400 aircraft on Tasman routes and introduces more 777 services.

170 Until recently, Qantas was operating 747-300 downtime (marginal capacity) on the Sydney-Auckland and Sydney-Christchurch routes. One of the purported benefits of the TNA was that this would switch to 767 aircraft. In fact, this has already happened.

Excess Capacity In Wellington?

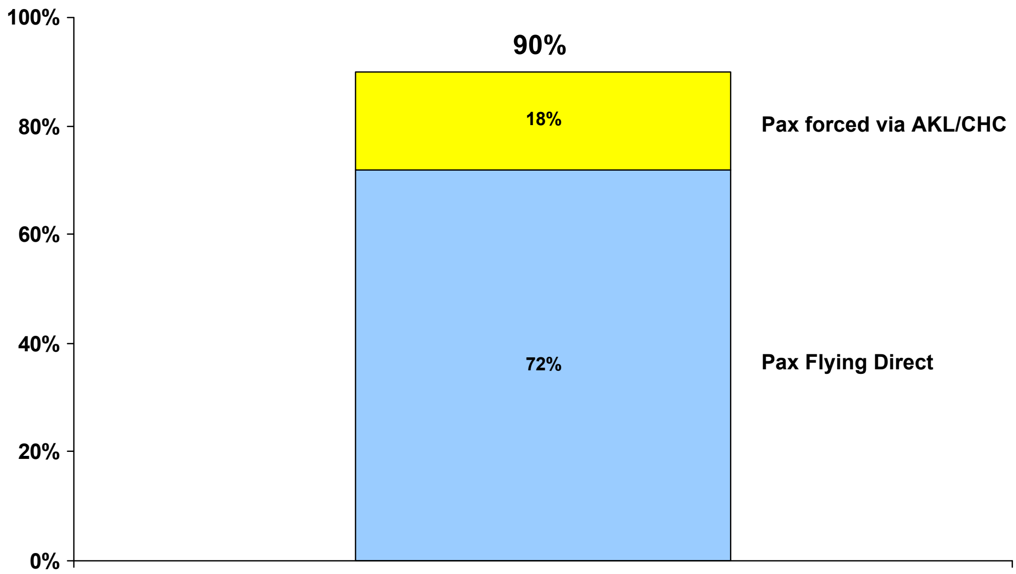
171 In addressing the Wellington business community and political leaders, Air NZ has argued that there is simply not the demand for travel to and from Wellington. They cite poor load factors – the overall load factor is approximately 72%, although Air NZ has revealed their own load factor at 66%.

172 That is, the load factors out of Wellington are in the normal range discussed above.

173 But this becomes even more startling when it is understood that 20% of passengers travelling between Wellington and Australia do not fly internationally from Wellington Airport. They fly domestically to Auckland (and some to Christchurch) and then transfer onto a Tasman flight.

174 So while Air NZ points to lack of demand out of Wellington, it is taking passengers to Australia through other ports. If those passengers were included into the load factors on Wellington Tasman services, the average load factor would be 90%.

Total Trans Tasman Load Factor - Wellington



175 So why does this happen? Who would choose to add 2 hours to what would otherwise be a three hour trip, along with a walk between terminals and an extra boarding process? Only those who had little choice:

- *The fare they sought was not available directly to/from Wellington (but was* available via Auckland) – most likely a highly price leisure passenger.

- *The time/day of flight was not available directly to/from Wellington (but was available via Auckland) – business pax.*

176 For example, a Kiwi family has been able to finally save to go for a holiday to Queensland. School holidays are coming up and the parents can get only a fixed time off work. They check flights and discover that it will cost $1,000 more for the family to fly direct from Wellington because all the cheaper fares have gone, whereas these fares are still available from Auckland.

177 Alternatively, a Wellington business person has to go to Melbourne for presentation, but can't leave until the presentation is finished. She finds that there are no seats available on the flight from Wellington, but could travel the following day. She finds she can fly via Auckland on her preferred day.

178 Both are common enough experiences.

179 In short, while Wellington is portrayed as lacking demand to fill the seats, our passengers are being forced over Auckland due to pricing, frequency or capacity constraints at peak times.

“AIRLINES CAN’T ACT UNILATERALLY”

180 Air NZ claims collusion is necessary because it cannot unilaterally reduce capacity on the Tasman. However this month Air NZ announced it is cutting capacity on some international routes (Auckland – LA – London) and dropping others (all routes to Singapore, and from Christchurch to London via Los Angeles). No cartel required.

181 Air NZ’s decision to operate the smaller 777 planes from Auckland to London, which Rob Fyfe says will save the airline $62 million a year in fuel costs alone, is an example that there are viable alternatives to colluding.

182 Indeed, Rob Fyfe outlined four options for the Tasman markets when speaking to the Chamber of Commerce in Wellington on 4 May 2006. Only one (the TNA) involved collusion. The others involved unilateral action (fare changes, capacity adjustments, withdrawal from routes).

183 The Minister should not be swayed by the idea, put by the Airlines, that they cannot adjust capacity for fear of losing network coverage. For airlines like Qantas and Air NZ with a variety of aircraft types operating the Tasman, it is possible and practicable to reduce capacity by changing aircraft types during periods of seasonal low demand. On routes already dominated by narrow bodied aircraft (such as those from Wellington), airlines often adjust capacity by making changes to schedules within seasons and adding or withdrawing services on days of particularly slow demand (eg: Saturday afternoon). That is, it is quite possible to unilaterally adjust capacity without losing network coverage and it is done regularly by the Airlines.

184 We would refer the Minister and the MoT to the Airlines’ answers provided to questions put by the ACCC. In particular, answers provided to Questions 3 & 4 on 20 June 2006. They reveal an extensive ability to unilaterally alter capacity on routes (up and down) through changes of aircraft type, including marginal downtime of the Qantas 747 aircraft. The Airlines say that these changes are on the margin, which is exactly what is proposed under the TNA. Where challenged, the Airlines come up with all manner of reasons why they cannot act (aircraft positioning, comparative frequency), but where they wish to do so, they seem to manage very well.

185 The claim that capacity cannot be adjusted unilaterally is completely at odds with industry practice. The Minister should demand to know the real reason for the cartel.

186 The Airlines have made a distinction between adjusting capacity through change of aircraft type (which they have agreed is possible after being

questioned by ACCC), and change of capacity through frequencies, which they maintain is impossible without a cartel.

187 The information below shows that they can and do change both, quite unilaterally.

Capacity Cuts Already Underway: AKL-SYD

188 In fact, the Airlines have already made capacity adjustments.

189 Qantas has already taken a 747-300 off the Auckland-Sydney route and replaced it with a 767 service. This was proposed as part of the TNA, but apparently could proceed without that collusive agreement. This action alone takes away 240 seats per day of the 566 seats that the Airlines propose to remove from the AKL-SYDvv route.

190 Qantas has also commenced converting its 737-300 operations to 737-400 operations. This lifts the seats per aircraft from 116 to 142. Similarly, in 2003 Air NZ put A320s (146 seats) on the Tasman to replace the smaller 737-300s. That is, for all the claims about excess capacity, Air NZ and Qantas have both responded to market conditions by unilaterally **raising capacity**, particularly in business class.

191 Qantas was also reported to have announced that it will be reducing its Auckland-Sydney service from 5 per day back to 4 per day. This was also indicated in the TNA, but it was reported in June that Qantas had already decided to make that change.

Capacity & Frequency Cuts Already Underway: WLG-BNE

192 Air NZ's schedule for the upcoming Northern Winter (our summer) has only five services per week Wellington-Brisbane. This compares with the current schedule, of 7 services per week (there were also 7 services per week in the last Northern Winter – the six services per week shown in the TNA application applied only for limited periods). This is completely unilateral action to withdraw frequencies and capacity on the only Wellington route that Pacific Blue serves directly. Qantas does not show any growth.

193 This astounding contradiction to the airline argument means that Air NZ capacity and frequency on WLG-BNE will be reduced by 29% and seats overall on that route will decline by 15%. In the cartel proposal, the Airlines say they aim to remove 176 return seats per week from the WLG-BNE route – this action removes 584 per week (or 83 per day).

194 In other words, in the upcoming Northern Winter schedule, there will be less seats on WLG-BNE than shown in the indicative TNA schedules. All through purely unilateral action on Air NZ's part.

They are well on the way (without a cartel)

195 In short, on two routes alone (AKL-SYD and WLG-BNE), Air NZ and Qantas have already unilaterally removed 323 seats per day. It makes a complete sham of the need for a long term price fixing cartel.

196 If need be, they could have all the capacity adjustments completed before any final decision of the Minister (and ACCC in Australia).

The Paradox of the Airline Position on Network Protection

197 In their submissions to the Minister and to the ACCC, the Airlines emphasise the importance of frequency and capacity as a determinant of success.

198 They say it is so important that they dare not make any marginal adjustment without a cartel agreement in place.

199 Yet at the same time, Qantas and Air NZ insist that Pacific Blue, Emirates and other 5th Freedom carries are a threat. This is despite the obvious disadvantages these airlines have with limited frequencies, well below those of Qantas and Air NZ, and often inconvenient schedule timings.

200 Qantas and Air NZ can't have it both ways – either frequency matters or it doesn't.

201 The truth is that frequency does make a difference to market share and fares, along with schedule timings, network coverage, loyalty programmes and domestic feeds. But Qantas and Air NZ are so far ahead of Emirates and Pacific Blue on all fronts that the marginal changes they seek can easily be achieved unilaterally. Even between Qantas and Air NZ, some differences in frequencies do not seem to matter. In Wellington, they operate with different frequencies on 3 of the 4 Tasman routes. If one of the two dominant airlines does not react to a change by the other, it will be unlikely to upset any market balance between them.

PRICES

Prices were much higher (and could go back to those levels)

202 There does not seem to be any debate that prices on the Tasman came down a long way in 2003. The cheapest available fares fell markedly from over $1000 return. During 2004 all inclusive return fares were commonly available for between $400-450. There were fares at periods of lower demand of approximately $300 and promotional fares as low as $250 return.

203 In 2006, a customer seeking a low fare across the Tasman is much more likely to face a return fare of around $550 - $650 return. Indeed, when we have sought fares for promoting Wellington in the Australian market, this is the level of fare airlines have offered as promotional fares. It may still be possible to travel for less than $500 return if a customer is very flexible with dates and times (this would compare with the $300 fares available in 2004).

204 Generally speaking, best available return fares fell by more half in 2003, but have increased by around $200 return since 2004 (about $104 of which is fuel levies). There have been no significant airport price increases in that time that would account for the difference (and certainly no price increase at Wellington Airport).

205 In their response to ACCC, the Airlines are quite defensive about these fare increases, saying that WIAL has no evidence that recent price increases are unjustified. We make no judgement on whether they are justified and do not seek to criticise. We simply note that they occurred and that the scale of the increase is more than fuel surcharges. While there is a level of competition and application of normal competition law, price increases require no further comment.

206 However, there is plenty of recent historical precedent for fares to be much higher than they are today, and both the Airlines would be well aware of that fact. Under a cartel, this will become significant.

All prices are not the same?

207 A focus on best available fares is helpful in some respects, but ignores the fact that most people are not travelling on the best available fare.

208 The principles of price discrimination in airline fares are well known. Airlines are able to charge differentially according:

- Class of travel;
- Need for flexibility and ability to rebook;
- Booking period before flight (as Professor Hazeldine's analysis has shown);
- Day of week;
- Time of day;
- Airline – especially where there are different frequencies.

209 In submissions to the ACCC, the Airlines have said that there are five families of fare, each with several fare levels.

210 Airlines can set different fare levels within a "family" of fares. So, for example an Air NZ Tasman Smart Saver Fare can vary considerably.

211 Generally there may be as many as 25-30 fare levels, with passengers in economy paying vastly different fares. Again, we do not criticise this – it may be quite efficient and rational. But it must be borne in mind when assessing claims that customers or fringe competitors will constrain a cartel.

212 For example, economy Tasman air fares on Qantas and Air NZ can vary by as much as 200%. The same is true of New Zealand domestic fares. On Pacific Blue, the variance between the cheapest economy fare and the most flexible economy fare is not as great, but the pattern is present nonetheless.

213 More importantly, the availability of different fare types can be managed using rich history of booking profiles and powerful predictive models.

214 At peak times, there will still be people paying almost $2000 return on an economy return ticket on the Tasman. Again, as long as there is some competition and application of competition law, this does not require regulatory scrutiny. But it is relevant to the airline arguments about competition from marginal players and "the marginal customer".

Customers Forced into Higher Price Categories

215 The Airlines give some indication of their expectation in their comments:

> *"Under the TNA, it is possible that more passengers will purchase tickets for higher fare buckets than would otherwise be the case… 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."
Air New Zealand / Qantas TNA Application to Minister of Transport, April 2006

216 Why would customers "choose" higher fares? According to the Airlines it is because the level of flexibility in schedules and service will be so vastly improved, that customers will want to pay more to take advantage of it.

217 We agree with the Airlines' comments above with the exception of the word "choose".

218 A more apt description is provided by Tourism New Zealand:

"The industry is currently considering the impact of Air New Zealand and Qantas code-share arrangements. This will decrease the number of weekly Tasman flights operated by the two airlines from 242 to 219, a decrease of approximately 10%. With both carriers signalling an increase in load factors it appears inevitable that airfares will increase and that few seats will be available at peak demand periods."
Tourism New Zealand, Regional Rap, May 2006

THE VARIOUS TASMAN MARKETS

Overview

219 The Airlines claim that there is a single market covering all the 25 city-pairs (routes) on the Tasman and that there is no difference between a Ponsonby business person travelling from Auckland to Melbourne on corporate account and a Kiwi family from Tawa who for the first time able can afford a to travel from Wellington for a holiday on the Gold Coast.

220 The absurdity of this position is obvious – and it is even more absurd because, within airlines themselves, nobody would dream of trying to manage "The Tasman" as one market. Nobody would market Auckland-Sydney services in Wellington. Nobody would try to sell Brisbane residents a Melbourne-Christchurch fare. Nobody would think that the capacity and prices they set on Christchurch-Sydney will drive demand out of Auckland.

221 Nonetheless, we are happy to review the Airlines' claims in full.

Market definition principles

222 When assessing the impact of the proposed arrangement between Air NZ and Qantas, market definition will be an important step. Market definition helps identify the impact on consumers from the proposed collusion, and it frames the discussion of whether new entry or expansion to any significant degree by existing niche carriers is realistic to expect. It also frames the question of differential impact on New Zealand consumers, which Part 9 requires the Minister to consider. WIAL submits it is important when considering the TNA to approach the market definition question afresh, and ask what is the market analysis that best brings to light the effects of the proposal?

223 The starting point is point-to-point markets. This is the approach taken in the United States. Markets are defined by city-pair routes (shorter haul routes are often defined as only non-stop services). Robert Willig, an eminent economist who was engaged by Qantas and Air NZ to consider the previous Alliance has stated:

> *Typically, it is concluded that an airline's relevant markets will not be larger than city-pair routes. Most flyers are determined to travel from their actual starting place to a particular intended destination, so that they would be unlikely to alter these plans in reaction to a five percent price rise. In addition, it is unlikely, except perhaps on the shortest of routes, that most flyers would find other modes of transportation to be substitutes, even in the*

> *face of a hypothetical five percent increase in air fares. Thus, an airline's relevant markets are unlikely to include more than air services between the origin and destination cities.* [5]

This is also the position in the EU. The recent EU judgement of the Court of First Instance in relation to EasyJet's opposition to the merger of KLM and Air France provides a good example of the EU's approach to market definition. At paragraph 56 the Court stated:

> *For the purposes of defining the relevant product market in this case the Commission carried out an analysis of demand-side substitution. The contested decision records that, in the case of passenger air transport, the Commission's view was that the product market should be defined according to the O&D method, whereby each route between a point of origin and a point of destination is treated as a separate market. In order to establish whether the combination of a place of origin and a place or destination is a relevant product market, the Commission rightly examined, in recital 9 of the contested decision, the various transport options available to passengers between those two points (see, to that effect, Case 66/86 Ahmed Saeed Flugreisen and Others [1989] ECR 803, paragraphs 39 to 41, and Air France v Commission, paragraph 28 above, paragraph 84).*

Previous approaches to the Tasman markets

224 Market definition is particularly difficult in a network industry, where a slavish adherence to substitutability criteria would result in an unworkable number of narrow markets. For this reason, judgment is required to select the market most appropriate for the application or proposal being considered.

225 When considering the previous cartel proposed by Qantas and Air NZ, the New Zealand Commerce Commission emphasised the central issue was identifying the market definitions most appropriate for the particular transaction or proposal, which is a matter of judgment. The New Zealand Commerce Commission stated at paragraph 240 of *Decision 511*:

> *…there is authority to support the approach of individual city pair routes as being the correct geographic markets in airline cases. The reasoning behind this is that travellers, in most instances, have little flexibility in terms of their origination and destination. The Commission considers that, in principle, such an approach is correct, but for the purposes of*

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5 Willig R., *Selected Program: Antitrust Lessons from the Airline Industry: The DOJ Experience* (1991) 60 Antitrust L.J. 695.

competition analysis in this case, it is more appropriate to aggregate city pairs into geographic groups, consisting of groups of city pairs that will be impacted similarly by the proposed Alliance.

226 This was the approach taken by the ACCC. At paragraph 10.12 of its determination the ACCC stated:

> *When examining international air transport passenger markets, the Commission has consistently stated that, after taking into account opportunities for indirect travel, a regional approach to market definition is generally the most appropriate. However, this does not preclude the Commission from adopting a different market definition including a point-to-point market, depending on the circumstances of the conduct at issue.*

227 The geographic aspect of market definition was not contested in front of the Australian Competition Tribunal and New Zealand High Court, and so the Tribunal and Court made no comment on this issue.

228 This approach was appropriate given the broader geographic scope of the previous cartel proposal, and the nature of the analysis conducted by the competition regulators. The regulators had to stand back and assess the net effect of the proposal. Here, the geographic scope of the cartel is more limited, and an analysis that more accurately reflects the position of consumers is practicable, and appropriate given the wide range of factors that must be considered when weighing the public interest. The inquiry into differential effects that is required by the CAA also requires more precise market definitions.

An aggregate market definition will obscure the competition effects

229 WIAL submits an aggregated Tasman market is not appropriate for the decision the Minister must make. Aggregating at the Tasman level was an acceptable and necessary compromise when analysing a proposal on the scale of the comprehensive Alliance. But the detail and the differential impacts of the TNA mean a less aggregated market definition is needed if all relevant effects of the proposed cartel are to be properly considered.

230 “The Tasman” in fact currently represents 25 different direct city-pairs. **Schedule 1** sets out the airlines serving the main city pairs and the frequency of their services.

231 WIAL submits that, now there has been a good opportunity to observe the actions of Emirates and Pacific Blue, there are at least three clusters of routes comprising a number of markets:

(a) Routes on which a number of other airlines represent an offer comparable to those of the Airlines. These would include Auckland-Brisbane, Christchurch-Brisbane and Christchurch-Sydney. These routes are characterised by frequency of services by other players that makes those services relevant to the combined Qantas-Air NZ schedule.

(b) Routes on which there is some competition (a daily service by another player), but that competitive offer pales compared to the schedule offered by the two Airlines. This would include Auckland-Sydney, Auckland-Melbourne and Christchurch-Sydney.

(c) Routes on which there is no comparable offer or a very limited offer from other airlines when compared to Qantas and Air NZ. These would include all routes in and out of Wellington, Christchurch-Melbourne, and all services from regional ports in New Zealand (Queenstown, Dunedin, Palmerston North and Hamilton) and other ports in Australia (Cairns, Adelaide, Perth and Gold Coast).

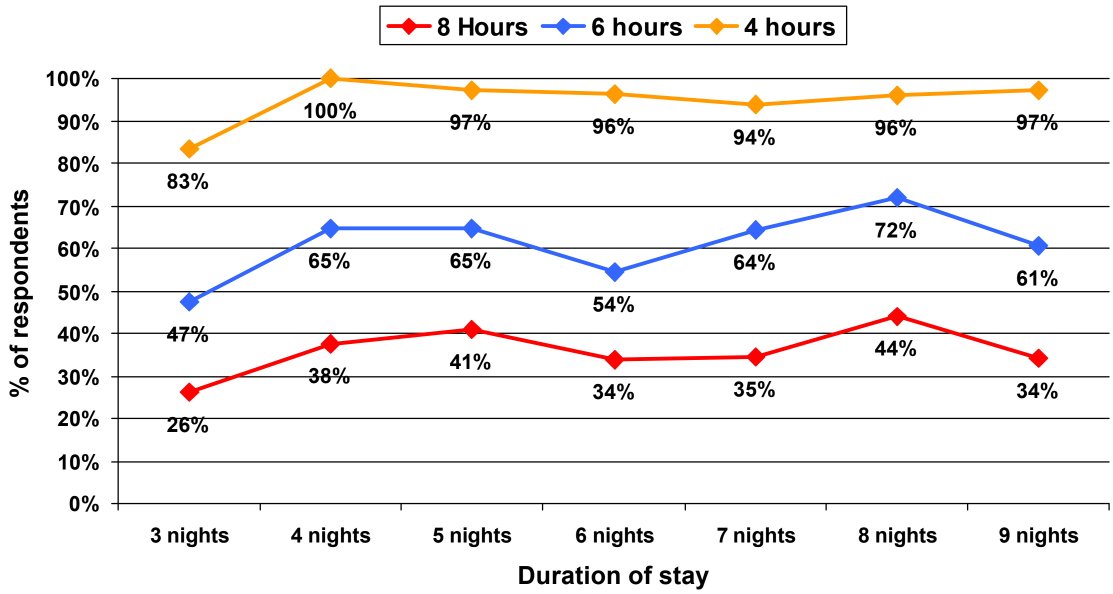
232 These clusters have distinct characteristics, and are impacted differently by the proposed TNA. Despite the minimal competition, Qantas and Air NZ seek to collude on all routes. The general point, however, is that an aggregated Tasman market will obscure rather than facilitate an analysis of the competition effects of the TNA. Factors relevant to the Minister's decision would be obscured.

Short haul leisure markets have a distinct competition dynamic

233 There are a body of travellers on short haul routes that are particularly price sensitive – principally leisure travellers on longer trips with time flexibility time on their hands. But there are many passengers who, on short haul routes, are particularly affected by time and convenience. For these passengers, it is not a comparable option to hub through other ports to get lower air fares.

234 They will always be willing to pay significantly more for a direct route, and it is that willingness that can be taken advantage of by a cartel.

235 In 2004, AC Neilsen conducted customer research on behalf of Tourism New Zealand. It showed that travellers on short stay holidays (those already more sensitive to price than business passengers) are **also highly sensitive to travel time and travel convenience**. The graph below shows the percentage of respondents who would take a short holiday of a particular duration, based on the hours required to travel to the destination.



236 This simply confirms what airlines have always known: the number of stops in an itinerary affects market share and yield. It also confirms that, even for most leisure passengers, flying via other ports is not a comparable substitute.

237 For most travellers on the Tasman, a direct service is highly valued and there is very limited or zero substitution with connections via other city-pairs. This is particularly so for leisure travellers on tight itineraries (short breaks, special occasions etc) and business people on short trips. Some business people travel across the Tasman just for the day – for these people, flying to Auckland to connect with a Tasman service is not an option. For example, the fact that there may be a greater degree of competition Auckland-Brisbane is not a competitive constraint on the proposed cartel when a person wants to fly Wellington-Brisbane.

238 An analysis based on a single aggregated Tasman market will not properly recognise this fundamental feature of Tasman travel, and not properly consider the significant competition impacts of the TNA.

The Wellington market

239 The routes from Wellington are distinct markets, with clear differences from other Tasman markets. It is a short haul market that requires convenient direct services. While some passengers fly the Tasman via Auckland, they can only do so if they are very inconvenienced by several hours and if they fly on Air NZ or Qantas on the domestic sector (which adds to their cost unless they also fly on Qantas or Air NZ on the Tasman). Insofar as people fly via Auckland, it is due to lack of competition in Wellington.

240 It is very unlikely that any other airline will enter the Wellington market. Emirates has repeatedly said that it will not do so, which has been borne out by its actions. Pacific Blue has not grown its fleet significantly, it has not entered domestic routes and its approach to the Tasman is now very limited compared to the Airlines. In Wellington, it serves one route three times per week. Indeed, WIAL has spent a great deal of time over a long period working with Pacific Blue to promote and increase its services from Wellington. Out of that experience, we are well aware of the difficulties that Pacific Blue faces in doing so.

241 It has already become clear that seats and services will be withdrawn diminishing the availability of affordable seats in the Wellington market. When seats have been withdrawn in recent past, volumes of passengers have fallen.

242 If the TNA goes ahead, WIAL expects average prices to increase substantially. In addition to no real competitive tension holding down headline prices, the reduction in the number of seats offered will force more customers into higher priced seats, especially during peak periods.

Routes & Substitutability

243 In trying to build a case that they are constrained by Emirates and Pacific Blue, the Airlines have emphasised the price sensitivity of passengers. They then claim the price behaviour of Emirates and Pacific Blue is the dominant feature of competition. However, in trying to say that indirect flights are substitutes (in their response to ACCC of 4 July 2006), the Airlines say that price isn't everything. They say that there is a matrix of factors in addition to price:

(a) Choice of airline

(b) Preferred time of day

(c) The time the journey takes relative to price (direct vs indirect)

(d) Which destination they fly to in New Zealand or Australia

(e) Whether to travel to New Zealand or Australia or elsewhere

244 To cap it off, the Airlines then say that some price sensitive passengers are indifferent to all these factors and therefore, the routes in and out of Australia are broadly substitutable! No doubt this is the Airlines' ubiquitous "marginal customer" (which we address at paragraphs 312 – 347 below).

245 It is a different story for customers who have preferences about when they travel, how much they pay and where they go. We suggest that most people who travel hold such preferences.

246 It is important to remember that the point of the Airlines' argument is to say that Wellington residents will be happy to travel via Auckland and therefore Emirates and other airlines are options. Alternatively, that Wellington travellers are happy to fly on Pacific Blue via Brisbane, and then connect to other destinations. Ignoring even the inconvenience, that argument completely ignores the fact that it is almost always more expensive for a Wellington traveller to fly via Auckland on Emirates or via Brisbane on Pacific Blue.

247 Indeed, LECG has examined best available fare data between Wellington and Sydney to compare the indirect services of Pacific Blue and Emirates with the direct routes. They found that:

(a) Emirates is on average 46% more expensive (assuming you could get the cheapest available domestic fare to Auckland);

(b) Pacific Blue is on average 39% more expensive.

248 That is, not only is it highly inconvenient and time consuming, but it costs a great deal more to fly on Pacific Blue and Emirates on that route.

249 The research presented above from AC Neilsen confirms that travel time and convenience are highly valued even by many leisure passengers on the Tasman.

250 Given it costs more and is highly inconvenient, it is not surprising that MIDT data shows that in practice, almost nobody from Wellington flies Emirates on the Tasman, and Wellington passengers on Pacific Blue are almost exclusively terminating in Brisbane (MIDT data is drawn from airline booking systems. These GDS systems do not pick up all passengers on airlines like Pacific Blue, but in this case, they appear to have collected the majority).

251 There is clearly a body of people who are forced through Auckland (and to a lesser extent Christchurch) due to unavailability of seats on direct flights or very large price differentials between prices at the preferred time and day of travel. But those people travel on Air NZ or Qantas, not Emirates.

252 The potential for using other carriers from Wellington is almost non-existent. There is no potential for taking connecting flights on the New Zealand side other than through Qantas and Air NZ. On the Australian

side, Virgin Blue can offer domestic connections, but suffers considerably on Tasman route diversity and frequency.

Airline Claims on Common Pricing

253 The Airlines claim that price increases to take advantage of market power are restrained by common pricing practices. They say that with the advent of the internet, customers know as much as airlines about fares. As a result, it is impossible to discriminate in pricing.

254 In reality, it is simply untrue that customers have anything close to equal knowledge of fares as airlines. Airlines have an extraordinarily rich history of actual fare behaviour and booking profiles, as well as powerful predictive technology that allows them to anticipate customer behaviour and manage the release of inventory.

255 They know how many seats remain unbooked how many seats have not been released on a flight and whether the flight might be cancelled (as happens more often). Airlines know what their competitors are selling at and some airlines have a knowledge of their competitors' detailed load factors on a flight by flight basis.

256 All a customer knows is that a seat is available on a particular flight at a particular price. They do not even know if it will still be available in 10 minutes time.

257 It is little comfort that under a competitive arrangement between Qantas and Air NZ, the advertised promotional fares are similar to those in Auckland. This says nothing about:

- Availability of those fares.
- The extent to which they are marketed.
- Comparability and availability of other fare categories.
- How the cartel would behave in the absence of any competitive dynamic between Qantas and Air NZ in Wellington.
- How fares will increase out of Auckland – for the reasons set out in this submission, we do not accept that Emirates or Pacific Blue will control the prices out of Auckland.

258 As LECG has pointed out, the principal incentive for Qantas and Air NZ to advertise prices in Wellington comparable to those of Auckland is competition in Wellington between Qantas and Air NZ. This incentive is

removed under the proposed cartel. While advertised prices may remain comparable, the availability and rate of release of those fares may vary quite considerably. It will be all too tempting for airlines to get the extra yield on a Friday night, Sunday night, Monday morning, school holidays and other peak periods, knowing that there is no competitor whose behaviour they need predict or be concerned with.

259 As explained elsewhere in this submission, even today Wellington passengers often find that the cheapest fare is via Auckland. Common rating of headline fares sounds good, but the passenger’s experience of availability is another matter.

COMPETITION ON THE TASMAN

260 Air NZ and Qantas have dominated the Tasman since its inception. The Tasman and domestic markets are one of the few places they do not face significant competitors. They regard it as "theirs", and so their reaction to any other competitor can tend to be exaggerated.

261 By focussing on the assertion that the cartel would be constrained by Virgin Blue and Emirates, the Airlines obscure a key aspect of the public interest. Competition between Air NZ and Qantas on the Tasman is overwhelmingly the most significant dynamic in the Tasman markets. They dominate in terms of market share, capacity share, brand presence, service frequency, network coverage, domestic connections and loyalty programme membership. Ian Thomas, Consultant with Centre of Asia Pacific Aviation, made the same point:

> *"The trans-Tasman route is competitive - no doubt about that. But the main competition is between Air NZ and Qantas."*

262 Virgin Blue and Emirates are niche providers, and are not competing for the same customers as Qantas and Air NZ.

263 A cartel would remove choice and the benefits of competition for most trans-Tasman travellers on almost every route (market).

264 This has previously been recognised by MoT. In its report on the proposed Air NZ and United Airlines arrangement in 2002, the Ministry stated:

> *Our general approach to competition issues has been that, given the relatively small size of the market, competition and consumer interests in Australasia are best served by a strong Australian based airline and a strong New Zealand-based airline, in separate global alliances. This is currently the case with Qantas in oneworld and Air New Zealand in the Star Alliance.*

265 The Airlines have made much of the claim that 8 airlines contest the Tasman markets. The detail of current routes and frequencies is discussed below. In short, the claim is misleading. No route has eight carriers. Most routes have only 2 or 3 carriers. Some have only one carrier. Even Auckland routes are not as competitive as people intuitively expect. Are the Airlines really saying that they would prefer to have Ryan Air or Easyjet as competitors on the Tasman than 5th Freedom carriers?

266 Many long haul / 5th Freedom carriers have tried to fly the Tasman. Almost all have gone. Others, like Singapore Airlines, have consistently avoided flying the Tasman for decades, despite having rights to do so.

267 There are major disparities between the frequencies and capacity offered by the Airlines and those offered by other airlines (including Emirates and Pacific Blue). Where there are more than three players on a route, the balance tends be made up of 5th Freedom operators with limited frequency and presence. All the 5th Freedom carriers except Emirates operate on only one route, and only a few times per week.

268 The Airlines themselves have emphasised the impact of relative frequency and schedule timings on market share and yield. It is a major premise of their argument. We agree and no serious industry player would consider 5th Freedom players serious competitors on the Tasman.

269 The 5th Freedom carriers, including Emirates, should be dismissed as a serious competitive constraint on these short haul, high frequency markets.

270 In this section we consider the current state of competition in the Tasman markets. Clearly this is relevant to the Minister's consideration of the impact of the proposed cartel on the New Zealand consumer. As discussed above, two of the myths the Minister must test is that numerous carriers are competing right across the Tasman markets, and that Virgin Blue and Emirates will constrain any Qantas/Air NZ cartel, holding the New Zealand consumer harmless.

271 The market data shows a different story.

Overview of trans-Tasman competition

272 A summary of routes and frequencies is provided in **Schedule 1**. This has been constructed from simple public information provided by the Airlines on their websites. There are some small disparities between this information and that provided by the Airlines in their submission, but none that changes the key message. Although there may be eight airlines operating across the Tasman:

(a) No route has eight carriers.

(b) Most routes have only 2 or 3 carriers. Some have only one carrier.

(c) There are major disparities between the frequencies and capacity offered by the Airlines and those offered by other airlines (including Emirates and Pacific Blue).

(d) Where there are more than three players on a route, the balance tends be made up of 5th Freedom operators with limited frequency and presence.

(e) All the 5th Freedom carriers except Emirates operate on only one route, and only a few times per week.

273 For services in and out of Wellington, competition is very limited. It is comprised entirely of Air NZ and Qantas, except for a single service to Brisbane by Pacific Blue (3 times weekly). In Auckland and Christchurch competition is still very limited, with the exception of two routes (AKL-BNE and CHC-BNE) and possibly a third (CHC-SYD).

274 Air NZ claims that competition is so fierce that it is has precipitated some kind of crisis of over-capacity. This is not the case. Load factors on Tasman sectors are in fact comparable with those on many commercially viable routes all over the world. This is discussed in the section on "excess" capacity, above.

275 The relatively benign competitive conditions (certainly as compared with the Airlines' claims) can also be illustrated by reference to market prices. They have been increasing significantly over the past 18 months.

Market Share and Industry Concentration

276 The Airlines point to a decline in total market share from over 90% as a part of their case for a cartel. It is contradictory that in recent submissions to the ACCC, they say that market share does not matter.

277 In our view, in the real world market share in the airline industry matters. It affects ability to hold loyalty, provide a dominant product, provide feed and take action to defend particular markets by taking a portfolio approach. It is an obvious indicator of the extent of competition from others.

278 Our calculation from BTRE data for the full year to December 2005 (when competition was said to be fierce) is that the two airline groups had 82% of passengers across all routes. The combined market share now appears to be relatively stable, in fact the twelve months to December 2005 is up slightly on the six months to June 2005.

279 That is, the cartel partners would hold 82% of the market and the other 18% would be divided up between (according to the Airlines) 6 different players.

280 Of course on many routes, such as 3 of the 4 out of Wellington, the cartel partners would hold 100% market share.

281 In recent submissions to the ACCC, the Airlines have accused WIAL of taking a snapshot view of competition. It appears to WIAL that the Airlines seek to extrapolate from a few years of small growth by two marginal players. You would expect the Qantas/Air NZ market share to decline between mid 2003 and 2005. This is the period over which Emirates and Pacific Blue began operations. That it is no indicator of an ongoing trend. Emirates and Pacific Blue have stopped or slowed in their growth.

282 Pacific Blue has no more aircraft operating on the Tasman now than they had in 2004. Any new routes have been at the expense of existing routes. The same is true of Emirates. The only way Qantas and Air NZ's market share will decline further is if they cut capacity and passenger volumes (thereby reducing the over all market).

283 The market behaviour of Pacific Blue and Emirates has been quite contrary to the counterfactual scenario proposed by the Airlines when the Alliance was proposed. It follows that the equally bullish predictions regarding these players in the factual (accepted "hook, line" by the Tribunal) would have missed the mark. We discuss this more fully below in our discussion of the "marginal customer" theory.

284 Only a market player with extreme expectations of market share would describe a market share of anywhere between 75% and 85% as anything other than dominant. We note that in data provided to the ACCC in relation to the JSA for the Kangaroo Route, the two Airlines on that occasion (Qantas and British Airways) had a combined market share of 44% between the UK and Australia, which is a marked difference to the combined market share of the Airlines.

285 The Airlines are keen to present market share in terms of capacity shares on various routes, rather than actual seats sold. This can be highly misleading as other airlines, particularly 5th Freedom carriers, operate with particularly low load factors. That is, their impact in the market is well below their capacity share.

286 LECG has undertaken a study of the concentration of the Tasman routes from Wellington using the Herfindahl-Hirschmann Index (HHI), which is used by the US Federal Trade Commission. They have found Wellington routes to be highly concentrated and far above levels that US authorities would consider allowing further anti-competitive mergers or arrangements.

Air NZ

287 Despite Qantas continuing to operate comprehensive services on the Tasman, Air NZ's own competitive position has improved markedly. In that regard, it is useful to reflect on the underlying commercial objectives

articulated in support of the original Alliance. Those were many and varied but, at least in the initial stages of the regulatory processes, the Airlines' rhetoric focussed heavily on Air NZ's perilous commercial position and in particular its vulnerability to being sent into a "death spiral" by Qantas.[6] A "failing company" argument all but in name.

288 Indeed, at that time, Air NZ's position was marginal. Fortunately for Air NZ – but unfortunately for the argument supporting the need for collusion – things improved quickly and dramatically. Of course, the "death spiral" forecast becomes less tenable with each incremental improvement in Air NZ's financial position.

289 It is apparent to any observer that those improvements were secured the "old fashioned way" – through strong management and innovation, not collusion. Recent notable commercial initiatives have included:

(a) Launch of the quasi-LCC "Express" product first on New Zealand domestic routes and then subsequently on the Tasman;

(b) Substantial additional fleet investment particularly in 777 and 787 aircraft types;

(c) Overhaul of the long-haul product in particular to bring its Business Class service to the forefront of the market and to establish the new "Premium Economy" class;

(d) Launch of new international routes establishing connections with destinations such as San Francisco, Shanghai and Delhi;

(e) Commitment to fly the (genuinely) competitive Hong Kong-London route, therefore being the only airline in the world to offer a seamless round-the-world service;

(f) Rationalisation of its engineering operations;

(g) Rationalisation of various ancillary services, such as aircraft cleaning;

(h) Growth of market share on various Tasman routes; and

(i) New marketing initiatives in Australia for the first time since the demise of Ansett.

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6 See "Updated Executive Summary" dated 17 March 2003 restating and updating the key arguments put to both the Commerce Commission and ACCC, page 10.

290 These are not the activities of an airline on the back foot. Any similar arguments about financial crisis or decline should be treated with caution this time around.

Qantas

291 Of course, there has never been any suggestion that Qantas should require competition shelter to secure its survival. Quite apart from its robust financial position, Qantas enjoys ongoing Governmental relief through the particular configuration of international air rights in and out of Australia – such as on the key "Kangaroo route" and the Pacific route.

292 Rather, this proposal will have the effect, and we assume the purpose, of encouraging Qantas to "close down" competition on the Tasman (and on New Zealand domestic routes). WIAL submits the effective $48m payment from Air NZ to Qantas needs to be seen in this context also.

293 Since the demise of the previous cartel proposal Qantas has launched Jetstar. Jetstar has entered the Tasman market and, by all accounts has been a great success. Qantas is now launching Jetstar International as part of a further partitioning of brands, which adds further competitive strength.

Pacific Blue

294 The Commerce Commission was (rightly) sceptical as to the competitive constraint likely to be exerted by Pacific Blue if the previous Qantas/Air NZ cartel were to proceed. In relation to the Tasman market, the Commission concluded that:

(a) Virgin Blue was unlikely to enter to a sufficient extent to constrain the Alliance for at least two years from that time; and

(b) Instead, Virgin Blue was likely to enter in a measured way as it received delivery of more of its B737-800 aircraft and depending on demand and the response it faced from the incumbents (*see paragraphs 747 and 751 of Decision 511*).

295 The Commerce Commission also noted that the establishment of Virgin Blue in Australia was greatly assisted by the collapse of Ansett and that it was unlikely that its growth in the Tasman and domestic New Zealand markets would receive a similar boost, so that its expansion would be slower (*paragraph 531 of Decision 511*).

296 By contrast, in Australia, the Australian Competition Tribunal (*ACT* or *Tribunal*) was (prematurely) bullish. The Airlines rely heavily on the ACT decision this time around. Claiming to have access to more up to date data

than that available to the ACCC in its rejection of the Alliance, the Tribunal found that:

(a) Virgin Blue appeared to be in a strong position to enter quickly or expand on any trans-Tasman city-pair route (*ACT Determination, [2004] AcompT 9 (12 October 2004), para 318*);

(b) Virgin Blue had built up a 9% market share of the aggregated main trans-Tasman routes within a very short time (since beginning in early 2004)(*para 299*);

(c) Virgin Blue had three aircraft in domestic operation in Australia in Pacific Blue livery which were capable of being deployed across the Tasman within two months and was therefore readily able to add another 42 weekly return flights across the Tasman (*para 315*);

(d) As there were no natural or strategic barriers to its long-run expansion, Virgin Blue was in a position to expand its current market share (*para 324*);

(e) Virgin Blue would not withdraw from the trans-Tasman markets, which it considered to be an extension of the Australian domestic market (*para 325*); and

(f) Virgin Blue intended to begin domestic New Zealand services from December 2004, suggested that it might enter the trans-Tasman Auckland routes to enable connectivity with its domestic services (*para 325*).

297 Time has proved the Tribunal wrong. Pacific Blue has been a shadow of the competitive constraint expected by the Tribunal. In particular Pacific Blue:

(a) Has not entered the New Zealand domestic market and – despite occasional flurries of PR - has never appeared close to doing so;

(b) Operates only 28 services per week each way across the Tasman (across six of the possible 25 routes). This is the equivalent of two aircraft.

(c) Has withdrawn from the Sydney-Wellington route completely, remaining only on the Wellington-Brisbane route three times per week;

(d) Operates only three routes out of Christchurch (its home base), not all of which have been trouble free;

(e) Operates only two routes from Auckland with limited frequency;

(f) focused much of its energy and resources on routes between Australia and the Pacific Islands;

(g) failed to enter new parts of the market or grow its fleet or presence; and

(h) remains somewhat pinned-down by the commencement of Jetstar in the Australian domestic market.

298 It is quite clearly wrong to claim that Pacific Blue is targeting business travellers. It has no lounges at international ports. It has no business class seats. It has very few corporate accounts. It sells food and in-flight entertainment. Its flights are timed to suit leisure travellers. It has absolutely no flights on the business oriented routes of AKL-SYD and AKL – MEL, WLG-SYD and has lowered capacity on CHC-MEL. Virgin Blue has always taken the approach that it is a leisure airline internationally and cannot match the Airlines' stranglehold on business traffic.

299 Virgin Blue's initiatives to capture some level of loyalty and business traffic, referred to by Qantas and Air NZ, are restricted only to the Australian domestic market. There are no such initiatives for Pacific Blue in New Zealand.

300 We refer more to Pacific Blue as a competitor in the later section on market entry and expansion.

Emirates and other 5th Freedom carriers

301 Meanwhile, in terms of competition from "5th Freedom" carriers, Thai Airways, Malaysian Airlines and Polynesian Airlines (now operating as Polynesian Blue) have all stopped flying the Tasman.

302 It is worth noting that there is nothing to stop the Airlines code-sharing with 5th Freedom carriers. For example, Qantas already code-shares with Lan Chile (one of the 'competitors' flying SYD-AKLvv that operates only four times per week).

303 All 5th Freedom carriers suffer from limited awareness of their Tasman offer. For example, most potential customers would only know that they can fly Royal Brunei between Auckland and Brisbane (three times per week) if they went into a travel agent (and then one with a relationship with Royal Brunei). In a short-haul market dominated by internet bookings, the 5th Freedom carriers are severely disadvantaged.

304 Emirates has been cited as the main destroyer of "yield" in the Tasman market. Air NZ has even gone so far as to claim that it has been unlawfully "dumping" capacity on the Tasman market. This is an allegation Air NZ seems content to make. The Commerce Commission has confirmed to WIAL that no complaint about Emirates' conduct in fact has been made by Air NZ.

305 Emirates provides services on the following routes:

(a) Auckland-Sydney (once per day, compared to 10 per day by Qantas and Air NZ);

(b) Auckland-Brisbane (once per day, compared to 4 per day by Qantas and Air NZ);

(c) Auckland-Melbourne (once per day, compared to 4 per day by Qantas and Air NZ);

(d) Christchurch-Sydney (once per day, compared to 4 per day by Qantas and Air NZ).

306 Emirates' "FSA" improved service offering will clearly have an appeal to some travellers. But Emirates' will always been confined to a niche of time elastic travellers, which represents a small minority in short-haul markets like the Tasman. Its effectiveness as a competitive constraint is structurally limited by:

(a) Comparative infrequency of service;

(b) Inconvenient departure times;

(c) Service to only 4 out of 25 city pairs;

(d) Lack of domestic connections in either Australia or New Zealand, which limits its market only to those in the cities it serves;

(e) Lack of presence as a Tasman player (that is, regular travellers on the Tasman are less likely to be members of its loyalty program or to check prices on the Emirates website);

(f) Relative inconvenience of flight times; and

(g) Lack of presence out of most centres.

307 We have also been advised that there have been efforts to have Emirates' rights to fly the Tasman withdrawn.

308 The Airlines have argued that 5th Freedom carriers operate at a marginal cost. Perhaps so. It is also the case that, despite the best intentions of some airlines, the Tasman is not a core market and their long term commitment to the market is also marginal. Fifth freedom carrier schedules are determined by long-haul imperatives. For most, the Tasman is a convenient add-on that is subject to other drivers of route decisions and their mere presence does not discipline Qantas and Air NZ in any material way. In any case, as explained elsewhere in this submission, Qantas and Air NZ also use downtime of 747 aircraft.

309 Emirates is unlikely to add a Dubai-Australia flight to contest a Qantas/Air NZ cartel in a Tasman market.

310 We cover Emirates further in the later section on market entry and expansion. Below we explain why Emirates behaviour is no significant constraint on Qantas or Air NZ.

THE MARGINAL CUSTOMER

The Airlines' Hypothesis

311 To overcome the absurdity of claiming Pacific Blue or Emirates as a competitive constraint on a cartel, the Airlines rely heavily on the pre-eminence of the "marginal customer".

312 They managed to convince the ACT of this in the heat of 2004 when expectations of competition ran very high, and now use that argument extensively.

313 The argument runs as follows:

- There are fixed costs in running an airline and a route.
- Therefore airlines must seek high utilisation of capacity.
- This means having to attract customers who are "marginal" and driven almost entirely by price and only enter the market at low prices.
- To achieve this, the cartel will have to price accordingly and compete with players like Pacific Blue and Emirates.
- Crucially, airlines cannot distinguish between a marginal customer and customers prepared to pay a higher price, and so "marginal customer" prices spread more widely and lead the market.
- This means the cartel will not be able to increase prices.

314 This could only be described as a long-bow, and the Airlines must themselves have been surprised when it was accepted by the ACT in 2004 in the midst of speculation about the growth of Emirates and Pacific Blue.

Fixed Costs and Utilisation

315 To start with, the impact of fixed costs does not drive marginal pricing in the airline industry. While an aircraft is a fixed and indivisible unit that contributes to the full cost of services it can be redeployed away from underperforming routes, as demonstrated by Air NZ's recent cancellation of the AKL-SIN route after 40 years of operation. Aircraft can also be substituted for different types to change the level of cost.

316 We have already seen that the economics of the airline industry only requires sale of 60%+ to break even and an 80% load factor would be considered excellent. So the incentive to continue selling seats if the "marginal price" impacts on other fares is limited.

317 Of course, the Airlines can effectively price discriminate. This is a major hole in their theory. The prices offered to marginal customers do not constrain pricing to other customers. This is the every day experience of travellers.

318 In practice, most airlines do not chase the marginal customer too hard because:

- They are making good returns at much lower levels of utilisation.
- They make those returns because they have spent a great deal of time developing a brand and holding up price expectations. Hence, when lower prices are offered, they are presented as very limited sales and are restricted to periods of low demand.
- Selling too many seats very cheaply undermines brand, causes resentment among those who pay higher prices and creates expectations that other seats should be sold at those prices.
- Those who pay higher prices are the more regular and desirable premium passengers.
- The gains of attracting large numbers of "marginal" passengers are far outweighed by the disbenefits of downward pressure on yields of non-marginal passengers.

319 This is no different to other businesses that place a high value on their brand.

Most Customers are in the Bag

320 In reality, Air NZ and Qantas do not need to chase the marginal customer. They can make reliable predictions that they will get the majority of their customers due to their network advantages (feed and beyond connections), loyalty programs, corporate accounts, schedule dominance, business lounges and their brand loyalty.

321 For a start, business travellers are pretty much in the bag. Speaking at the Chamber of Commerce on 4 May 2006, Rob Fyfe, CEO of Air NZ, said that more than 30% of travel on the Wellington-Melbourne route is transacted on the Air NZ corporate travel card. He said that if you are a corporate or

business traveller, it is likely that your company travel policy ties you to one airline. So, thirty per cent are in the bag before a single price is posted.

322 Along the same lines, the ACCC has posted on its website the records of a meeting with Travelforce, a major Australian corporate travel management company. The findings are not surprising. Travelforce confirms that Air NZ and Qantas are always first preference because of their frequency, route diversity, schedule, loyalty programs, corporate policies and corporate contracts. They say that, for these reasons, they do very little business with Emirates or Pacific Blue.

323 Secondly, travellers who need to make connections are pretty much in the bag for Qantas and Air NZ. Examination of MIDT data shows that, for Qantas and Air NZ, between 20% and 30% of passengers on a given flight either have connected from another flight or will connect to another flight when they arrive. There are services where this is much higher and some where it is much lower. Connections are split between passengers connecting with a domestic network and those joining other long haul international flights.

324 For Pacific Blue, there number of connecting passengers is insignificant.

325 So conservatively, Qantas and Air NZ have around 50%-60% of customers for whom they do not have to compete with Emirates or Pacific Blue, even out of Auckland. Insofar as there is any competition for these passengers, it is only between Qantas and Air NZ.

Leisure Passengers are not all Marginal Customers

326 Of the balance that are not guaranteed to go to Qantas or Air NZ, very few would be considered "marginal passengers".

327 As portrayed by the Airlines, a marginal passenger is quite indifferent to:

- Which airline they fly on;
- What time of day they fly;
- What day of the week they fly;
- Which destination they go to;
- Which airport they arrive at (where there is more than one in a city);
- Which route they fly on (although hope that the Airlines would accept that they at least have to start from their home town);

- How many stops and connections they have to make; and

- Whether they have almost no flexibility to change plans.

328 Indeed, on the Airlines' view, you have to wonder whether these marginal customers are potential airline customers at all. They appear to have little desire or motivation to travel.

329 Certainly very few Tasman leisure passengers fall into the marginal customer category:

- Many are restricted by day of travel holiday bookings or special events, coupled with work restrictions;

- Many are visiting friends and relatives and so have limited choice of destination;

- Many are on short itineraries and are reluctant to spend a long time waiting and connecting (as confirmed by the AC Neilsen Research commissioned by Tourism New Zealand and referred to elsewhere in this submission);

- Many are also members of loyalty programs and travel extensively for work, and so have strong airline preferences.

Full Service Airlines aren't driven by the "Marginal Customer"

330 In reality, full service airlines do not pursue the "marginal customer" at the expense of its main body of customers. The so called marginal customer is a very small part of their business (although they can certainly play havoc with Pacific Blue if they choose to do so). Many would openly say that they do not seek to attract these passengers and prefer to leave them to others. Even Air NZ has expressed its strategy as being the preferred airline for repeat customers in New Zealand (not the highly infrequent traveller).

331 Both Air NZ and Qantas have created low cost subsidiaries (with separate strategies underpinning the Freedom and Jetstar brands respectively) to partition off more marginal passengers from core passengers and avoid dilution of yield on the full service brand. Indeed, this partitioning approach has been so successful for Qantas (with its particular need to respond to Virgin Blue) that it has reconfirmed its two brand strategy to the share market, and is rolling out Jetstar International extensively.

> *"This is a further step in Qantas' strategy of having two brands; brands for the markets they are most suited for"*
>
> *Geoff Dixon, Qantas CEO, announcing new routes for Jetstar International (reported in AFR, 27 July 2006)*

332 In Australia, Qantas has already successfully partitioned the market – it has protected its premium market and has the marginal customer market under control. This is very clear from the differential yields on Jetstar and Qantas. Later in this submission, we review lowest available domestic fares in Australia and New Zealand. The principal purpose is to show the high fare environment in New Zealand. However, those figures also demonstrate that there is a strong brand partitioning between Qantas and Jetstar, and that this partitioning has a dramatic effect on yield.

333 Importantly, this market development has occurred since the ACT decision in 2004. The ACT did not have the benefit of a full analysis of how airlines market to and serve the "marginal customer".

334 This is not surprising or exclusive to airlines. To take a simple example, HP owns Compaq and offers two brands of notebooks at quite different price ranges (HP and Compaq brands). Serving the lower end of the market with one brand protects the brand of the high yielding brand. They don't need to identify or distinguish the marginal customer as an individual – they just establish two brands and two price ranges to relate to two different customer "profiles".

Can Airlines Distinguish Valuable Customers from Marginal Customers?

335 Airlines such as Freedom and Jetstar - as well as Tiger Airways and Air Asia - do tend to carry many "marginal passengers" who in the past may not have travelled due to affordability. That is the stimulation effect.

336 But it is quite false to say that full service airlines cannot distinguish between marginal customers and other customers. They have extensive databases on booking history and knowledge of corporate accounts, connections and FFP memberships. Most of us will have received personalised emails or correspondence that refer to our specific travel behaviour. They may not know the marginal customer, but they know those who are not.

337 Further, full service airlines continue to be very effective at price discrimination. The marginal customer is known to be prepared to book flights well in advance, and to the extent the FSA airlines serve these customers this is when they make (limited) seats available. The prices rise

as departure date gets closer (and are in no way constrained by the marginal customer).

338 The full service airlines do not need to "know" the marginal customer. It is enough to know that they can ignore them or serve them through a separate brand and/or different price.

Do prices support the airline hypothesis?

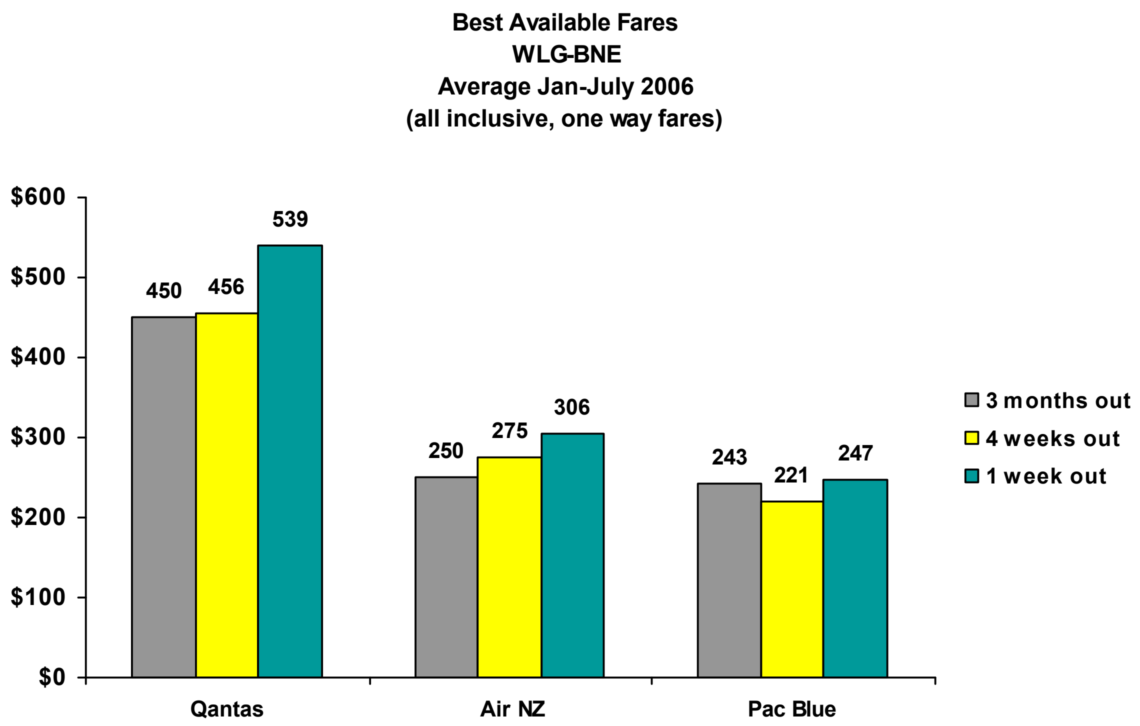
339 If the Airlines' hypothesis is correct, you would expect to see consistent fares over:

- Airlines, regardless of connectivity, corporate travel or schedule;
- The booking period leading up to a flight;
- Time of day and day of week.

340 Professor Tim Hazeldine has undertaken an empirical analysis of market data to test this idea and presented his results to MoT and in the journal of the Institute for Competition and Regulation Studies. He confirms that in fact airlines on the Tasman continue to effectively discriminate in prices in the way described above. The claim that pricing for marginal customers constrains all pricing runs counter to the very effective price discrimination systems of the airlines, and is simply untrue. A copy of Professor Hazeldine's findings published by ISCR is attached at **Schedule 3**.

341 WIAL collects information on fares on a weekly basis. The evidence shows that there are strong differentials between airlines.

342 In the example below, we use the only route out of Wellington with a competitor to Qantas and Air NZ (Pacific Blue). On the WLG-BNE route, Qantas is clearly able to command higher fares than either Air NZ or Pacific Blue. This is probably due to their Australian and New Zealand network along with their brand strength and loyalty ties of various kinds.



343 That is, even with Pacific Blue operating on the route at the same frequency as Qantas, prices vary markedly between airlines. Air NZ is also able to charge well above Pacific Blue in the lower fare categories, probably mainly attributable to its frequency and brand strength with New Zealand customers and business customers.

344 In terms of time of booking, Qantas and Air NZ seem to replicate the behaviour predicted of a full service airline, with best available fares increasing as the flight approaches. In this case, Pacific Blue appears to have demonstrated a more concerted sales push about a month out.

345 It is telling that, even 3 months out, Qantas was so confident of getting its loadings that it had the average all inclusive one way price at $450.

346 And as mentioned elsewhere in this submission, the data collected by WIAL shows that the flexible economy fare is commonly double that of the best available fare.

347 Even in the "best available" fare category, there does not appear to be any evidence of an indiscriminate race to the bottom in pursuit of the "marginal customer". The claim that competition for the marginal customer constrains Qantas and Air NZ is not supported by the facts.

MARKET ENTRY AND EXPANSION

Overview

348 The Airlines rely very heavily on a claim that the proposed cartel will be constrained from harming New Zealand consumers by competition from fringe competitors such as Virgin Blue and Emirates. No evidence is provided to support this assertion.

349 The Airlines' predictions in 2003 and 2004 of new market entrants and crisis have not come to pass. They now must resort to saying (as they have in recent submissions to the ACCC) that it did not happen because the merger was not approved. It does not matter that fares have increased (above fuel levies) over that time. The Airlines speculate that Pacific Blue and Emirates remain "poised" for entry (but provide no evidence whatsoever). After 3 years of remaining in a crouch position ready to pounce on Qantas and Air NZ, their legs must surely ache.

350 In this section we discuss the law and the facts on the possibility of new entry or expansion by existing fringe competitors. The law is clear that the question is one of practical likelihood in the near term (three years), not theoretical assertions about the long term. In the context of the previous proposal for a cartel, both the High Court and Commerce Commission determined existing market participants – Virgin Blue and Emirates – were unlikely to constrain the cartel.

351 The assertions made by Qantas and Air NZ at that time about the competitive threat of Virgin Blue and Emirates have since then been shown to be false. Recent market experience contradicts the claim that Virgin Blue and Emirates will expand aggressively. As shown above, a Qantas/Air NZ cartel would be dominant, and both Airlines have a record of responding aggressively to new competition.

Market Entry – Probability Matters, Not Theoretical Possibility

352 The proper approach to assessing the likelihood of entry or expansion by competitors was recently reemphasised in *Commerce Commission v New Zealand Bus Limited,* Miller J, 29 June 2005, High Court, CIV 2006-485-585, Wellington. In that case, the High Court stated the question was one of practical likelihood, and it is not appropriate to take a theoretical economic approach.

353 The High Court emphasised that competition effects should be assessed over a three year timeframe. The court stated that theoretical, long-run economic views of what constitutes a condition of or barrier to entry are not

appropriate. If, over the next three years, a new entrant faces a cost that would not be borne by the incumbent, then it was likely to be a barrier to entry. The threat of retaliatory response by incumbents is relevant to the assessment of the likelihood of entry or expansion, as it is a pragmatic consideration taken into account by entrants and fringe competitors. [7]

The TNA cartel makes entry and expansion less likely

354 The High Court in *Air NZ v CC (No 6)* (2004) 11 TCLR 347 asked whether a LCC or competitive carrier could possibly "expand in sufficient time and to such a degree as to restrain prices to counterfactual levels (para [110]).' The Court found it clear that neither entry nor the threat of entry is sufficient to constrain prices in the airline markets, stating:

> *The predictable competitive response of the incumbents would be to increase capacity and reduce price on those routes. This conveys to the entrant the likely conditions of expansion while permitting the incumbent to maintain prices on other routes. The Commission argues, in our view with logical force, that the proposed alliance has stronger incentives to respond to entry in this way because it reaps the benefits if it succeeds in delaying or deterring entry on other routes on which it has a higher and, as yet, uncontested market share. (para [115])*

355 The Court respected the Commerce Commission's judgement that incumbent response to new entrants on the Tasman was a formidable barrier. The High Court also held that frequent flyer schemes are a barrier to expansion, as growing airlines face a competitive disadvantage in attracting new customers (who may be part of an incumbents frequent flyer programme) *Air NZ v CC (No. 6)*. In considering all factors the High Court found that the Alliance would substantially lessen competition.

356 The two Airlines have a large combined fleet at their disposal comprising 747-400s, 747-300s, 777s, 767-300s, 737-800s, 737-400s and A320s. They operate on all routes with dominant shares in all markets. They are able to incrementally intensify or reduce their market presence at will and to swap equipment. By contrast, the other players have a limited number of aircraft and equipment types. They operate only on selected markets. They publish schedules and cannot flick from one route to the other at will.

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[7] In *New Zealand Magic Millions v Wrightson Bloodstock Ltd* [1990] 1 NZLR 731, 757, Tipping J found that the likelihood of "a very considerable fight" from incumbents was a barrier to entry. See generally: C Noonan *Navigating Barriers to Entry and Expansion Under the Southern Cross* (2003) 9 (February) NZBLQ 66.

357 There is good reason for Pacific Blue and Emirates to understand the response of the cartel to new services. Pacific Blue's every move has been matched by Air NZ, to the extent that they have joked that one of Air NZ's cost savings is to sack its route planning section – they simply follow whatever Pacific Blue does. Similarly, Pacific Blue knows from bitter experience that:

(a) Air NZ will compete aggressively on fare whenever they feel threatened.

(b) Qantas will place Jetstar against them on an route that they appear to be growing. It is surely more than coincidental that Jetstar elected to base its operations in Christchurch – Pacific Blue's home base and biggest market.

358 There is nothing wrong with competition, but Pacific Blue will be well aware of the strength of opposition it faces with Qantas and Air NZ competing. Notwithstanding, the possibility of incremental opportunities at the margin providing a "silver lining", it will be many times worse under a cartel if they try to expand.

359 If they seek evidence of this beyond their own experience on the Tasman and in Australia, they need only look at Origin Pacific's plight in the New Zealand regional markets.

Potential entrants - let's name names

360 Faced with a cartel, there is a degree of wishful thinking that "somebody" will enter the market if fares increase or service levels drop.

361 The best test is to name names.

(a) Singapore Airlines has had unexercised rights for years, all through the periods of high Tasman fares. They are not interested.

(b) Other 5th Freedom carriers? Most have been there and withdrawn. They can never develop the frequency offered by Air NZ and Qantas on the Tasman, and even if they enter, as welcome as they are they are no threat to the major incumbents. And their aircraft types are often unsuited to the route.

(c) A new start up in Australia or New Zealand? Extremely unlikely.

362 That really just leaves Pacific Blue and Emirates. We have had plenty of opportunity to observe their behaviour, but we will deal with them below.

Recent market experience

363 As the law requires a consideration of what is practically likely in the near term, WIAL submits the Minister must focus on recent market experience and market data, and not the theoretical and unsupported claims of the Airlines.

364 Both Qantas and Air NZ have systematically disciplined the market in recent years, signalling to the market that any expansion will be met with increased capacity. Market participants know the threat of incumbent response is real and not theoretical, and complaints have been made to the competition regulators on both sides of the Tasman. Air NZ's ability and willingness to target and deter entry is evident with its response to Origin Pacific's expansion and entry into certain domestic routes (causing Origin Pacific to complain to the Commerce Commission about Air NZ's predatory behaviour). Allowing a combined response from Qantas and Air NZ would be fatal to any prospect of expansion by Pacific Blue or others.

365 Recent market experience contradicts the Airlines' claims that Virgin Blue or Emirates would expand in the face of such a cartel. Similar claims were made in 2004, and the Australian Competition Tribunal in 2004 relied on predictions by the Airlines of growing competitive constraints on any Qantas/Air NZ collusion. As demonstrated below, this confidence in fact was misplaced. Despite rises in Tasman fares since then, the evidence is that Pacific Blue and 5th Freedom carriers such as Emirates have been, and will continue to be, of limited competition significance.

366 Virgin/Pacific Blue simply has not had the competitive effect, in terms of price leading, and further expansion that many originally believed. There are still few flights available; they operate at limited frequencies; and they are to relatively few destinations. Brand recognition serves little purpose if not matched by actual availability.

367 Indeed, WIAL's price information from the previous six months reveals that Virgin Blue prices are determined independently from Air NZ and Qantas and do not have the downward effect that the Airlines' claim. That data is presented elsewhere in this submission for the one route that Pacific Blue flies out of Wellington (WLG-BNE).

368 But the situation will only worsen if the two incumbent airlines are officially sanctioned to combine their resources against Virgin Blue. The Airlines' declared rationale for the TNA, of course, is to respond to the competitive challenge from Pacific Blue (and Emirates). Threat of incumbent response already constitutes a substantial limitation on Pacific Blue's expansion, especially at the New Zealand end.

369 The Airlines rely on a theoretical assertion that there is little to stop other airlines entering new routes and "cherry picking", and that this was a view taken by the ACT.

370 At the time, the Tribunal was relying on only a short period of participation in the market by Pacific Blue and Emirates. It was encouraged to believe that "the worst is yet to come" in terms of competition. It has often been said that competition must be viewed as a process rather than a snapshot. We now have two years of actual observations that show that the picture provided to the Tribunal was quite wrong.

The Airlines' response

371 The Airlines (in a submission to the ACCC) have sought to refute the view that time has proven Virgin Blue and Emirates to be competitive light-weights on the Tasman markets, and the Tribunal wrong. The Airlines say that the Tribunal's predictions were in the context of the Alliance being implemented (ie in the "factual"), and that WIAL takes an overly "snap-shot view" of the Tasman market.

372 First, the Tribunal itself noted that benefit of hindsight in reversing the ACCC's determination:

> *… at the time the Commission handed down its determination it did not have available to it any of the significant developments and evidence of interactive rivalry which has occurred across the Tasman with the introduction of Virgin Blue and the expansion of Emirates' activities. At that stage the Commission could only speculate as to the future. By the time of the hearing before us, a significant part of that "future" had arrived. We therefore had the opportunity to examine the strategic behaviour which had occurred and in respect of which we had the basis for assessing future market conduct.*

373 Second, it is clear that the Tribunal predicted the fringe participants would grow regardless of either factual or counter-factual scenarios. Many of their comments were not exclusive to the "factual", such as:

> *Both [Emirates' and Virgin Blue] have the ability to play the role of maverick in the market, thereby keeping the applicants on continual competitive alert, both proactively and reactively; (para 423)*
>
> *Virgin Blue represents the current reality of aggressive, pro-competitive market expansion.(para 424)*

374 Now we have the benefit of two more years of market experience. Indeed, it could be argued that the Tribunal took the "snap-shot" view, assuming

that Virgin Blue and Emirates would continue to grow at initial rates. Virgin Blue entered the market with a flurry, pumped itself up with cheap introductory offers, and promised new and exciting opportunities. Time has revealed Virgin Blue to have consolidated its position, and revealed a lack in capacity which has seen it focus on Australian domestic routes. It simply isn't in a position to further penetrate (or constrain) the market.

375 Just as important for the Minister when considering this application, it was the Airlines themselves that in 2004 claimed that Virgin Blue and Emirates would continue to expand regardless of the Alliance. Qantas submitted that in its view of the counter-factual:

> *there would be continued expansion by Virgin Blue on the trans-Tasman routes; and*
>
> *there would be increased capacity by FCCs on the trans-Tasman routes, including increased expansion by Emirates on other routes;(para 487)*

376 Air NZ similarly submitted regarding the counter-factual:

> *It was likely that within two to five years Virgin Blue would have entered the domestic New Zealand market and further trans-Tasman routes. Virgin Blue would expand swiftly if Air New Zealand and Qantas were to increase fares in the trans-Tasman market. Even if the applicants were to continue to price on a real declining basis, it was probable that Virgin Blue would still seek to expand, although it would be one route at a time and slower than its rate of expansion in domestic Australia; and*
>
> *Emirates was likely to expand its presence across the Tasman by increasing flights and city-pairs and employing larger aircraft. Emirates would seize a significant share of both corporate and leisure passengers.(para 488)*

377 The fact is that Virgin Blue was eagerly (but speculatively) promoting its own potential in 2004 – it was in its interest to do so. It was also in the interests of Qantas and Air NZ to go along with it. The actuality is that both Virgin Blue and Emirates have a weak presence in the Tasman, and will continue to do so. Faced with either competition between two heavy weights, or a cartel with bone crushing dominance, their respective strategy and focus sensibly lie elsewhere.

Pacific Blue Expansion?

378 Having recognised that Pacific Blue remains a small player with just two aircraft, a handful of routes and limited frequencies, the Airlines must seek to paint a picture of a company poised to expand further. All sorts of factors are brought up to support the case – acquisition of booking technology to allow them to code-share, domestic loyalty programs in Australia, the marketing of a "new world airline" proposition.

379 The reality is that the Tasman is marginal for Virgin Blue. It occupies only 2 of 50 aircraft and is not core for the strategy or brand development of Virgin.

380 As WIAL knows from recent experience, even profitable services don't mean expansion. We reliably understand that Virgin Blue makes a respectable profit on its Wellington-Brisbane services. Yet those services have not been expanded, despite good reasons to do so:

(a) A respectable profit;

(b) The inefficiency of positioning crew for a three day a week service (with no other services in that port) – it would make a lot of sense to expand services to improve efficiency;

(c) A well communicated opportunity for joint marketing with Wellington and WIAL.

381 Why would Virgin not expand opportunistically where there are profits?

382 Most importantly, Virgin Blue's core market is Australian domestic. It faces a tough challenge to hold its 30% of that market, and will not do anything that risks it relinquishing that market share. Shifting aircraft from Australian domestic to the Tasman would surely have that effect.

383 It has incremental aircraft deliveries scheduled for 2 years time, but only enough to keep up with natural growth in the Australian domestic market and maintain its market share. In fact, initiation of new aircraft deliveries have been slowed down. In any case, it has a very limited fleet mix (737-700s and 737-800s, which is essentially one aircraft type), so it will never just take whatever aircraft it can get. Its ability to grow is limited by the availability of those aircraft.

384 In effect, Virgin Blue is caught in a trap in Australia. It doesn't know whether to price against Qantas, which has a large proportion of passengers in the bag, or Jetstar which serves the flexible leisure market. In response, it is working hard to establish a place between the two with a range of initiatives, many of which are referred to by the Airlines (although

they fail to provide the defensive background or the limitation to the Australian domestic market):

(a) Loyalty programs;

(b) Greater capacity for interlining and code-shares;

(c) New IT systems;

(d) Refurbishment of lounges in domestic terminals; and

(e) In seat entertainment.

385 Secondly, organisations can only manage a limited number major initiatives at a time. Virgin has made public the fact that it has a senior team working on potential start up on the far more lucrative Australia-US route. Brett Godfrey has said that this will take at least two years. That is a major change for Virgin Blue and it will absorb an enormous amount of management and Board focus. And this is on top of its need to deliver the changes it has announced in the Australian domestic market.

386 Third, in this environment, Virgin (and its investors) are not looking for an antagonistic fight over the Tasman. There may be some incremental opportunities under a cartel with its associated fare increases and brand confusion. But there is no long term or strategic prize for taking on a combined Qantas/Air NZ cartel on the Tasman. That is a fight that Virgin would surely lose. There is little to gain and is mostly likely only to result in Qantas and Air NZ attacking the routes on which Pacific Blue currently makes most of its money. If anything, it would lead to the rapid demise of Pacific Blue on the Tasman.

387 Finally, Virgin Blue has had major changes in its ownership, Board and senior management. Many of those who thought the Tasman was a good idea in 2003 are now gone, and, while the Tasman is profitable for them, there is nothing in the performance of the Tasman to excite the interest of the new team. They are focused on domestic and the US.

388 All the 2004 predictions of Pacific Blue becoming a major player on the Tasman and domestically in New Zealand have proven to be dramatically over-stated. In fact, they were just wrong and there are even less reasons today why Pacific Blue would expand on the Tasman in the face of a cartel. In particular, there has been no shift of aircraft from the Australian domestic market to the Tasman, as predicted. It has become clear that participation on various Tasman routes is subject to aircraft availability, and even demand from Pacific Island routes can constrain growth on the Tasman.

389 In short, Pacific Blue does not meet the criteria set by the High Court that competitive expansion be practically likely in the next three years.

Expansion of Emirates?

390 The Airlines present absolutely no evidence that Emirates would expand on the Tasman.

391 Emirates is constrained by being a long-haul player with long-haul equipment. Its service of Tasman routes relies on having aircraft on the ground in Australia and has simply not found opportunities to expand. Even in an environment of price increases, Emirates only expansion on the Tasman in recent years has been at the expense of another route (SYD-CHCvv replaced MEL-CHCvv). Emirates is most unlikely to make a decision on flying to Australia from Dubai based on an opportunity for more Tasman flying.

392 The Airlines acknowledge that Emirates is very unlikely to expand into Wellington. They do however point to the potential to operate 787s into Wellington. The 787 has not yet been ordered by Emirates and if it is, it is unlikely to be deployed from Dubai to Australia. In any case, the aircraft does not commence operations for 3 years and for airlines who have not yet ordered the 787, delivery will be several years away (generally around 2011).

Experience on Entry in the New Zealand Domestic Market

393 If competitors will enter opportunistically whenever fares are artificially high, one has to wonder why:

- Virgin Blue has never entered the New Zealand domestic market, as was widely speculated in 2004 (and occasionally receives a new round of speculation);
- Qantas has such a minimal coverage in the New Zealand domestic market and pulled out of the code-share with Origin Pacific;
- Jetstar has not commenced in the New Zealand domestic market;
- Rex from Australia has never entered the New Zealand regional market;
- Origin Pacific has struggled to survive in New Zealand;

394 The New Zealand domestic market also provides some hints on what happens when "Joint Business" controls more than more than 80% of the market.

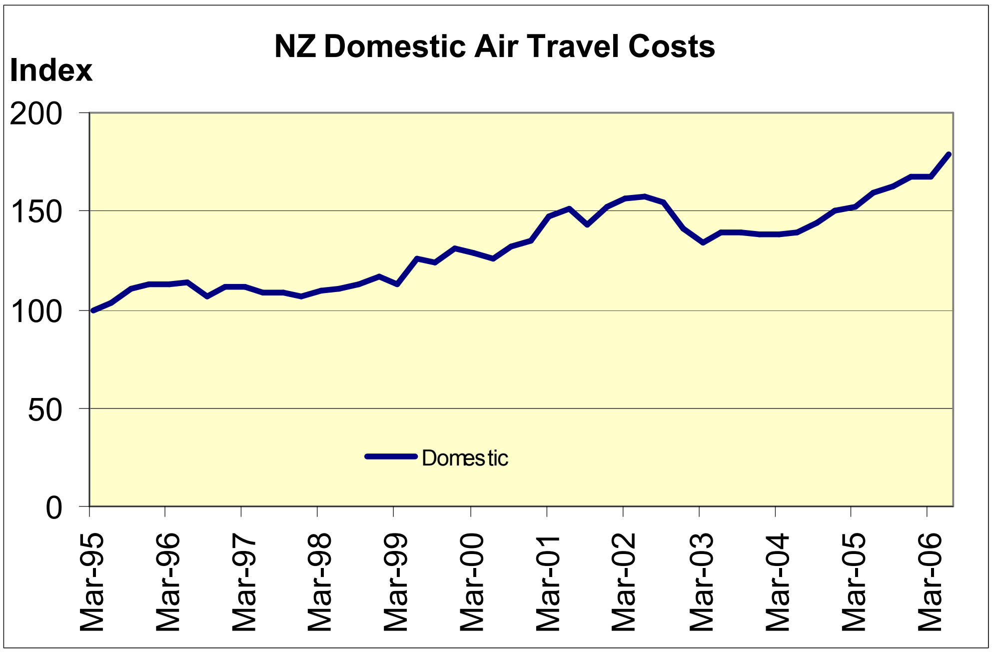
395 Fares on New Zealand domestic trunk routes are high. A survey of *best available* domestic fares over a six month period in 2006 showed that on average:

- the *best available* fares range from 15 cents/km (at the absolute bottom) to 35 cents/km.
- only rarely do best available fares come in below 20 cents/km
- best available fares in the range of 30 c/km to 35 c/km are very common.

396 If anything, regional routes were even more expensive. On New Zealand regional routes, we found no routes where best available fares were less than 22 cents/km. The cheapest fares were most commonly in the range of 27 cents/km to 35 cents/km, but there were several cases where the average of best available fares was in the range of 50 – 60 cents/km.

397 Of course, these are not average or top end fares – these are the cheapest fares available on the day.

398 New Zealand domestic fares have increased markedly over the years. They are higher than they have been in the past decade, and higher than they were in 2002/03 when domestic express and "low cost" domestic travel was introduced. They are 14% higher than their previous peak in June 2002 (prior to domestic express) and 33% higher than they were in March 2003.



Sourced from Statistics NZ indices

399 Some may assume that this is solely caused by fuel prices. But total fuel bill fuel makes up approximately 20% of overall airline costs (and obviously far less a percentage of revenue). Even a significant increase in fuel prices would not come close to accounting for these price trends.

400 By comparison, best available fares are as low as 7 cents on competitive long haul routes and 12-13 cents on the Tasman. Sector lengths would explain some of the differences with New Zealand domestic fares, but by no means the full extent of the gap.

401 A similar one-off survey of Australian domestic fares reveals that New Zealand domestic fares are very high even compared to Australian domestic fares. Australian domestic fares are not known for being low in an international context, although they have fallen somewhat since 2001.

402 An examination of routes was undertaken to examine best available fares one week out and four weeks out. Five routes were surveyed for Virgin Blue, Jetstar and Qantas (where they fly that route directly). Only direct services were included and long trans-continental routes were excluded. The routes examined were a mix of business and leisure routes:

- Adelaide – Melbourne.
- Brisbane – Newcastle.
- Canberra – Melbourne.

- Melbourne – Sydney.

- Gold Coast – Sydney.

403 The key findings of the survey of Australian fares were that:

- Fares were markedly cheaper than the comparable fares in New Zealand (both measured in NZ cents/km, converted at NZD 1 = AUD 0.83).

- Best available fares in New Zealand are generally around twice as much as the best available fares in Australia.

- Fares ranged between 11.5 cents/km and 15 cents/km for Virgin and Jetstar.

- Only on two occasions did Virgin fares exceed 15 cents/km (CBR-MEL was 19 cents and MEL-SYD was 19 cents for a booking one week out).

- Qantas was significantly more expensive than Virgin and Jetstar, as might be expected, but still well below fare levels in New Zealand.

- Qantas' best available fares were generally in the range 20 cents/km to 24 cents/km (only the MEL-CBR route was higher at 29.5 cents/km).

404 It is worth noting that Virgin and Jetstar reportedly have a cost base at less then 8 c/ASK (or 10.5 c/RPK at a load factor of 75%), even on very short haul routes and including all fuel increases.

405 Following the logic applied by the Airlines about market entry; Virgin would be operating extensively on New Zealand routes to take advantage of high fares. After 5 years operating in Australia and 2.5 years having set up in New Zealand, they have not done so. There is regular speculation that they will do so, but we have been hearing that for nearly three years. Similarly, Origin Pacific would be expanding rapidly and Rex would have entered the regional market.

PURPORTED BENEFITS OF THE TNA

406 The Airlines claim that Benefits resulting from the TNA will be:

(a) *Increased efficiency via cost reduction*;

(b) *"National Interest"*

(c) *Better schedule spread for consumer – removal of wingtip flying*;

(d) *Better Connectivity/seamless travel experience for consumers*

(e) *Greater Flexibility for consumers to change itineraries*

(f) *Frequent flyer benefits*

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

Robust scrutiny and a transparent process is required to ensure that these claimed benefits are likely to eventuate, and not just rhetoric to pacify the public and decision makers. It is also required to weigh up these purported benefits against the costs of higher fares, less services and poorer levels of service, all of which are predictable features of a cartel.

407 The Minister's role is to rigorously test these claims. This means the Minister must:

(a) require evidence rather than assertion for each claimed benefit;

(b) conduct a public process to test that evidence;

(c) be satisfied the claimed benefits result from provisions of the TNA that are within his jurisdiction, and not other provisions such as revenue sharing, fixing of capacity, tariffs and schedules beyond code-share activity;

(d) be satisfied the claimed benefits are not achievable without the TNA;

(e) be confident the benefits that satisfy each of these conditions are sufficient to outweigh the costs of the TNA (discussed in the next section); and

(f) How will the Airlines' conduct be monitored on an on-going basis to ensure that the operation of the TNA does not exceed the scope of the authorisation?

408 Before separately addressing the claimed benefits, the Minister should query generally:

(a) How will these claimed benefits be measured and monitored?

(b) Will any figures resulting from measurement be publicly available?

(c) Will the Minister require reports showing whether these claims become realities?

(d) What guarantees do consumers have that these objectives will be met?

(e) What will happen if the TNA does not result in the objectives being met?

(f) How will the Airlines' conduct be monitored on an on-going basis to ensure that the operation of the TNA does not exceed the scope of the authorisation?

Is the Cartel Required to Provide Benefits?

409 Most importantly, is a price fixing cartel even required to deliver any benefits?

410 For the most part, the Airlines' answer to that question seems to be that they refuse to consider alternatives. Significantly, the Airlines acknowledge that "benefits" can be delivered without a price fixing cartel. But they say they will only provide them if the Minister approves the TNA.

> *"While it may be possible for one or more of the benefits outlined below to be achieved by other means, the TNA offers the only commercially viable means of obtaining all the benefits in the current market place … The Commission should not attempt to unbundled the suite of benefits …Nor is it appropriate to pose alternative hypothetical commercial arrangements (absent any real commercial agreement between the Applicants) whereby the benefits outlined below may be separately obtained."*
>
> Airline response to ACCC questions, 20 June 2006
>
> *"The benefits which flow from the TNA (both to the Applicants and to the public) should be considered as a package. The TNA is the result of lengthy commercial negotiations between the Applicants and is the only commercial agreement on offer..."*

> *"When considering the benefits flowing from the TNA, the issue is not whether one or more of the benefits could be achieved absent the TNA … In this regard, the questions raised by WIAL are not relevant"*

Airline Submission to ACCC, 4 July 2006

411 In short, the Airlines are seeking to box the ACCC and Minister into a corner. The benefits, such as they are, are not exclusive to the TNA, but they will choose not to provide them unless they get approval.

412 The other significant question is why airlines need to jointly fix prices and schedules on a weekly basis in order to achieve their goals. The answer provided by Rob Fyfe to this question was that it is to avoid "gaming". We can only interpret this to mean that it that the participants cannot trust each other not to compete for customers. In short, the whole deal is set up to avoid competition.

Increased efficiency via cost reduction

413 Despite the Airlines' claims, we believe that it is relevant that capacity can be changed and costs reduced unilaterally. It is clear even from the Airlines' own statements and actions that this is so (see earlier sections of this submission in relation to unilateral actions). Not only can they achieve the changes, but they are already doing so.

414 It is clear from the statements of senior executives that these private benefits to the Airlines will be pursued regardless of the TNA. Rob Fyfe has assured Wellington leaders that if the agreement is not approved, he will be cutting capacity and costs on the Tasman. Qantas has made similar statements.

415 The payment of $48m from Air NZ to Qantas seems to undercut claims of cost savings (at least for Air NZ).

Better schedule spread for consumer – removal of wingtip flying

416 At a superficial level, this prospect has some appeal. But, on closer examination it is at best a "double edged sword".

417 For one thing, the TNA schedule provided by the Airlines shows ***increases*** in wingtip flying out of Christchurch.

418 Just as importantly, while *additional* flights at other times of the day would be a benefit to consumers, schedule spreading through the removal of some services has costs for consumers. Airlines fly wingtip to wingtip in

part because those are the times when consumers most want to fly – it fits with planning business meetings, or making the most of your days off.

419 Once services are withdrawn from those peak times to provide services at other times of the day, demand at peak times risks becoming constrained. It is even worse when only one carrier remains offering a service at that time, and that carrier has a price fixing deal with the other carrier.

420 A Wellington business person travelling today to Sydney for a meeting can fly out first thing in the morning, hold a day of meetings and return the same day or first thing the next morning. He or she has a choice of two airlines with different fares, and there are 288 seats available on the morning flights. Under the TNA, that business person will have the choice of only one airline that has fixed prices with its only competitor, and there will be 146 seats available. The fact that there is a flight at 1pm is of little comfort – it simply doesn't meet their needs.

421 If airlines believe that there is strong demand for departure times at other times of the day, there is nothing to stop them providing them unilaterally, either by changing existing services or adding services.

Connectivity/seamless travel experience for consumers

422 In WIAL's view, the Airlines do a good job of providing connectivity on Tasman services.

423 To date, we have seen no evidence of how it will be improved with less flights.

Greater flexibility for consumers to change itineraries

424 This is of course one of the great myths of the application. The benefit is said to be that passengers can travel on the other airline's service.

425 There is no net benefit, because at the moment customers have a great deal of flexibility within one airline's operation. The only reason that customers will need to rely on another airline to provide that flexibility is that the TNA will reduce overall choice.

Frequent flyer benefits

426 Again, the only reason why it would be a benefit to accrue and use FF points on the other airline is that a customer's normal airline is no longer flying the service they sought (as a direct result of the TNA).

427 It is quite possible for the Airlines to agree a reciprocal arrangement on FFP without the price fixing cartel, if they wish. In any case, many customers are members of both Airlines' FFPs.

The "national interest"

428 The Airlines provide almost no explanation on this. In Australia, the proposition simply boils down to "What is good for Qantas is good for Australia".

429 The Airlines have said that the cartel assists Qantas strengthen its competitive position and ensure it remains a strong airline "uniquely placed to deliver important benefits to Australia". No detail is required, because it is assumed that nationalistic fervour is enough.

430 The reality is that Qantas has no significant issue on the Tasman that it cannot solve by itself and the Tasman represents a very small part of its business. More importantly, assisting Qantas is not a relevant objective for the Minister, particularly as it will come at the expense of the New Zealand consumer.

431 In New Zealand, Air NZ simply says:

(a) The price fixing cartel will further strengthen Air NZ's financial position.

(b) It is in the national interest for Air NZ to be financially secure, as proven by the Government's rescue in 2001.

(c) Air NZ carries tourists to New Zealand and has an incentive to promote New Zealand.

432 In short, the Airlines expect unconditional support on the basis of national interest, regardless of the costs to Australians and New Zealanders. They promote the profitability of the Airlines as an end in itself and encourage the idea that support for their profitability should be unqualified.

433 There are some who buy this proposition. Indeed, insofar as there has been support, it has largely been on the basis that "we've got to have a strong airline". The Airlines have certainly promoted this idea and sought to create the impression that they are financially under threat (although in their formal submissions, which can be subject to expert scrutiny, they avoid this claim). In fact, Qantas has recently complained that it is so profitable, that it finds it hard to get the public support it desires to change its practices. A financial crisis is required.

434 As Air NZ and Qantas have both emphasised, they are not charities - they are companies whose purpose in life is to deliver profit to shareholders. Indeed this is the core of their argument for a price fixing arrangement.

435 It is worth examining the benefits of national airlines here in the context of the application for a price and capacity fixing agreement:

(a) *Tourism Marketing & Sponsorships*
Airline's spend money on marketing in pursuit of their own profit objectives. It is not an altruistic initiative to promote the national industry, and we do not advocate that it should be. Most countries have Government tourism marketing agencies funded by public taxes and those agencies generally try to work with those who have a commercial interest in promoting inbound tourism and travel, and often the company with the greatest interest is the dominant home based airline. It is an area where interests coincide and many (including airports) participate in marketing cooperation.

While a great deal of Tourism New Zealand marketing is destination oriented, a very large proportion of airline marketing expenditure is tactical sales activity, focused on the airline rather than the destination. Insofar as the destination is involved, it is incidental to the airline promotion.

Participation in tourism marketing by private companies is a good thing and should be encouraged, but it is not a good enough reason to support a home based airline unconditionally, nor approve anti-competitive arrangements.

Indeed, Qantas has been a strong advocate for globalisation of airlines that disentangles national positions and home markets from airline businesses. As Emirates have shown, some foreign based carriers with a commercial interest in a market will commit to supporting local events and teams.

If tourism marketing is the issue, it is probably far more efficient and transparent to impose a tax on travellers and use that fund to promote New Zealand, than to allow a cartel that will accrue more profits in Air NZ in the hope that they will spend that marketing New Zealand. We do not advocate new taxes, but use this example to bring the issue into the open.

(b) *Support for Local Market and Services*
As Air NZ and Qantas have said themselves, they will withdraw from routes that they do not deem to provide an adequate return. One analyst recently described Air NZ as "relentless" in withdrawing from routes. Home carriers are similar to other carriers – they supply services where they think they can make money. They withdraw where they believe they cannot. While Air NZ and Qantas dominate, others are not likely to enter their home markets. But without a

dominant home based carrier, it is almost certain that most routes would be served by other carriers, as long as Government provides them the rights to do so. If there were no Air NZ, the domestic market would certainly be served by others as one of the most profitable areas for most airlines.

(c) *Nationalistic Pride*
Nationalism is a common but curious reason to provide unconditional support to an airline. It is a cliché (but true) that nationalism can hide many ills and provide excuses for much ill conceived behaviour. The airline sector is no different. Home based airlines are commercial enterprises (even if Government owned). Air NZ is not a "national team", like the All Blacks, and surely would not seek to compare themselves to them or seek that type of dedication. Certainly, if there were any basis for this argument, withdrawal of Air NZ from Tasman routes to hand them over to Qantas (as proposed in the application by the Airlines) would not be allowed.

(d) *Local employment and local supply contracts*
Some believe that home based companies will provide contracts and employment locally out of nationalism or altruism, regardless of commercial considerations. This is clearly not the case (and we do not advocate that it should be). Airlines, including Air NZ and Qantas, have made the point that they have to move jobs and contracts off-shore to remain competitive in their cost base. While jobs and contracts are a useful lever in securing concessions from Government and unions, home based airlines have been quite willing to move jobs and contracts off-shore.

(e) *Export Fitness & "Level Playing Field"*
Some believe that if Kiwi companies combine with others and get the support of Government, they will be more fit for competing internationally. This is extended to often asserted (but rarely proven) support for foreign companies by their governments ("they do it, so we have to as well"). There is a major policy debate to be had on this topic. Regardless of the outcome of that debate, it is certain that the price-fixing cartel between Qantas and Air NZ is not in this category. The TNA is not about local companies combining to take on the world. It is about two already dominant national carriers combining to dominate their shared regional routes.

436 In short, the role of home based airlines should be seen in a commercial context, unless there is an explicit intention to return to Government owned and protected airlines that are meant to be an instrument of policy, rather than a commercial company. There is a temptation among many to adopt that view. Support for Qantas and Air NZ should recognise that they are

commercial businesses, not national institutions, and be conditional upon them serving the best interests of consumers. Claims to the contrary need careful scrutiny.

437 Most importantly, there is no reason to believe that if the price fixing cartel is rejected, Air NZ will decline or collapse. No reason whatsoever. The Airlines have not suggested it in their formal applications – in fact they have specifically rejected the idea that they have a financial crisis to contend with. Nonetheless, that is the argument presented by some supporters of the code-share application, with encouragement from the Airlines themselves. That argument should be put aside completely by MoT and the Minister.

Reduced Fuel burn and carbon emissions

438 The Airlines' claim that the more efficient deployment of Air NZ capacity alone allows Air NZ to burn approximately 15.87m litres less fuel each year than without the TNA, and that the resulting increased profitability will provide the parties greater scope to invest in more fuel efficient aircraft.

439 Obviously, less aircraft will result in less fuel burn, however the difference between the factual and counter-factual, in terms of fuel-burn may not be as pronounced as the Airlines claim. We submit the Minister should query how Air NZ determined 15.87m litres. For example:

(a) Does the figure compare to the status-quo or the likely counter-factual (unilateral decrease in capacity across the Tasman)?

(b) Do the figures take into account the use of the more fuel efficient Airbuses that Air NZ have ordered?

(c) Do the figures balance the likely continual use of uneconomic long-haul flights that will be cross-subsidised by the economic rents earned with the TNA in place?

(d) How will the fuel cost change on a per passenger basis? Increased load-capacities would suggest increased fuel-consumption;

(e) Have the figures been scrutinised by an independent auditor?

440 In addition, Air NZ has forward purchased its new aircraft for the mid-term future. The "increased profitability" due to the TNA (ie economic rent) is unlikely to have any impact on future aircraft orders whatsoever. Speaking with leaders in Wellington, Rob Fyfe has said that the increased profitability will be provided as a return to shareholders.

441 If the Government is genuinely concerned about greenhouse gas emissions from aircraft on the Tasman, the proper response to is to commence a process for examining this issue more widely (as has been commenced in Europe). Options under consideration are emission rights and a carbon tax. More price fixing cartels are not one of the policy options.

Increased likelihood of additional direct flights/new destinations

442 It is of course tempting for regional cities, starved of direct services and competition, to hope that this price fixing cartel will deliver them additional services. No doubt, inferences have been made and hopes raised in the lead up to the Airlines' application.

443 However, the Airlines have made clear in their subsequent submissions to the ACCC that they are not forecasting new services and certainly there are no undertakings to do so. They say that it may in the future be more viable on thinner routes.

444 The reality is that whenever new routes to regional cities have proliferated in Australasia it has been because of competition, not a cartel.

(a) In New Zealand, Hamilton, Palmerston North and Dunedin got Freedom Tasman services only because of the start of Kiwi Air.

(b) In Australia, ports like Newcastle and Maroochydore have grown dramatically with jet aircraft. This has been only because of the extensive competition between Jetstar and Virgin.

445 Cartels sit on route structures that most comfortably accommodate their needs, not those of customers. A cartel makes new routes less likely, not more likely.

The Issue of Private Benefits vs Public Benefits

446 For the most part, the benefits from the cartel will fall to the two Airlines. In recent submissions to ACCC, the Airlines say that this does not matter. Benefits to the Airlines should be treated as public benefits.

447 It is important that customers and the public understands this point.

448 In the case of the CAA, there is no symmetry between benefits to the Airlines and benefits to customers. The Act specifically sets out the Minister's obligation to protect consumers. This is a much higher standard than a net public benefits test proposed by the Airlines.

COSTS AND RISKS OF LOSING COMPETITION

The Importance of International Air Services

449 New Zealand is geographically isolated and highly dependent on international air services. There is no real inter-modal competition, even to Australia.

450 Australia is our biggest trading partner and the economy with which we conduct most business. Many Kiwis rely on their business dealings in Australia for their income and standard of living.

451 The cost and availability of air services between the two countries is about far more than holidays in Australia, or even inbound tourism from Australia (although that is important). The costs imposed on New Zealand businesses by a price fixing cartel may far outweigh many other economic development initiatives of the government.

452 For many regions, accessibility is also vital to retaining their working population. The brightest and best tend to leave "backwaters" and air service connections is one of the biggest influences on that behaviour.

Summary of Risks and Costs

453 The key detriments flow from the fact that Qantas/Air NZ collusion on Tasman routes will result in higher prices and fewer passengers. Most directly, this means Australian and New Zealand consumers will lose. Travellers will pay more than they have to, and more than they do now, and more than they would under other scenarios in the counterfactual. Further, some travel will no longer occur, significantly detracting from consumer welfare.

454 There will be secondary impacts in related markets in New Zealand as well as Australia. Most obviously, those markets for the provision of other services to Tasman travellers and those firms which rely upon air carriage of perishable and other goods.

455 In addition, the idea of sharing revenue (but retaining independent responsibility for reducing costs) would seem to incentivise sub-optimal gaming such that both Airlines will be looking to ensure that the other airline incurs the expense of carrying its passengers. This particular aspect of the proposed TNA is highly distortionary and therefore likely to give rise to significant additional detriment.

456 It is also likely that service levels will diminish. The declared intention of the Airlines is to spread schedules and increase the number of direct routes to new destinations. However, it goes against experience that less competition leads to better service and more options. Usually the opposite is observed.

457 In particular, it seems unlikely that under the cartel Jetstar will enter new routes to regional centres, as Freedom has done on the Tasman for many years and Jetstar has done in Australia. The TNA dramatically decreases the likelihood that new regional routes will emerge (that would otherwise benefit consumers in those areas).

458 There are longer term detriments also. Both Australian and New Zealand governments have emphasised the importance of an open economy, export-led growth and "connectedness" with a rapidly globalising world. Within that context, both governments have recently re-energised the Closer Economic Relationship between Australia and New Zealand. New Zealand is a significant destination for Australian exports and foreign investment. And, of course, the reverse is true.

459 On the weekend of 6-7 May 2006, a forum of businesses and unions was conducted in Auckland to promote increased harmonisation between Australia and New Zealand. One of the strong themes to come out of that forum was that Australia and New Zealand need to work more closely to promote the economic potential of businesses in those two countries. It is not our understanding that this was intended to mean that Australian and New Zealand businesses should form anti-competitive arrangements or adopt a protectionist approach against companies from other parts of the world.

460 Instead, we understood the message from that forum to mean that Australian and New Zealand businesses should be in a position to participate and invest as much as possible in each other's markets, without artificial constraints and costs of doing business.

461 We support that goal. However, we have a concern that the arrangement proposed by the Airlines will in part diminish the effectiveness of efforts to promote cross-border business and trade. In particular, we fear that it will drive up the costs of doing business by increasing costs of travel and air freight significantly and reduce the ease with which business people will be able to operate across Australian and New Zealand markets.

462 The arrangement itself appears to be contrary to the original policy intentions to liberalise aviation markets between the two countries.

463 This proposed collusion makes it harder for Australia and New Zealand to move in the direction identified by their governments as being in the long term interests of both countries.

Independent economic assessment

464 LECG has provided an expert report on the likely impact of the TNA, and the report is attached to this submission at **Schedule 2**.

465 LECG demonstrates:

(a) Using the Commerce Commission's analysis and assumptions, we should expect prices out of Wellington to increase by 19%, the number of leisure travellers to fall by 24%, and business travellers fall by 11%.

(b) The airlines will face strong incentives under the TNA to reduce service quality and marketing.

(c) The current level of spare capacity is likely to be efficient. The changes proposed by the Airlines are likely to reduce net welfare.

(d) Air NZ and Qantas Wellington services are not constrained by competing carriers on other Tasman routes. Air NZ and Qantas could raise low cost fares to Sydney by at least 46% and remain competitive with the best prices offered by other carriers out of Auckland.

466 This report demonstrates the significant harm to consumers that will result from the TNA. It deserves to be considered in detail by the Minister. To date, it is the only independent and expert economic analysis of the likely impact of the TNA.

467 The real and pervasive impacts of the TNA are discussed in more detail below.

Shoddy expensive service

468 A cartel dominating the Tasman will see:

(a) Fare increases;

(b) Fewer cheap seats;

(c) An end to the rapid growth in the numbers who can afford to travel;

(d) Reduced marketing and promotional spend as the Airlines "mine" the market rather than developing it;

(e) More Wellingtonians forced to fly through Auckland. Without competition Air NZ and Qantas won't care if travellers have to pay for two legs instead of one;

(f) Fewer flights and therefore less choice of export freight space; and

(g) Collusion by the two Airlines to block any other carrier that could be interested in filling the gap.

Wellington Vulnerability

469 For Wellington the almost complete loss of competition is critical. Pacific Blue flies only three times a week between Wellington and Brisbane. Emirates and other airlines will not add a Wellington leg to their international Australian flights because of the short Wellington runway.

470 Increased costs and inconvenient travel times will discourage business from staying or locating in Wellington.

Platform for collusion over domestic competition?

471 An arrangement that requires continual and detailed joint business planning is a constant temptation, and a perfect cover, for colluding to end or to noble domestic market competition, even if that is not the reason for it.

472 Normally it is hard for competing businesses to get together to conspire without risking investigation. It is hard to run covert cartels without either meetings or documents. TNA will ensure that airline personnel meet every week who are best equipped to jack things up without documentation.

Why pay Qantas $48m for the deal?

473 Air NZ seems to be overpaying Qantas for its convertible notes. We need to know why Air NZ is paying $48m to Qantas to enter the agreement? Is it a reflection of some extra benefit to Air NZ? We need to know that it is not the price for a deal limiting domestic competition by Qantas. Their respective shares of traffic on the Tasman would suggest that the benefit of the agreement should be reasonably equal. Presumably they both benefit from the fuel and other savings, so why is Qantas is being paid so much up front?

Prices

474 The Australian Competition Tribunal said that cost savings would go initially to Qantas and its shareholders, but that they are "capable of being passed through in the form of a potential lowering of fares, or a delay in increasing fares." Which is to say, anything is possible. The question is what is probable.

475 The Commerce Commission forecast price increases of 16% overall. On individual routes this could have been much higher. LECG has closely examined the TNA and has forecast price increases in Wellington in excess of those forecast by the Commerce Commission in 2003 (a copy of LECG's report is attached at **Schedule 2**).

476 Average fares will increase dramatically as seats are reduced and inventory becomes jointly managed to maximise yield per ASK in a less competitive market. It is also likely that advertised fare levels in each category will increase significantly above those under any of the counter-factual scenarios. That is, the Airlines will enjoy an increase not only in yield per ASK (through higher load factors) but also an increase in yield per revenue passenger kilometres (RPK) through higher fares.

477 Based on fares that prevailed in the past on the Tasman, prices could increase not just significantly but dramatically. There have been periods when travellers faced paying 50% - 100% more than they do today.

478 WIAL is unable to determine what the Airlines say will actually happen to prices because sections of their proposals on prices have been withheld.

479 However, we are confident of two outcomes:

(a) Fares within each category will over time be set at much higher levels than if one of the counter-factual scenarios applied. The minimal competition from other players will be insufficient to prevent this happening; and

(b) The availability of fares in more affordable categories will reduce markedly particularly over peak periods of travel, pushing people into higher and higher fares.

Spill over effects

480 The Airlines identify affected markets as comprising only:

(a) air passenger services between Australia and New Zealand (the Tasman routes); and

(b) Tasman air freight services.

481 Management of the Tasman Network is to be undertaken by a Committee (comprising 3 members appointed by each applicant) the functions of which include – but are not limited to – the following activities:

(a) setting strategic objectives for the Tasman Network, including as to scheduling, pricing, passenger processing, code-sharing, frequent flyer programmes, lounge and check-in facilities at airports included in the Tasman Networks, co-ordinating in-flight product standards and marketing plans;

(b) ensuring optimisation of the Tasman Network schedule;

(c) ensuring coordination between each of the Airlines with respect to the above activities; and

(d) assuming responsibility for decisions that have a material impact on the base revenue including aircraft type and configuration changes and all capacity additions, reductions and deployments.

482 While those activities relate specifically to the Tasman operations of the Airlines there is an obvious competition risk here – namely, that there will be "leakage" of that co-operation into other markets.

483 Connectivity is said to be of vital importance to all airlines, but especially network carriers. Involvement in the scheduling and pricing, and knowledge of the loading and profitability, of all Qantas Tasman flights must give Air NZ unique insight into Qantas' operations at the point where those passengers arrive in New Zealand. While Air NZ and Qantas may notionally "compete" with each other for those passengers who seek to fly on to other New Zealand designations, they will do so with a substantial information advantage over other carriers – such as Origin Pacific – who might also seek their custom.

484 Similarly in Australia, Qantas will have a unique advantage over other Australian carriers competing for arrivals from New Zealand.

485 Even with complete purity of purpose on everyone's part, the Airlines will be significantly advantaged within their respective domestic markets by the scheduling, operational and financial information that flows to them from the TNA. But, of course, the Airlines will not be incentivised to compete too vigorously against each other in those markets excluded from the TNA. For Air NZ in particular, having a benign rival "contesting" its home markets may be much more comfortable than having a hostile one. Qantas, for is part, may be hesitant to attack the profitable main trunk route within

New Zealand if it would harm its TNA partner to the extent that the TNA were put at risk.

486 Put bluntly, the real price of combining on the Tasman to drive off Pacific Blue and Emirates, may well be forbearance within each other's "home" or domestic markets.

487 Such forbearance of course does not require overt collusion or understanding – simply each applicant acting in what it perceives to be its own self interest, but that incentive to forebear would not be present without the TNA.

A Dead End for Air NZ

488 Both Qantas and Air NZ have emphasised at different times that they need to join with other airlines to prosper into the future.

489 On Air NZ's side, it seems unlikely that the public will forever want to own a full 80% of the airline. But the scale of the competitive detriments accruing under such a deal means that it seems extremely unlikely that a full alliance or merger with Qantas will ever be accepted or permitted by competition authorities and the Courts.

490 For that reason, this arrangement is a dead end for Air NZ.

491 It may be that Air NZ does not agree and hopes that a merger with Qantas is achievable (despite the costs to Kiwi consumers and the economy identified by the Commerce Commission), and that this is the first step. If so, they should make that clear.

ALTERNATIVES TO THE CARTEL

492 WIAL believes that if the application is not authorised, the likely medium term counter-factual is more important and possibly more complicated than the Airlines have publicly stated.

493 Airlines seek to create the impression that the TNA is the only option and the only deal on offer. The Airlines have consistently claimed that, without authorisation, the consequences will be dire and that there are no alternatives. But Qantas and Air NZ are highly professional and successful companies. They are extremely unlikely to simply allow their businesses to be damaged if the authorisation is not granted. Like most businesses they will adapt, and in large part have already started to do so, albeit that a competitive malaise must surely develop between the parties when arrangements such as the Alliance and the code-share are being developed and negotiated over a prolonged period (at least the last four years).

494 However, in a speech to the Chamber of Commerce in Wellington on 4 May, Rob Fyfe said that there are at least three other options for Air NZ:

(a) Unilaterally withdraw from routes (which it is doing in any case under the TNA);

(b) Unilaterally increase fares– even a small increase in fares of 1-4% would increase Air NZ revenues by $18 million per annum; or

(c) Unilaterally reduce capacity (although in the applications the Airlines claim they cannot do so).

495 This is unlikely to be the full suite of options, but each (a) to (c) would be preferable to the cartel, especially since there will be service withdrawals, capacity reductions and fare increases under the cartel. They just wont be disciplined by any competition.

496 Qantas has publicly referred to a "plan B". The head of New Zealand operations, Grant Lilly said so as the recent TRENZ conference in Christchurch.

497 Until now, a great deal of effort within the two Airlines has been focused on an arrangement between them. However, if the authorisation is not granted it is likely that their efforts will individually turn to other strategies. Indeed, when the Qantas-Air NZ Alliance was rejected by the New Zealand High Court, Qantas' CEO Geoff Dixon was quoted as proclaiming it "dead". It is very unlikely that at that point, Qantas and Air NZ did not consider a range

of alternatives that they are yet to pursue. The current application is but one of those options.

Arrangements with other airlines

498 Air NZ in particular has argued that it needs an arrangement on the Tasman with an Australian airline. The issue with the current application is that the proposed arrangement is with ***the other major competitor***, Qantas. It is possible that Air NZ could pursue an arrangement with another airline without the negative consequences of the current proposal.

499 In the case of Virgin Blue, an arrangement with Air NZ could be even more extensive than the TNA in that, in addition to the various Tasman markets, it could involve the domestic networks of Virgin (in Australia) and Air NZ (in New Zealand). It is worth noting that there are changes in control at a parent company level that may allow such proposals to be revisited, even though they have been dismissed in the past.

500 On occasions, Air NZ has said that the obstacle with Virgin Blue is that it does not have the systems to allow it to code-share and interline. As the Airlines state in their own submission, this is no longer correct. Virgin Blue has invested in new systems capable of integrating with full service carriers and has managers with those duties. It has interlining arrangements with some carriers already.

501 For Virgin, this would accelerate their capability to fly the Pacific routes, since Air NZ already has services and expertise in these areas.

502 This would result in two stable but competitive blocks in Australasia: Qantas/Jetstar and Air NZ/Virgin. This would be an excellent outcome for consumers – and as, several people have said, a "marriage made in heaven" for Air NZ and Virgin.

503 The fact that many ex Air NZ executives now work at Virgin would surely make it easier.

Further development of lower cost product and brands by each airline

504 In other airline markets, including the Australian domestic market, there has been an acceptance that competition and lower fare environments will be a permanent feature of short haul routes. That is, those markets have been transformed by airlines offering high frequency, high convenience, affordable prices and a product to meet every part of the market. This is certainly the case in Europe and it is increasingly the case in other regions.

Airlines of this type have a specific strategy of low costs and stimulating new markets through affordable fares, direct services and new routes.

(a) In Australia, there was a major shift with the entry of Virgin and then Jetstar. Although customer acceptance of Jetstar has been mixed on some Qantas routes, it was a very positive initiative, well executed and has proven highly successful. Few would like to see Jetstar and Virgin disappear from the Australian domestic scene. At the same time, Qantas remains a highly valued airline for a large body of travellers. The Australian domestic market has demonstrated a demand for a variety of products and airline models.

(b) On Tasman routes, the transformation is far from complete, although there have been some halting moves toward new short haul models:

- Air NZ started Freedom in 1996 in the face of competition from Kiwi Air. Freedom has been a positive force in many ways, but has not developed to the extent of other low cost leisure carriers and struggled to get brand presence in Australia. Freedom has largely been integrated back into Air NZ.

- Virgin was welcomed onto some Tasman markets in 2004, based in Christchurch. However, after more than two years, they have entered the market in a reasonably limited way. It remains a relatively small player compared to its presence in Australian domestic markets and compared to the Airlines on the Tasman.

- Air NZ introduced Tasman Express fares in late 2003 and Qantas did the same, but this reflected a reaction on fares rather than a permanent shift in underlying costs.

- Air NZ has been taking steps to address its costs and in some cases this has required some hard decisions. They would no doubt argue that this application is part of that process. But transformations to low cost environments are not achieved through anti-competitive arrangements.

(c) Jetstar entered the Christchurch market in December 2005 and was very welcome. Jetstar has made it quite clear that, for the time being, it will only serve Christchurch. This is different to the experience of low cost carriers in other markets, including Australian domestic markets where Jetstar and Virgin have opened up routes previously unavailable to consumers. In the absence of the TNA, Jetstar might be expected to enter more markets (which may explain some of the enthusiasm for the TNA by at least one of the Airlines).

505 However, there is unlikely to be a full and permanent shift to new models for short haul travel on the Tasman while the two major players pursue an arrangement between themselves. That is, we will see a fuller transformation and diversification of product when Qantas and Air NZ are liberated from any sense of competitive inactivity.

Unilateral Actions to Improve Performance on the Tasman Markets

506 It is open to airlines to take unilateral actions in accordance with their own assessment of the potential passenger markets. If the judgement of those who would withdraw capacity or put up prices is correct, their competitors will probably do the same. If not, then the arguments put for the authorisation are flawed and it should not proceed.

507 We note that the Airlines have ruled out unilateral action as their network may be considered inferior and that their passengers would "spill" to the other applicant or other competitors.

508 This is in contrast to their position that Emirates, Pacific Blue, Lan Chile, Royal Brunei, Garuda, Aerolineas Argentinas are genuine competitors on Auckland routes (and to a lesser extent Christchurch), despite their poor frequencies and network.

509 However, in their public statements, the Airlines have made very clear that they can and will act unilaterally without the code-share (see Rob Fyfe's comments of 4 May 2006 in Wellington and Grant Lilly from Jetconnect comments about Qantas' plan B at TRENZ in June 2006). Rob Fyfe in particular has been very forthright in saying that he will not hesitate to act unilaterally on the Tasman.

510 As we have set out in an earlier section of this submission, not only will they act unilaterally on Tasman capacity and fares, they have already done so.

Proposals for more limited arrangements between Qantas and Air NZ

511 It is also possible that the Airlines will continue to focus on an arrangement between them, but of a more limited nature and without price-collusion. This may include a small number of routes where there is some level of genuine competition. It is not at all uncommon for code-shares to have "carve outs". There are no such routes out of Wellington with genuine competition, and even in Auckland, not all routes would qualify. If that were

the alternative pursued, some very precise controls would be required to avoid diminution of competition in other markets, and any authorisations would need to have regular sunset clauses to revisit the markets in question (rather than periods of five years as sought by the Airlines).

THE LEGAL FRAMEWORK

Summary

512 In this section we submit on the legal framework within which the Minister must exercise his or her discretion. The key relevant features are:

(a) the Minister only has the ability to authorise provisions relating to "tariffs" and/or "capacity". The TNA contains a number of significant provisions that relate to other matters, and these cannot be authorised by the Minister;

(b) the Minister's discretion must be exercised in the public interest. The Minister is **not compelled** to (nor indeed able to) authorise a code-share merely because it does not transgress any of the section 88(4) criteria;

(c) the Minister should, in exercising his discretion in the public interest, consider competition issues;

(d) when evaluating the impact of any proposal, the scheme of Part 9 of the CAA requires the Minister to be satisfied any authorised pricing will be in consumers' interests. The Minister cannot – acting reasonably – be satisfied of this, as the TNA contains no protections against excess pricing, and the Airlines have provided nothing to show the TNA is in consumers' interest. This submission demonstrates consumers will be harmed significantly; and

(e) the CAA provides for a number of "negative conditions" which prevent authorisation. The TNA offends one of these conditions – it unjustifiably discriminates between consumers in the access they have to competitive tariffs. For this reason alone, the Minister cannot authorise the TNA.

Introduction

513 Part 9 of the CAA provides for the Minister to authorise code-share arrangements when such arrangements are in the public interest and consistent with New Zealand's international obligations (for example, increasing airlines' networks and providing a globally accessible range of prices and service options).

514 An authorisation specifically exempts agreements relating to tariffs and/or capacity from scrutiny under ss27-29 of the Commerce Act 1986.

515 However, the TNA goes much further than what the policy makers ever intended the CAA to cover. As discussed above, viewed in its entirety the TNA would result in a de facto merger of the competing trans-Tasman operations of Air NZ and Qantas, rather than facilitate an increase in network expansion. In fact, the parties have stated they intend to operate as a "joint business" and reduce the number of flights available to consumers.

516 As the legislation never contemplated such a de-facto merger, it is no surprise the CAA does not empower the Minister to authorise the TNA in its current form.

Key features of the TNA fall outside the Minister's jurisdiction

517 The Minister's power to authorise any code-share is defined by section 88(2) of the CAA. Simply, section 88(2) provides that the Minister has a discretion to **specifically** authorise all or part of an arrangement **so far as it relates** (directly or indirectly) to the fixing (or application) of tariffs and/or capacity.

518 Essentially, a "tariff" is a statement "specifying…[t]he fares, rates, and charges applicable to international carriage by air" between two specified points, and includes the conditions of such travel (s 88(1) "Tariff").

519 Section 88(1) of the CAA defines "capacity" as:

> ***Capacity*** *means a statement, expressed to apply to one or more specified airlines, or to all airlines other than one or more specified airlines, or to all airlines, specifying the number of flights to be undertaken between specified points in a period or successive periods by the airline or airlines, whether or not by reference to specified classes of aircraft or the number of seats or volume of cargo space to be provided.*

520 This limited jurisdiction reflects the standard understanding of the content and purpose of code-share arrangements. As discussed earlier in this submission, analysing typical code-share arrangements reveals that the TNA seeks to go much further than the arrangements contemplated by section 88(2). Some of the features of the TNA are unnecessary if a code-share is the sole objective. These features mean the TNA is in substance a merger or a cartel on the Tasman routes, and they cannot be authorised by the Minister.

521 We have already provided Professor Michael Taggart's opinion (the *Taggart Opinion* attach as **Schedule 4**), but in his words, "there is no magic wand of authorisation under s. 88 for the Minister to wave over the TNA as a

whole…" (see paragraph 22 of the Taggart Opinion). Only provisions that relate to tariffs and/or capacity may be considered by the Minister.

522 Below we identify material aspects of the TNA which are outside the Minister's jurisdiction to authorise.

Revenue and loss sharing cannot be authorised

523 The TNA includes a revenue and loss sharing mechanism whereby Qantas and Air NZ pool their earnings together and distribute the earnings based on their proportions of passengers in 2005 (although we cannot ascertain the exact the details as this is not available on the public version) (the *TNA Payment Model*).

524 All revenue earned on Tasman flights is "pooled" together and subject to the TNA Payment Model. This cannot by any stretch be described as relating (directly or indirectly) to the fixing of a tariff (ie, specifying a rates between two points).

525 Importantly, the fact that the Airlines would like to collude by way of revenue sharing does not of itself make this aspect of the TNA *indirectly* related to the fixing of tariffs. Simply because the Airlines propose to collude on a matter in addition to fixing tariffs does not make that matter indirectly related to the fixing of tariffs. To take that approach would be to open a loop hole large enough to swamp the jurisdiction tests in section 88. The Minister can only authorise matters that are a necessary or integral part of fixing tariffs.

526 The revenue and loss sharing provisions are essentially a means to merge operations by stealth. They do not relate – directly or indirectly – to the fixing of tariffs or capacity. It isn't surprising that the TNA Payment model does not fall within the section 88(2) ambit – that section was never intended to cover agreements of such a collusive nature. The TNA Payment Model (and the whole mechanism of pooling revenues together) does not relate to "tariffs" and/or "capacity" and it cannot be authorised by the Minister.

Comprehensive tariff and capacity collusion cannot be authorised

527 The Airlines have treated the Part 9 regime as a loop hole, and sought authorisation for agreements on tariffs and capacity that go beyond what is needed or contemplated to support code-share arrangements. As discussed in this submission, to implement a code-share the airlines involved must reach some agreement on some capacity and tariff matters *relating to the seats that are the subject of the code-share*. The TNA proposes collusion that goes well beyond that to encompass all capacity, tariff and schedule setting by Qantas and Air NZ on Tasman markets - whether seats or flights are subject to a code-share arrangement or not.

528 WIAL submits the Airlines are promoting an erroneous view of the Part 9 scheme. As Lord Steyn noted in *R (Daly) v Home Secretary* [2001] 2 AC 532 of 548 "In law context is everything". The law requires that Part 9 of the CAA be read in context, and the context here is a purpose to facilitate code-share arrangements where they advance the public interest. Section 88 must be read in this context, and, in context, the power to authorise provisions relating to the fixing of tariffs or capacity is not as broad as the Airlines suggest. The TNA would be a surprising use of the Part 9 power precisely because large parts of it fall outside the ability to authorise.

529 The sweeping proposals to collude on all aspects of tariff, capacity and schedule setting cannot be authorised by the Minister. Any agreement must be limited to the seating or capacity that is the subject of a code-share. Part 9 of the CAA cannot be read as addressing more sweeping collusion and the conduct by competitors of a "joint business".

Co-ordinating on minimum service standards cannot be authorised

530 Clauses within the TNA relate to the level of service standards[8]. For example, clause 6.6 provides;

> *"In order to ensure that a minimum standard of service is provided to customers on Code-share Flights, the Minimum Inflight Service Offering must, as a minimum, be provided by an Operating Party on all Code-share flights that it operates."*

531 Minimum service levels cannot be said to relate to the fixing of tariffs and/or capacity and are therefore outside the Minister's jurisdiction. The inclusion of such provisions is indicative of the true intent of the TNA – to merge operations, not extend by code-share.

532 Competition occurs over many dimensions, including non-price aspects such as new and innovative service levels (for example the new "Premium Economy" Class introduced by Air NZ). Giving effect to the TNA would remove the incentives for Qantas and Air NZ to develop innovative service aspects. On the contrary, as we have already shown, it will create a new incentive to cut costs associated with better service, forcing costs on to the other TNA participant. Even if the Minister were in a position to authorise such provision, it would be contrary to the public interest to do so.

Authorisation via Commerce Commission

533 If the Airlines want these aspects of the TNA to be authorised, they must apply for authorisation under the Commerce Act.

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[8] See clauses 6.5, 6.6, 6.7, 6.8, and 6.10.

534 In any event, the Commerce Commission will have jurisdiction to investigate under Part II of the Commerce Act 1986 those provisions that are outside the scope of the Minister's authorisation (see paragraphs 27 – 29 of the Taggart Opinion).

The Minister's discretion must be exercised in the public interest

535 The Airlines claim that "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 88(4) of the CAA." (see pg 54 of the Airlines' application)

536 This is a transparent attempt by the Airlines to constrain the Minister from considering the public interest. The position of the Airlines is legally incorrect, and the Minister would be ultra vires if he were to follow the approach suggested by the Airlines. As Professor Taggart states at paragraph 9:

> *"it is axiomatic that power is delegated for the furtherance of the public interest, and hence all statutory discretions (no matter how wide or narrow) must be exercised in the public interest".*

537 The legal analysis is presented in Professor Taggart's opinion. Professor Taggart's advice is that the approach urged by the Airlines does "violence to the language, statutory scheme and legislative history". The Minister has a true discretion that must be exercised for the public benefit having regard to all relevant considerations.

538 WIAL has been advised this legal position is clear. If officials or the Minister are considering taking the approach suggested by the Airlines, WIAL requests that officials inform submitters at the earliest opportunity.

Competition issues are relevant to the public interest

539 Competition issues, and the very real impact a lessening in competition can have on New Zealand consumers, clearly fall within the public interest that the Minister must consider in determining whether or not to authorise any aspects of the TNA. As Professor Taggart states (at paragraph 1(vii)):

> *In exercising that discretion, the Minister may take account of the effects of the provisions in the agreement (if authorised) upon competition and the broader public interest. The point of exempting certain types of provisions in international carriage by air agreements from domestic Commerce Commission scrutiny under ss.27-29 CA was not to disavow the relevance of competition matters, but rather to place these matters in the hands of the Minister responsible for*

international civil aviation obligations. Such matters clearly fall within the discretion of the Minister to further the public interest.

Lack of price protection relevant to the public interest

540 The Airlines have not proposed any particular tariffs, but instead propose a mechanism by which the two competitors will regularly fix price. No protections against excessive prices are offered. The Minister is asked to authorise a process that gives a dominant cartel carte blanche over pricing.

541 Professor Taggart advises that the criteria for authorising tariffs under section 90 will be relevant to the Ministers assessment of the public interest under section 88 (see paragraph 19 of the Taggart Opinion). It is hardly likely that Parliament intended airlines could by agreement get away with pricing under section 88 that they could not individually get away with under section 90.

542 Section 90 sets out the following criteria:

(a) *Whether the proposed tariff is excessive in terms of a reasonable return on investment by the supplier of the carriage; and*

(b) *Whether it is likely that supply of the relevant carriage can be carried on for a reasonable period at the level of tariff proposed; and*

(c) *Whether there is likely to be a substantial degree of benefit accruing to consumers generally, or to a significant group of consumers, as a result of the application of the proposed tariff.*

543 As Professor Taggart states, it is relevant to the public interest that the TNA contains no protections that would ensure the pricing fixed by the Airlines meets this criteria. It would be "unreasonable" in any administrative law sense for the Minister to decide the TNA pricing will meet this criteria when there is no basis for knowing what pricing will result; and certainly no reasonable basis for deciding the pricing will observe these limits.

The Minister must apply a consumers' interests standard

544 The fact that Part 9 of the CAA measures pricing by the consumers' interests standard has significant implications for the Minister's decision. The Minister must be satisfied the TNA is of net benefit to consumers, and not just the private benefit of the Airlines.[9]

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[9] The government has also applied the consumers interests test in the gas pipelines and telecommunications regulation.

545 WIAL is not aware that the Airlines have put before the Minister reliable evidence that the TNA will benefit consumers. Without that evidence, the Minister cannot – acting reasonably – authorise the TNA.

546 On the contrary, the information in this submission shows consumers will in fact be significantly harmed if the TNA proceeds. The LECG report demonstrates prices are likely to rise significantly, and the number of travellers fall. The amount of seating capacity made available at lower priced fares is likely to reduce. The TNA will incentivise both carriers to cut costs and service levels. In these circumstances, the Minister cannot be satisfied the TNA will be a net benefit to consumers.

Unjustifiable discrimination between consumers

547 Sections 88(3) and 88(4) CAA list negative criteria providing when the Minister must decline an authorisation. These negative criteria are addressed at para 9.7 of the Application. However, the Airlines gloss over section 88(4)(c), which is highly relevant to the Minister's consideration of the Application. Section 88(4)(c) provides:

> *Authorisation shall not be given under this section to any provision of any contract, arrangement, or understanding that – …*
>
> *(c) unjustifiably discriminated between consumers of international air services in the access they have to competitive tariffs*

548 Consumers travelling on differing routes will be disproportionately affected by the TNA. Consumers on Tasman routes where 5th Freedom Carriers and low-budget airlines compete (such as CHC – SYD and AKL – BNE) will face smaller price increase and smaller reductions in quantity than consumers on routes where Qantas and Air NZ are the only carriers with any real presence (such as Wellington routes).

549 There is no justification for this disproportionate impact on different groups of New Zealand consumers. There is no justification for authorising a price fixing arrangement that will result in a passenger travelling from Wellington to Australia facing a larger increase in price than a passenger flying from Auckland. For most routes out of Wellington, the TNA will have the effect of creating a monopoly provider, who will undoubtedly use market power to extract larger rents. This would offend against section 88(4).

550 The Airlines have not demonstrated this discrimination is justified by their private commercial objectives, nor have they demonstrated the TNA is the least discriminatory way to achieve their objectives. The Minister cannot be satisfied the discrimination is justified, and so must reject the TNA under section 88(4).

THE ROLE OF THE MINISTER AND GOVERNMENT

551 Air NZ has said[10] that the reason why it should not have to go to the Commerce Commission is that:

> *… the Transport Ministry was the expert in assessing the impact of code-share agreements, not the Commerce Commission.*
>
> *It was also unfair to allow the Commission to decide on the code-share when Air New Zealand did not have recourse about the "unfair" way Emirates competed on Australia – New Zealand routes, including predatory pricing and capacity dumping.*

552 Aside from the fact that Qantas and Air NZ also use marginal capacity on the Tasman, the Commerce Commission has confirmed to us that it has never received a complaint, from Air NZ or anybody else, that Emirates is competing unfairly and has never had cause to investigate the conduct of Emirates.

553 Emirates' "record" with the Commission should perhaps be compared with that of Air NZ. Our 80% state-owned airline:

(a) Was recently fined $600,000 and over $60, 000 costs for making misleading statements, the then largest penalty ever imposed under the Fair Trading Act;

(b) Was the subject of protracted investigation for allegedly dumping capacity on domestic routes flown by Origin Pacific;

(c) Was declined authorisation for its 2002 Alliance with Qantas.

554 It is obvious that New Zealand firms are generally small on a world scale and face special challenges when they seek to compete on distant global markets. But, the Commission is not blind to that. On the contrary, in the Chair's Foreword to the Commission's Statement of Intent 2006 – 2009 Paula Rebstock said:

> *"There is therefore, inherent tension between the potential for market power (because few firms compete in a market), and sub-optimal firm size (because the size of firms is limited by the size of the economy). This tension means that small economies like New Zealand's may need to pay more attention to economic efficiency*

[10] Rob Fyfe reported in the Dominion Post of 5 May 2006.

considerations than would be appropriate in a larger economy. It also means that our concentrated markets can facilitate unilateral or coordinated market power.

…

For example, the Commission takes New Zealand's market conditions into account when applying the substantial lessening of competition test to merger and acquisition decisions. The vast majority of mergers are beneficial to the economy, and we accept the consequences of declining applications are particularly significant in a small economy like New Zealand's. No matter how global our perspective, we must bear in mind the realities of our local markets."

555 The simple fact is that the Commission, through its close liaison with its overseas equivalents and its consistent pursuit of international best practices in the competition law field, is the body best equipped to make decisions on issues affecting competition in the relevant international air carriage markets.

556 That reality was recognised by the OECD report which in July 2005 recommended closure of the loophole in the CAA by eliminating the Minister's power, or at a minimum, by requiring proper consultation with the Commission.

557 Indeed, it was already assumed by the Australian Treasurer, Peter Costello, that the TNA would be subject to such detailed scrutiny by the Commission.

558 The desirability of reviewing Part 9 of the CAA, to achieve consistency with the regimes now operated by this country's major trading partners, has been recognised by successive Ministers of Commerce. It is perhaps no coincidence that the TNA seeks to pre-empt that review.

559 However, the MoT, in its letter to us of 28 July, does seem to remain oblivious to its own inadequacies. The letter concludes:

"I do not intend to refer the application to the Commission."

560 It is puzzling that MoT should want so jealously to guard its current scrutiny of TNA, when not only is the current application more extensive and more offensive to competition law principles than any previous code-share, but a review of legislation has been signalled.

561 The Commerce Commission's Statement of Intent also claims "our competition law has come of age". That claim will prove hollow if the TNA were authorised by the Minister under an anachronistic process that has

attracted wide criticism. Put bluntly, the Commission's – and the Government's – credibility for dealing with international cartels will be irreparably damaged if the Minister of Transport is seen to be involved in allowing one that will have such adverse effects for New Zealand consumers, businesses and the economy generally.

Government as Shareholder & Regulator – Reasons for Scepticism

562 There are meant to be walls and separations between shareholder and regulator, for good reason.

563 Many commentators have pointed out that, as an 80% shareholder, the Crown stands to benefit financially from any excess profits made under a cartel at the expense of the public and consumers. A tax in all but name. As one person commented to WIAL "it is almost an application from one Government department to another".

564 Perhaps more accurately, it is an application to one Government department to exempt a state-owned company from the competition laws that are rigorously enforced against all other firms by another Government agency.

565 This is exacerbated by the closeness between Air NZ and government. Traditionally the MoT and Air NZ have worked hand in glove. They have jointly negotiated bilateral agreements and not surprisingly, a feeling of being "on the same team" has developed. Indeed, Air NZ might be seen as an extension of the Government's transport policy infrastructure.

566 Some MoT officials will recall a time when there was little separation between government and airline and it was the practice for fares and freight schedules to be "filed" with MoT for approval. That practice is now part of history — and should remain so.

567 So, too, should a cosy and informal style of government and public administration. We know, however, that, a month before the current application was filed, there was a dinner discussion between Air NZ representatives and key Ministers about the Tasman and Emirates impact on the Tasman. Those topics are extensively dealt with in the Airlines' applications, Airlines' public statements and in our own submission. Prior to that dinner, the Minister of Finance had been briefed by Treasury about the prospect of a code-share. After that dinner, the Minister of Finance received a detailed report from Treasury on how that code-share application might be handled.

568 The list of attendees at the dinner was provided when the Minister of Finance's office responded to our request for information about the code-share. The attendees were:

(a) The Minister for Finance (shareholding Minister);

(b) Minister for Commerce (regulatory Minister);

(c) Minister for Transport (regulatory Minister);

(d) Minister for Tourism;

(e) Chairman of Air NZ;

(f) CEO of Air NZ; and

(g) a Director of Air NZ.

569 Our successive requests for further details as to what in fact was discussed at the dinner have been met with the persistent response that "no records were made by Ministers and officials".

570 It is easy to laugh off those dinner discussions as conspiracy theory, but it is too serious a matter to be lightly dismissed. The now delegated Minister and the MoT are declining to discuss the code-share or related matters with anybody. That contrasts with what appears to have happened at the dinner and questions over separation remain.

571 MoT's letter to us of 28 July would appear now to recognise the seriousness of that "Ministerial audience" having been granted to one of the applicant Airlines before the application was made. MoT stresses that the now delegated Minister "has not met Air NZ over the application".

572 The now delegated Minister has already distanced himself from that Ministerial audience. In his letter to us of 21 July he is at pains to point out that he has no record of having received the briefings prepared by Treasury for the other Ministers.

573 The unfortunate appearance of closed decision making has been exacerbated by the persistent unwillingness of MoT to recognise that other parties should be accorded the same rights of audience and to be heard as the applicant Airlines.

574 As another example of the interchangeability of Government and Air NZ, the MoT has never independently provided copies of the TNA applications to

interested parties (despite several requests). We are still left to rely on Air NZ itself and what it considers acceptable to release.

575 It may be that the MoT are trying to make the best of a bad situation, but the Minister and MoT have a long way to go to establish an adequate degree of separation. In particular:

(a) All matters that can be handed over to the Commission, should be handed over;

(b) Parties should have the right to see supplementary airline submissions and provide additional information;

(c) The MoT should specifically set out its criteria for assessing the application and release Crown Law advice;

(d) The Minister should release a draft decision and provide opportunities to comment before making a final decision;

(e) Legal counsel to interested parties should be provided with the information that Airlines have withheld on a confidential basis so that claims can be properly examined and submissions prepared.

576 All of this is quite normal in other jurisdictions.

MITIGATIONS?

577 WIAL is quite unconvinced that there is any need whatsoever for this extraordinary price-fixing proposal. Mitigations and compromises are normally only suitable when there is a good case for proceeding but there are adverse and unintended consequences.

578 Certainly we can see no scope at all for Wellington routes being included in the code-share. Even those who are sympathetic to the proposal in Australia seem to agree with that point.

579 Some people have asked about a scheme to protect travellers to and from Wellington by having prices benchmarked against prices out of Auckland. This is totally inadequate.

(a) Most routes out of Auckland have very limited competition. This should not be overlooked in focusing on the absolute lack of competition at Wellington and other cities. The two genuine competitors are Qantas and Air NZ. It is very likely that fares will increase significantly out of Auckland also;

(b) Capacity will be cut on Auckland routes too. People will be pushed into higher fare categories (or at least anybody who has to travel on a particular day and leave at a reasonable time of day, has a corporate travel policy, is a frequent flyer or club member or requires some schedule flexibility, all of which airlines say are highly valued by customers); and

(c) Advertised and headline prices tell you nothing about availability of those fares or the mix of fares sold on a service.

580 The only solution for Wellington travellers is to exclude Wellington, although that does little to protect customers travelling on non-Wellington routes. The only scheme that might offer some protection for them (apart from declining the application) is a highly involved and independent monitoring regime that can compare capacity and fares sold with fare sold in the 12 months from July 2005 to June 2006:

(a) Route by route;

(b) Fare category by fare category.

581 That would require independent access to detailed and audited airline data, and it would require a well resourced monitoring unit with the power and responsibility to report publicly on a regular basis. It would also require a

series of sanctions for fare increases or restrictions of seats, including termination of the approval.

582 This is obviously expensive for taxpayers and involved and intrusive to the Airlines. It is also totally unnecessary if the cartel proposal is rejected. Given that there are no sound arguments for the cartel, that is exactly what should happen.

SCHEDULE 1

Trans-Tasman City Pairs - Weekly Frequencies by Airline (Auckland, Christchurch and Wellington only)

Auckland	Services/wk
AKL - SYD vv	5 airlines
Emirates	7
Pacific Blue	no service
Lan Chile	4
Aerolineas Arg.	3
Total Competition	14
Air NZ	34
Qantas	37
Total Code-Share	71
Total Services	**85**
AKL - BNE vv	6 airlines
Emirates	7
Pacific Blue	6
Garuda	2
Royal Brunei	3
Total Competition	18
Air NZ	18
Qantas	10
Total Code-Share	28
Total Services	**46**
AKL - MEL vv	3 airlines
Emirates	7
Pacific Blue	no service
Total Competition	7
Air NZ	14
Qantas	14
Total Code-Share	28
Total Services	**35**
AKL - OOL vv	2 airlines
Emirates	no service
Pacific Blue	2
Total Competition	2
Air NZ (Freedom)	6
Qantas	0
Total Code-Share	6
Total Services	**8**

Christchurch	Services/wk
CHC - SYD vv	4 airlines
Emirates	7
Pacific Blue	5
Total Competition	12
Air NZ	14
Qantas/Jetstar	14
Total Code-Share	28
Total Services	**40**
CHC - BNE vv	3 airlines
Emirates	no service
Pacific Blue	8
Total Competition	8
Air NZ	8
Qantas/Jetstar	7
Total Code-Share	15
Total Services	**23**
CHC - MEL vv	3 airlines
Emirates	no service
Pacific Blue	4
Total Competition	4
Air NZ	8
Qantas/Jetstar	7
Total-Code Share	15
Total Services	**19**
CHC-OOL vv	2 airlines
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ (Freedom)	3
Qantas/Jetstar	2
Total Code-Share	5
Total Services	**5**

Wellington	Services/wk
WLG-SYD vv	2 airlines
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	12
Qantas	14
Total Code-Share	26
Total Services	**26**
WLG-BNE vv	3 airlines
Emirates	no service
Pacific Blue	3
Total Competition	3
Air NZ	7
Qantas	3
Total Code-Share	10
Total Services	**13**
WLG-MEL vv	2 airlines
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	7
Qantas	7
Total Code-Share	14
Total Services	**14**
WLG-OOL vv	1 airline
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ (Freedom)	2
Qantas	0
Total Code-Share	2
Total Services	**2**

AKL-ADL vv	2 airlines
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	3
Qantas	3
Total Code-Share	6
Total Services	**6**

CHC-ADL vv	-
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	0
Qantas	0
Total Code-Share	0
Total Services	**0**

WLG-ADL vv	-
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	0
Qantas	0
Total Code-Share	0
Total Services	**0**

AKL-PER vv	1 airline
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	6
Qantas	0
Total Code-Share	6
Total Services	**6**

CHC-PER vv	-
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	0
Qantas	0
Total Code-Share	0
Total Services	**0**

WLG-PER vv	-
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	0
Qantas	0
Total Code-Share	0
Total Services	**0**

AKL-CNS vv	1 airline
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	3
Qantas	0
Total Code-Share	3
Total Services	**3**

CHC-CNS vv	-
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	0
Qantas	0
Total Code-Share	0
Total Services	**0**

WLG-CNS vv	-
Emirates	no service
Pacific Blue	no service
Total Competition	0
Air NZ	0
Qantas	0
Total Code-Share	0
Total Services	**0**

Note 1: Thai Airways pulled off Tasman since last Alliance proposal
Note 2: City pairs with Hamilton, Palmerston and Dunedin not counted (zero competition)
Note 3: Queenstown not included - only QF and NZ services
Note 4: 15 routes above. Routes to NZ regional cities account for balance of 25 Tasman routes

Key:

SYD	Sydney
BNE	Brisbane
MEL	Melbourne
OOL	Gold Coast
ADL	Adelaide
PER	Perth
CNS	Cairns
AKL	Auckland
CHC	Christchurch
WLG	Wellington

SCHEDULE 2

LECG REPORT

SCHEDULE 3

PROFESSOR HAZELDINE'S FINDINGS

SCHEDULE 4

PROFESSOR TAGGART OPINION