

3 May 2013

Ministry of Transport
PO Box 3175
Wellington 6140

Attention: Mr Richard Cross, Senior Adviser
r.cross@transport.govt.nz

APPLICATION BY VIRGIN AUSTRALIA GROUP AND AIR NEW ZEALAND FOR RE-AUTHORISATION OF ALLIANCE

1 This letter is a submission by the New Zealand Airports Association (NZ Airports) in relation to the application made by the Virgin Australia Group and Air New Zealand (together the Applicants) to the Minister of Transport for re-authorisation of the trans-Tasman alliance between those two airlines.

2 NZ Airports has a number of concerns about the request for unconditional authorisation of the alliance for a five year period or beyond. We write to set out those concerns and to explain why NZ Airports opposes an unconditional authorisation. We understand that some individual New Zealand airports will also make submissions to the Minister.

3 Contact details for NZ Airports are as follows:

Chief Executive: Kevin Ward

Office Address: Level 6, 99-105 Customhouse Quay, Wellington, New Zealand

Postal Address: PO Box 11-369, Manners Street, Wellington 6142, New Zealand

Mobile: +64 21 384 524

Phone: +64 4 384 3217

Email: kevin.ward@nzairports.co.nz

Executive summary

4 NZ Airports is opposed to the unconditional re-authorisation Australasian Alliance sought by the Applicants. It is the strong view of NZ Airports and its international airport members that the interests of the flying public on both sides of the Tasman are best promoted by encouraging competition and independent carriers.

5 That said, NZ Airports recognises that benefits flow to the carriers from operating as an Alliance, and also acknowledges that some of these benefits can be passed on to the travelling public in the form of access to broader and deeper networks, enhanced flying schedules and the sharing of frequent flyer benefits. NZ Airports was supportive of the conditions associated with the original authorisation of the Alliance. The capacity conditions have worked to enable the benefits of the Alliance to flow to the Alliance partners, without exposing vulnerable markets to the potential for collusive capacity restriction and the price increases which could result.

- 6 The Ministry of Transport correctly recognised this significant risk in the original authorisation process and NZ Airports is of the view that the risk remains very real. For this reason appropriate conditions put in place to protect consumers should remain a key component of any decision to re-authorise the Alliance.
- 7 It is clear that the Alliance will inhibit the natural competitive dynamics of New Zealand's most significant air travel market and just as it did in 2010. In NZ Airports' view the Ministry must recognise the materiality of the risks associated with this change. The Alliance currently controls 51% of all capacity flown on trans-Tasman sectors. In the absence of the conditions requiring the Alliance carriers to maintain capacity growth rates in line with market growth, there are clear and easily recognised economic incentives driving the carriers to restrict capacity on routes with limited competitive constraint.
- 8 It is important to recall that it is the Alliance itself which reduces the degree of competition on trans-Tasman routes. It is entirely appropriate that, to offset the reduction in natural competitive constraints, a regulatory proxy is introduced to protect consumers from the potential detriments recognised by the Ministry in the original approval process.
- 9 With regard to the level of competition in the market for trans-Tasman services, nothing has materially changed to increase this since the authorisation of the Alliance and further, today's market is facing a significant further constriction of competition should the proposed coordination between Qantas and Emirates be approved. It is therefore the view of NZ Airports that any re-authorisation should be accompanied by appropriate capacity conditions. It is only in this way that the travellers using Tasman routes can be protected from the significantly enhanced market power achieved by the Applicants under an authorised Alliance.

The New Zealand Airports Association

- 10 NZ Airports is the industry association for New Zealand's airports and related businesses and includes all international airports. It is a not-for-profit organisation whose members operate 31 airports that span New Zealand and enable the essential air transport links between each region of New Zealand and between New Zealand and the world.

Trans-Tasman services from New Zealand airports

- 11 As you will know, the three largest international airports in New Zealand are at Auckland, Wellington and Christchurch. Historically, these were the only airports in New Zealand from which international services, including trans-Tasman services, operated.
- 12 In the last 15 years or so, trans-Tasman services have been offered at various regional airports in New Zealand, namely Hamilton, Dunedin, Queenstown, Palmerston North and Rotorua. Trans-Tasman services are no longer offered at Palmerston North and Hamilton, but they are currently offered at the other regional airports mentioned, either all year round or on a seasonal basis.

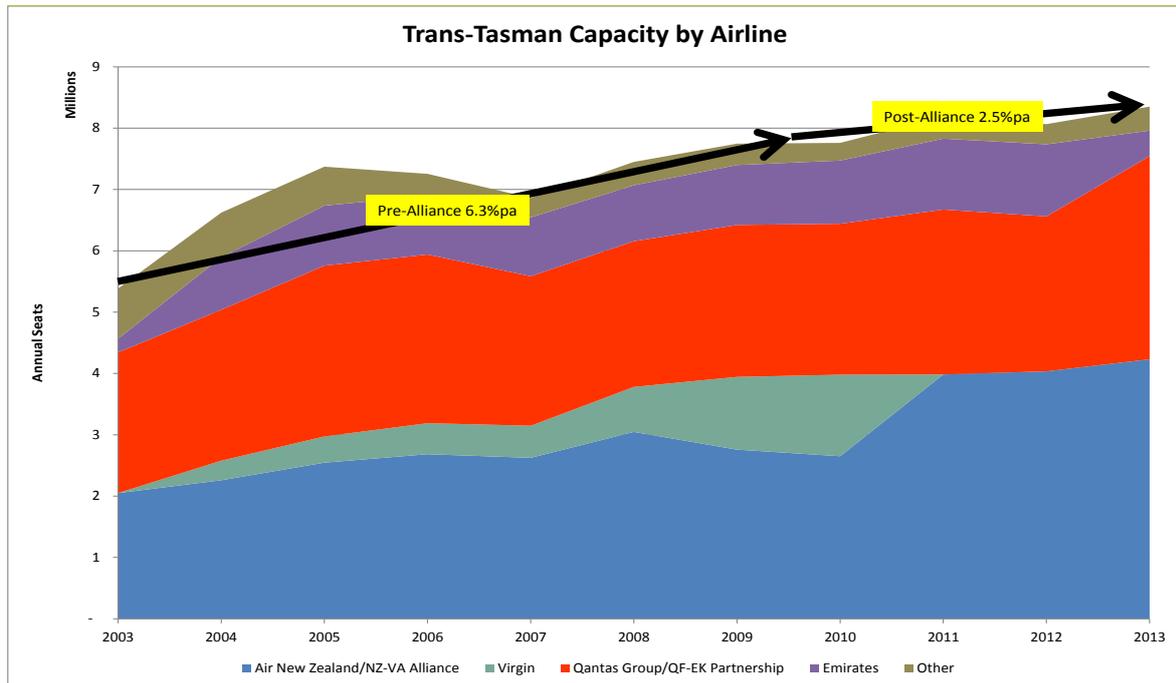
- 13 The passengers arriving in and departing from New Zealand on trans-Tasman air services represent 58%¹ of New Zealand's total international passenger volumes. There is no doubt that this market is vital to our remote country and there is real benefit to be gained from promoting competitive, accessible and viable air services in this market. Likewise the potential for detriment is significant should the market be exposed to and suffer from capacity restriction.

The purpose of capacity conditions

- 14 In its final decision on the original authorisation, the Ministry referred to a report completed by Covec in 2010. The Ministry noted Covec's finding that, based on the relationship between market concentration and fares, the Alliance had the potential to cost the New Zealand economy \$41 million dollars per annum. This was the value placed on the 120,000 passengers which would be expected to refrain from travelling on trans-Tasman routes following the anticipated air fare increases associated with the Alliance.
- 15 Although the Ministry recognised that other competitive dynamics may mitigate a degree of this impact, this analysis was generally in line with the ACCC assessment of potential consumer detriment and similar analysis completed by other interested parties. Even the applicants recognised that a sanctioned increase in market power had the potential to deliver material consumer detriment in the form of restricted capacity and higher prices.
- 16 The applicants addressed this shortcoming by proposing capacity conditions to ensure that, as a minimum, capacity on routes facing a material reduction in natural competition, as well as their overall Trans-Tasman capacity, would grow at a rate consistent with general market growth. Given that the stated core rationale of the Alliance is to grow passenger volumes, these conditions seemed to align entirely with the Alliance.
- 17 The incorporation of capacity conditions with the authorisation of the Alliance enabled the Alliance carriers to benefit from the various synergies flowing from the Alliance without abusing the market power they were granted.

¹Sabre ADI 2012 Calendar Year

The brief history of the Alliance



Source: Sabre ADI.

18 The chart above illustrates the rate of Tasman market capacity growth in the years the applicants operated together on the Tasman prior to the authorisation of the Alliance and in the time since. Interestingly, and contrary to the claimed benefits of the Alliance itself, the average annual rate of capacity growth pre Alliance was 6.3% and has dramatically slowed to 2.5% following authorisation.

19 Even more strikingly, when focussing on the combined capacity of the applicants alone, the average annual rate of capacity growth was 13.5% pre Alliance and since has reduced to 2.1%. NZ Airports trusts the Ministry to see beyond the commentary provided by the Applicants to recognise the genuine impact of the reduction in competition.

There is no reason to move away from appropriate conditions

20 NZ Airports has considered the statement made in the application that the Alliance has delivered sufficient benefit to justify re-authorisation on an unconditional basis. NZ Airports does not agree. The capacity conditions should not be considered by the applicants or indeed the Ministry as a particularly difficult target to reach in terms of capacity growth.

21 Indeed, prior to the authorisation of the Alliance, the competitive market produced rates of growth far greater than those required to reach the levels required by the capacity conditions on many trans-Tasman routes.

22 The conditions simply protect the market from the commercial incentives facing the Alliance partners by ensuring that a *minimum* level of capacity growth is maintained. With the Applicants' clearly stated goal being to increase passenger volumes, which

will require a degree of capacity addition over time, the only downside for the Applicants would appear to stem from the circumstance in which they would seek to restrict capacity to a level below natural market growth.

- 23 Given the clear link between capacity and price, this activity would have the effect of increasing air fares and suppressing demand from the price sensitive majority of trans-Tasman travellers. The Applicants have failed to illustrate how the stated benefits of the Alliance such as better schedule spread, access to networks and reciprocal frequent flyer benefits would ever be expected to offset this clear and material detriment.

The impact of unconditional authorisation

- 24 Although the precise outcome in specific markets can only be determined over time and will be affected by a variety of specific factors, an increase in market power will in the long run be expected to lead to an increase in the prices charged to consumers. To illustrate the scale of potential detriment NZ Airports has prepared the sensitivity analysis below. Using a demand elasticity of -1², and calculating the expected outcome of a range of scenarios, the impact of the Alliance on total trans-Tasman travel can be estimated.

Average Price Increase (%)	Reduction in annual passenger movements	Direct annual economic impact (inbound visitor spend)
1	53,183	-\$21,000,000
3	159,549	-\$64,000,000
5	265,915	-\$107,000,000
10	531,830	-\$214,000,000

- 25 For example, a 5% increase in fares would be expected to lead to a 265,000 reduction in total passenger movements, of which 72,000 would be Australian visitors to New Zealand contributing \$107M in direct spend.
- 26 The analysis highlights the significance of the Alliance’s market power and the ability it would have to impact upon New Zealand’s most significant aviation market should it be granted the power to do so. NZ Airports recognises that the ability of the Alliance to exercise this power will be limited to an extent by competitors, however, as determined in the original authorisation proceedings this constraint is insufficient – with severe limitations existing on certain routes.
- 27 As with the previous authorisation, these limitations can be addressed by way of capacity conditions restricting the ability of the Alliance partners to unduly exercise the power granted by the authorisation.

² IATA Economics Briefing 09, Air Travel Demand, -1 is average of Route level and Supra-National level.

Inflexibility of conditions

- 28 NZ Airports has considered the Applicants' comments regarding the degree of inflexibility which the capacity conditions bring to the Alliance partners' respective operations. Our members acknowledge that the conditions introduce a level of inflexibility which prevents the airlines reacting as quickly as they might otherwise wish to react to situations affecting passenger demand. Notwithstanding this, in NZ Airport's view any inefficiency caused by this feature is substantially outweighed by the benefits bestowed by the existence of capacity conditions.
- 29 The Applicants' suggested course of action - being to abandon the capacity conditions to address what can only be described as a marginal inconvenience - would in our view be a severe and dangerous overreaction. NZ Airports members are committed to working with airlines to build a sustainable network of services and would be supportive of a mechanism to hasten the approval for justified departures from the specific capacity conditions. For example a process to approve an ash cloud related capacity reduction via a truncated approval process may well be perfectly acceptable in certain circumstances. Whilst some flexibility may be appropriate in such conditions, NZ Airports remains firmly opposed to the removal of the conditions protecting vulnerable routes.

Test claimed public benefits of the Alliance

- 30 In the application for reauthorisation the Applicants advance a number of claims regarding significant and substantiated public benefits achieved and to be achieved as a direct consequence of the Alliance. NZ Airports urges the Ministry to carefully analyse these. In NZ Airport's view it will be particularly important for the Ministry to consider carefully the time periods analysed and total revenue recovered from passengers when seeking to determine the impact of the benefits of the Alliance. As the capacity information above suggests, the two carriers delivered a significantly higher rate of growth when acting independently than they have since being authorised to collude. This is in spite of the capacity growth conditions which the applicants are suggesting should be removed. NZ Airports is of the view that the Ministry should consider very carefully the quality of the information suggesting that the "benefits" of the Alliance have proved sufficient to justify a removal of capacity conditions.

The impact of ancillary revenue

- 31 NZ Airports wishes to bring to the attention of the Ministry the increases airlines are achieving in the generation of ancillary revenue. This revenue stream is becoming more and more important to the economic outcomes achieved by airlines. NZ Airports stresses the need for the Ministry to consider this when reviewing the information provided by the Applicants regarding any apparent reductions in airfares during the course of the brief history of the Alliance.
- 32 Where an argument could potentially be made that average air fares have reduced on some routes over the course of the Alliance, when considered alongside a substantial increase in ancillary revenue collected for services such as seat selection, on board entertainment and the ability to check-in baggage, the reality may be that the price faced by consumers to travel has not in fact reduced.

33 To ensure these factors are taken into account it would be wise for the Ministry to consider total revenue collected per sector when establishing the movements in air fares over the course of the Alliance.

Conclusion and recommendation

34 NZ Airports opposes the unconditional re-authorisation of the Alliance proposed by Virgin Australia Group and Air New Zealand. It believes that any re-authorisation granted by the Minister should remain subject to appropriate conditions limiting the negative consequences possible given the substantial increase in market power bestowed upon the Applicants.

35 We commend these matters to the Minister's consideration. If you have any queries, please contact me.

Yours faithfully

A handwritten signature in blue ink, appearing to read 'Kevin Ward', is positioned above the typed name.

Kevin Ward
Chief Executive
NZ Airports

CC. Australian Competition and Consumer Commission