

APPLICANTS' RESPONSE TO THIRD PARTY SUBMISSIONS – TASMAN NETWORKS AGREEMENT

19 SEPTEMBER 2006

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INTRODUCTION

1. On 13 April 2006 Air New Zealand Limited (**Air NZ**) and Qantas Airways Limited (**Qantas**) (collectively, the **Applicants**) applied to the Minister of Transport (the **Minister**) for authorisation under section 88 of the Civil Aviation Act 1990 (the **CAA**) of the Tasman Networks Agreement signed by the Applicants on 12 April 2006 (the **TNA**).
2. This submission responds to the views of third parties that have been forwarded to the Ministry of Transport (the **Ministry**) and made available on the Ministry's website as at 31 August 2006. A full list of the third party submitters is attached to this submission as **Appendix A**.
3. Where third party submissions oppose the Minister granting authorisation for the TNA, the Applicants have grouped those concerns into a series of issues and dealt with those concerns under these defined issues in this submission.

GENERAL COMMENTS

4. The Applicants make the following general comments regarding the submissions made by third parties.
- (a) **(Issue One: Jurisdiction)** The TNA falls squarely within the terms and intended application of Part IX of the CAA. The TNA does not involve any market other than the Tasman. Nor is the Applicants' application for authorisation unique – Air NZ has consistently adopted the process of applying for authorisation of codeshares under Part IX of the CAA. The TNA is not a reincarnation of the previous proposed alliance. The previous proposed alliance involved a number of markets including the domestic New Zealand market as well as an equity investment by Qantas. The provisions of the TNA involve a free sale codeshare on Tasman sectors supported by scheduling revenue and pricing arrangements, all of which can be authorised under the CAA.
- (b) **(Issue Two: TNA is necessary)** The TNA is necessary. It offers Qantas and Air NZ a unique opportunity to reduce their costs by removing some surplus capacity without sacrificing frequency of flights or either airline's network offering. The importance of securing these cost savings is highlighted by the fact that average fuel prices have increased by 94% since the 2004 financial year.¹
- (c) **(Issue Three: Tasman is a single market)** Notwithstanding submissions to the contrary, the evidence demonstrates the commercial reality that all Tasman routes form part of a wider Tasman market. There is no compelling evidence to demonstrate that Wellington forms its own distinct market.
- (d) **(Issue Four: Market developments, barriers to entry or expansion and strong competitive constraint exercised by Virgin Blue and Emirates)** Third parties have placed undue weight on the static market shares of those airlines currently operating on the Tasman when assessing the competitive environment. Competition is an evolving process and it is the threat of a competitive response via new entry or expansion by existing competitors that limits a firm's behaviour. There are no barriers to entry or expansion in the Tasman market and both Virgin Blue and Emirates are able to quickly expand onto new routes in response to a price increase. The Applicants endorse the conclusion of the Australian Competition Tribunal (the **ACT**) that:

"...we expect that the Alliance will be promptly and competitively constrained should it seek to raise fares"²

¹ See paragraph 32(a) below.

² Qantas/Air NZ Decision at para. 445.

The competitive significance of Virgin Blue and Emirates is illustrated by the fact that since their Tasman entry in 2003, average fares have fallen significantly. In a report prepared by Dr Michael W. Tretheway for Air NZ (the **Tretheway Report**) which has been provided to the Ministry under cover of a letter dated 28 August 2006, Dr Tretheway found that based on the Applicants' average fare data over the period 1999-2006:

"The evidence indicates that even with modest capacity shares, carriers such as Pacific Blue and/or Emirates will effectively constrain the ability of the Applicants to achieve a significant and sustained price increase".³

- (e) **(Issue Five: No Impact on fares)** Various submitters have argued that the TNA will lead to increased fares. The analysis and argument relied on by third parties is flawed. It is not inevitably the case that a reduction in capacity will result in increased fares as explained by Dr Tretheway in a report prepared for Air NZ in response to a report by LECG that was submitted to the Ministry on behalf of WIAL, "Benefits and costs to the public of proposed Air NZ and Qantas Code share: Trans-Tasman services to Wellington" (**Tretheway Response to LECG**)⁴:

"Under the TNA, capacity, and associated costs, can be removed from the market (creating a public benefit) without a corresponding reduction in consumer demand served. Costs will be reduced and load factors will go up, removing the basis for the argument put forth by LECG that capacity reduction under the TNA must imply higher fares".⁵

Furthermore, Dr Tretheway has found that:

"...the statistical evidence does not support a finding that higher concentration leads to higher fares on trans-Tasman routes where a low cost carrier is present in the market"⁶,

and

"...the impact of Virgin Blue and Emirates is felt in a sizeable way even on routes they do not serve".⁷

- (f) **(Issue Six: The counterfactual)** Third party discussions of how the likely "future without" the TNA might look are mere speculation. The Applicants' view of what will occur in the counterfactual was set out in response to Question 16 from the Ministry and Question 19

³ Tretheway Report at 2.4.3.

⁴ A copy of the Tretheway Response to LECG was provided to the Ministry under cover of a letter dated 28 August 2006.

⁵ Tretheway response to LECG at 2.4.11.

⁶ Tretheway Report at 2.2.14.

⁷ Tretheway Report at 2.2.20.

from the Australian Competition and Consumer Commission (the **ACCC**), a copy of which was supplied to the Ministry.

- (g) **(Issue Seven: Public benefits)** The TNA generates demonstrable public benefits for New Zealand, which will not be achieved in the absence of the TNA.

ISSUE ONE: THE MINISTER HAS JURISDICTION UNDER SECTION 88

5. Various third parties have claimed that the Minister does not have jurisdiction to authorise aspects of the TNA,⁸ or that the Minister should decline to consider the authorisation and instead pass that assessment onto the New Zealand Commerce Commission.⁹ Some submitters have also sought to frame the authorisation test to be applied by the Minister as a substantial lessening of competition test akin to that applied under section 27 of the Commerce Act 1986.
6. Each of these submissions is incorrect and without foundation.

Minister's jurisdiction

7. Contrary to the submission of various third parties, the TNA in its entirety is an arrangement falling within the terms of section 88(2) of the CAA and, therefore, the Minister has jurisdiction to authorise the TNA.
 - (a) The Minister's jurisdiction is not confined to authorisation of specific tariff levels or tariff structures, or specific capacity levels;
 - (b) The Minister can authorise a general machinery provision for the setting of tariffs and where the parties apply that authorised machinery provision to set tariffs and capacity, the resulting tariffs and capacities are exempt from Part II of the Commerce Act 1986; and
 - (c) The Minister can authorise the revenue allocation provisions of the TNA because those provisions relate directly or indirectly to the fixing of tariffs and capacity in terms of section 88.
8. The Applicants' views are supported by legal advice obtained independently from both Mr Alan Galbraith QC and Mr David Goddard QC, which have each been provided to the Ministry under cover of a letter dated 14 August 2006.
9. Contrary to the submission of WIAL, there is no provision in the CAA which limits the Minister's jurisdiction only to authorisation of matters that are a "necessary" or an "integral" part of fixing tariffs or setting capacity.¹⁰ The power given to the Minister to authorise provisions which "indirectly" relate to tariffs or capacity makes this wider jurisdiction clear.

⁸ See WIAL Submission dated 31 July (**WIAL Submission**), Chapman Tripp letter dated 24 May 2006, Wellington Chamber of Commerce letter dated 18 May 2006 (**Wellington Chamber of Commerce 2**), TAANZ Submission dated 31 July 2006 (**TAANZ 2**), Wellington Mayoral Forum.

⁹ See Rotorua Regional Airport, New Zealand Hotel Council, Mayor of Rotorua, Wellington Chamber of Commerce Letter dated 18 April 2006 (**Wellington Chamber of Commerce 1**), Wellington Chamber of Commerce 2, TAANZ submission dated 20 June 2006 (**TAANZ 1**), Wellington Mayoral Forum, and letters from member of the public dated 3 May 2006 (x4), 5 May 2006, 13 May 2006, 15 May 2006.

¹⁰ WIAL submission, at 525.

10. The TNA is an agreement that allows the Applicants to co-ordinate capacity and pricing on the Tasman. This co-ordination allows the withdrawal of some surplus capacity by the Applicants to the benefit of each airline and the travelling public. There are many provisions in the TNA which facilitate, or are required in order to give effect to, this fundamental objective. As Mr Galbraith stated in his opinion:

*“Use of the terms “relate” and “directly or indirectly” in the legislation which...were specifically adopted in preference to the former narrower term “provide for” makes it clear that the application of the section is intended to be wide and will encompass considerations which bear upon or are connected to tariff or capacity issues but which are not themselves directly the fixing of tariffs or capacity”.*¹¹

11. The Applicants' response to the specific clarifications sought by the Ministry are contained in **Schedule 1** to this submission.
12. In relation to revenue sharing, in order for the TNA to operate effectively each of Air NZ and Qantas must be indifferent as to whether a passenger is carried on a service operated by it or the other airline. It is only in that situation that the Applicants have the incentive to remove some of the surplus capacity currently operating on the Tasman because, if the Applicants are indifferent, then there is no additional benefit in operating a particular service.
13. Revenue sharing is the mechanism by which this “capacity indifference” is given effect. Accordingly, contrary to WIAL's submissions¹² revenue sharing is “indirectly” related to the fixing of capacity under TNA. Also contrary to WIAL's submissions,¹³ the revenue allocation provisions of the TNA do not include loss sharing. Each of the Applicants is left to bear the burden of its own cost structure, although each airline's costs will be reduced through removal of some surplus capacity.
14. For similar reasons, WIAL's submission¹⁴ that the Minister cannot authorise minimum in-flight service standards is incorrect. Air NZ would not be indifferent as to whether a passenger travelled on its aircraft or a Qantas aircraft if it could not be satisfied that Qantas would provide a minimum quality of service (the same applies in reverse for Qantas). Faced with competition from Virgin Blue and Emirates on the Tasman (not to mention other competitors across their networks), neither Air NZ nor Qantas would risk losing a dissatisfied customer to a competitor. Accordingly, coordination of in-flight service indirectly relates to the fixing of capacity.

¹¹ Letter from Mr Alan Galbraith to Bell Gully and Russell McVeagh, 3 August 2006.

¹² WIAL Submission at paras 523-526.

¹³ WIAL Submission at paras 523 - 526.

¹⁴ WIAL Submission at paras 530-532.

15. Furthermore, coordination of in-flight service indirectly relates to the fixing of tariffs. In the absence of a common understanding of the level (and, hence, the likely cost) of in-flight service, there will be incentives to game the tariff setting process.

The matter should be referred to the Commerce Commission

16. The TNA is not exceptional nor is it outside the scope of Part IX of the CAA.¹⁵ Air NZ has consistently sought authorisation for its codeshare and other alliance arrangements through Part IX of the CAA, including its Tasman Airshare arrangement with Qantas in the 1990s, its tripartite codeshare agreement with Singapore Airlines and Ansett, and its codeshare/alliance agreement with United Airlines. The Singapore Airlines and United Airlines arrangements included similar mechanisms to those found in the TNA. Furthermore, when authorised the Singapore Airlines arrangement was an alliance between the only two airlines operating direct services between Singapore and New Zealand (this agreement was also considered and authorised by the ACCC in Australia). In addition, Qantas has sought authorisation in respect of its Joint Services Agreement with British Airways.
17. While every agreement that includes a codesharing aspect will have different characteristics and will reflect the commercial agreements reached between the parties, a codeshare:

*“...can mean as little as one airline allowing another airline to use its computer reservation system codes to sell seats on its planes on routes in which the second airline cannot compete, or as much as comprehensive integration of marketing and operations that involves joint decisions on price, capacity, schedules and other competitively sensitive matters”.*¹⁶

18. The Applicants support and endorse the comments of the Tourism Industry Association who state:

*“From a global perspective, the rationalisation of international carriers with code-share arrangements is not new and has been the key to their financial sustainability and growth”.*¹⁷

19. It was appropriate for the Commerce Commission to consider the previous proposed alliance because it involved an equity purchase and because the codesharing arrangements of that alliance related to a number of markets including the domestic New Zealand market. Both those features meant that parts of the previous proposed alliance would not fall within the Minister's jurisdiction under Part IX, and the Applicants considered it would be cumbersome to run parallel

¹⁵ Some submitters have suggested the TNA is unique. See WIAL Submission, Wellington Chamber of Commerce 2, letter from member of public dated 3 May 2006.

¹⁶ Statement of John M. Nannes (Deputy Assistant Attorney General Antitrust Division U.S. Department of Justice) Before the Subcommittee on Aviation Committee on Commerce, Science and Transportation United States Senate Concerning Consolidation in the Airline Industry Washington, D.C. June 4, 1998.

¹⁷ Tourism Industry Association Submission, page 2.

authorisation processes in New Zealand. In contrast the TNA, a codeshare supported by revenue and pricing arrangements, falls squarely and totally within the terms of section 88(2).

20. An authorisation under section 88(2) operates as an exemption from the application of the relevant provisions of the Commerce Act. This exemption works via section 43(1) of the Commerce Act. This provision is wide and was intended by Parliament to remove international aviation agreements from the jurisdiction of the Commerce Act and the Commerce Commission.¹⁸ The Minister of Transport's power to authorise such arrangements reflects:

- the unique nature of the aviation industry and in particular its underlying international characteristics;
- the need for speed and flexibility in approving international airline arrangements; and
- the Ministry's competence in developing and administering New Zealand aviation policy, in particular, the familiarity with New Zealand's obligations under international aviation agreements and the requirement of the Minister to consider the effects on international comity between New Zealand and other states.

The relevant statutory test

21. Various submitters have attempted to frame the test by which the Minister should exercise his discretion as a question of whether there is a substantial lessening of competition.¹⁹
22. However, the conferral of the discretion on the Minister is consistent with a broad discretion to be exercised in the public interest and for the purpose of pursuing the goals of the CAA, for which the Minister has responsibility.²⁰ Nothing in the CAA expressly limits the breadth of this discretion in the way proposed by some submitters. The Mayor of Porirua recognises in her submission that the test is wider than merely one which focuses on competition impacts, although the Applicants agree with Treasury that distributional considerations (whether between groups or between groups of consumers in different regions) should not play a role in determining whether the public interest is served.²¹ The Applicants have established that there are demonstrable and substantial public benefits associated with the TNA.
23. In any event, for the reasons set out in the Application for Authorisation and this submission, the Applicants do not consider that the TNA would substantially lessen competition.

¹⁸ This point is evidenced by the Parliamentary debates on the Civil Aviation Bill.

¹⁹ For example, the Mayor of Rotorua has submitted that the Minister should decline authorisation if it was considered "detrimental to the market".

²⁰ MED notes in its submission that competition impacts are only one of a number of relevant considerations.

²¹ Treasury Submission. The Mayor of Porirua suggests in her submission that the Minister should consider regional impacts.

ISSUE TWO: APPLICANTS' RATIONALE

24. The Applicants' rationale in implementing the TNA is to reduce each airline's costs through the removal of some surplus Tasman capacity without adversely impacting upon the frequency of flights, or the network offering and the city presence of each airline. The TNA will enable the Applicants to concurrently:
- (a) remove some of the surplus capacity currently on the Tasman resulting in cost savings of **[CONFIDENTIAL]** for Air NZ and **[CONFIDENTIAL]** for Qantas; and
 - (b) maintain, and even improve, their network connectivity and schedule spread creating a higher standard of service for passengers.
25. The Applicants agree with Invercargill Airport Ltd that the only way to ensure sustainable low fares is to reduce the cost structure of the Tasman market. As the Tourism Industry Association stated in its submission, a continuation of the status quo is not sustainable.
26. The Applicants also agree with WIAL that ensuring that New Zealand's connectivity to the world is maintained is a key driver for New Zealand's future economic growth.²² However, the Applicants do not agree that the TNA will only serve to increase New Zealand's geographic remoteness.²³ Reducing Air NZ's cost base will provide Air NZ with the opportunity to improve profitability on the Tasman and will facilitate its development of other markets offshore. Forcing Air NZ to unilaterally reduce capacity with the associated inherent risk to its network position that a unilateral reduction involves is much more likely to increase New Zealand's geographic remoteness. As the Tourism Industry Association noted in its submission, a strong national carrier is critical to ensuring that New Zealand remains front of mind for international travellers.²⁴ The public benefits inherent in the TNA are discussed fully at paragraphs 117 to 119.
27. Various third parties, including WIAL, have attempted to call into question the Applicants' rationale for implementing the TNA. The reasons offered include Tasman route profitability, the importance of cost savings to airlines (particularly given rising fuel costs), the notion of excess or surplus capacity and the concept of unilaterally withdrawing capacity. Each of these matters is addressed below.

Tasman route profitability

28. Certain submitters have supported the Applicants' right to operate their respective businesses to make an economic return.²⁵ The Applicants welcome these comments. However, some submitters have also suggested that there may be indirect evidence which indicates that the

²² WIAL Submission at 36 and see also the Tourism Industry Association.

²³ WIAL Submission at 32.

²⁴ Letter from Tourism Industry Association, 26 July 2006.

²⁵ See WIAL Submission at 8, Wellington Mayoral Forum, Positively Wellington Tourism.

Tasman routes are profitable on a sustainable basis. However, Air NZ has provided evidence that Air NZ's Tasman profits (including Freedom) have been:

[CONFIDENTIAL]

29. [CONFIDENTIAL]

30. In addition, neither of the Applicants are currently achieving an acceptable return on capital investment as explained in the response to Question 10 of the Ministry's letter dated 28 July 2006.

31. In arguing that the Tasman is not inherently unprofitable, WIAL has not taken into account the differing costs of different airlines. Network carriers such as the Applicants have a higher cost base (and, therefore a higher break-even load factor at a given fare level) than low cost carriers such as Virgin Blue and fifth-freedom carriers flying on a marginally costed basis such as Emirates. Indeed, this was acknowledged by Virgin Blue in its record of meeting with the ACCC where Virgin Blue stated:²⁶

"... its LCC business model allows it to price below Full Services Airlines (FSAs) such as Air NZ and Qantas by 10 – 15 per cent."

Fuel costs

32. WIAL has attempted to down play the impact of the recent increases in fuel prices by claiming that: the Applicants are immunised from price rises through their hedging policies, the Applicants recover the cost of fuel increases through fuel surcharges, and fuel price increases are a passing issue. The facts do not sustain WIAL's claims:

- (a) (**Impact of Hedging**) The Applicants acknowledge that they hedge their fuel costs. However, hedging only reduces volatilities in fuel prices around a trend and acts to delay the impact of rising fuel prices. Hedging does not change the fact that the cost of fuel is increasing and as hedges roll-off, the cost of fuel will continue to escalate. Even net of hedging, Air NZ's full year 2005 fuel cost as disclosed in its Annual Report increased by NZ\$144 million to a total of NZ\$626 million. For 2006, Air NZ's fuel cost increased by a further NZ\$[CONFIDENTIAL] to NZ\$[CONFIDENTIAL]. If fuel prices remain at average 2006 levels in the 2007 financial year, Air NZ estimates that its fuel cost will increase by a further [CONFIDENTIAL] in 2007 compared to 2006, resulting in a total fuel cost of nearly [CONFIDENTIAL].²⁷ Overall the average fuel price in full year 2005 was US\$54 per barrel compared with US\$40 per barrel in 2004 – an increase of 35%. The average fuel price in full year 2006 was US\$77 per barrel, an increase of 44% since 2005 and 94% since 2004.

²⁶ ACCC "Record of Meeting between ACCC and Virgin Blue, 25 May 2006" at 3.

²⁷ It is acknowledged that fuel prices have fallen very recently, however, there is no way of knowing whether this fall represents a change in the overall trend of increasing fuel prices.

Not only are these large increases in absolute terms, the fact that fuel constitutes such a large proportion of an airline's total cost base, and an even larger proportion of non-controllable costs, means these increases have had a significant impact on the Applicants' *overall* cost structures.

- (b) (***Applicants are not recovering full costs of fuel price increases***) Price competition means that airlines are not able to increase their fares sufficiently to recover the total increased cost of fuel across their networks.
- (c) (***Fuel prices are not a passing issue***) WIAL's submission that "fuel price is another passing issue"²⁸ is incorrect and without basis. Certainly Air NZ is now treating this level of fuel price (or a higher level) as part of the continuing structure of the industry.
[CONFIDENTIAL]

Excess capacity

- 33. It is suggested that there is a natural range of load factors for airlines and that the Applicants' current Tasman load factors fall within that range, or that "empty seats are a fact of life for all airlines, on all routes, in every country" and that "pricing is based around achieving a stable average load factor of between 70% and 80%".²⁹ LECG also argues that the airlines have adopted a false definition of "excess capacity".³⁰
- 34. The Applicants do not claim that all unused capacity in airline markets is excess. Rather, under the TNA the Applicants will have a unique opportunity to remove some surplus capacity while maintaining (and in some cases enhancing) their network offerings. Furthermore, the Applicants are aware that if they removed any non-surplus capacity they would simply be creating an opportunity for competing airlines to enter or expand into any gaps left by withdrawing services.
- 35. The submission that Tasman load factors are adequate is flawed. The Applicants have already demonstrated the following:
 - (a) (***Comparison with international load factors***) The most recently available full year figures for major carriers worldwide on international routes illustrates that other airlines are achieving higher load factors:
 - (i) European Scheduled Traffic, Total International (76.9%).
 - (ii) US Majors' Scheduled Traffic, Total International (79.7%).³¹

²⁸ WIAL Submission at 137.

²⁹ Rotorua Airport Submission.

³⁰ LECG Report at 6.1.

³¹ "Aviation Strategy", May 2006.

(b) (*Air NZ's load factors*) [CONFIDENTIAL]

(c) (*Qantas' load factors*) [CONFIDENTIAL]

36. Furthermore, in the Tretheway Response to LECG, Dr Tretheway notes that LECG (and this comment can be made equally of some of the other submitters) seems unaware that different carriers in the same market may have different break-even load factors (based on different cost bases or average yield) or that changes in the average fare in a market change the break-even load factor.
37. While WIAL does note the concept of a break-even load factor at paragraph 145 of its submission, WIAL refers to a TRL study. This study shows:
- that average load factors are 73.8% which WIAL cite; and
 - that break-even load factors average 70.3%, which WIAL does not cite. Rather, WIAL chooses to selectively refer to an unreferenced statement by Ian Thomas from the Centre for Asia Pacific Aviation that (apparently) suggests for most routes the break-even load factor is 60%. In the absence of any information on the source of this statement (or any study on which it was based), the Ministry cannot place any weight on that statement.
38. Emirates has publicly stated that its break-even load factor for the Tasman is 40%.³² Dr Tretheway notes:
- (a) Since 2003, the Applicants' yields on the trans-Tasman routes have declined markedly, which would have dramatically increased the Applicants' respective break-even load factors on Tasman routes. Conversely, over this period the Applicants' load factors have declined.
 - (b) Over the past five years, legacy airlines in Australia, New Zealand, Canada, the United States, Europe, Brazil, Malaysia and others have reduced their fares and/or experienced significant declines in their yields (revenue per passenger kilometre), which raised break-even load factors materially. The break-even load factors of LCCs have generally not increased, or at least not increased by the same magnitude.
 - (c) Whether the Applicants are experiencing *adequate* load factors requires more than a simple comparison to other airlines, especially airlines with lower costs per seat kilometre.
39. WIAL's submission that the increase in the Applicants' combined load factor which will result from the TNA is merely "statistical noise" is equally flawed.³³ An increase in combined load factor over three years of approximately 3% is forecast under the TNA. This is a significant rise in the context

³² In early 2005 Emirates publicly claimed "... it only has to fill 40% of its seats to be profitable over the Tasman": Scott Rochford, "Emirates moves in on Tasman routes", *The Age*, 1 April 2005.

³³ WIAL Submission at 160.

of the Applicants' break-even load factors. The fact that these increases may be proportionally small merely reflects the Applicants' awareness that it would not be profitable to remove non-surplus capacity due to the competitive constraints faced by the Applicants on the Tasman.

Unilateral withdrawal of capacity

40. The reductions in capacity attributable to the TNA cannot be achieved by either one of the Applicants acting unilaterally. The term *capacity* has two dimensions. It can refer to the frequencies or services (i.e., the number of flights per week) that a carrier offers on a particular route. It can also be used to describe the number of available seats a carrier offers on a route. Capacity can also alter without any change to the number of frequencies on a route where an airline elects or is compelled to alter the aircraft type (for example, a move from B737s to A320s) or to change the internal seat configuration of its existing aircraft.
41. In the present context capacity should be read as referring predominantly to frequencies. That is, if a network airline unilaterally reduces the number of frequencies it offers in a market like the Tasman (for example, it withdraws a particular service) in many situations there are likely to be negative network consequences. As a result, significant unilateral reductions in frequency generally only occur in exceptional marketplace circumstances or where necessary decisions taken elsewhere in the network have flow on implications for Tasman operations.
42. While the Applicants can (and do) make marginal adjustments to their total seat capacity, there is a limit to the steps that a network airline can take in implementing capacity reductions without reducing the value of its overall network through reductions in the frequency or route density of Tasman services. Under the TNA the Applicants can achieve the removal of some surplus capacity while maintaining network connectivity and city presence by code-sharing on each other's services and extending the number of flights that are available to passengers across Tasman routes.
43. WIAL has submitted that these frequency and capacity reductions could be achieved by the Applicants acting unilaterally. WIAL points to Qantas' withdrawal of capacity from the Auckland-Sydney route and Air NZ's reduction in frequency and capacity on the Wellington-Brisbane route and withdrawal from Auckland-Singapore route as evidence of this. These selected cases do not evidence an ability to unilaterally achieve the cost savings inherent in the TNA.

[CONFIDENTIAL]

44. Despite WIAL's submission to the contrary,³⁴ the Applicants' claim that frequency and capacity are important to network carriers is consistent with the fact that Emirates and Virgin Blue constrain the Applicants despite their more limited frequencies and capacity. Any advantage which the

³⁴ See WIAL Submission at 200-201 where it suggests these claims are not consistent.

Applicants may enjoy in this respect does not allow either airline to act unilaterally beyond a certain point without a significant effect on its competitiveness. It is generally acknowledged that leisure travellers (who make up the majority of travellers on the Tasman overall) are likely to place less emphasis on frequency and more on price.³⁵ Furthermore, as the ACT acknowledged, to the extent Virgin Blue is unable to offer sufficient frequencies this is:

“... somewhat alleviated by the increasing availability of one way fares, which mean that passengers may choose their own schedules using different airlines.”³⁶

45. Ultimately, both Virgin Blue and Emirates enjoy a fundamental cost advantage and therefore, a pricing advantage over the Applicants, which means they are serious competitive constraints. This point is expanded upon in the Applicants' response to Issue Four below.

Payment by Air NZ to Qantas

46. WIAL notes in its submission that concurrent with the TNA Air NZ will pay Qantas NZ\$98m for its convertible notes over a period of four years. WIAL imply that the reason that Air NZ is willing to pay this money is that it considers that it will prevent Qantas from competing “more robustly” in the New Zealand market.³⁷
47. This implication is unfounded. Air NZ has demonstrated that there is a rational motivation for the agreement to implement the TNA which has nothing to do with competition in the domestic New Zealand market. **[CONFIDENTIAL]** The TNA contains strict confidentiality and operational protocols that ensure that there will be no diminution in competitive tension between the Applicants in any market other than the Tasman.

³⁵ See Record of Meeting between the ACCC and the Australian Consumers Association (**ACA**) by way of example – “... the lowest possible fare was the highest priority for a consumer. The ACA commented the “ordinary” traveller is prepared to put up with a lot to ensure the lowest possible fare.”

³⁶ Qantas/Air NZ Decision at para. 354

³⁷ WIAL Submission at 99-103.

ISSUE THREE: TASMAN IS A SINGLE MARKET

48. Some submissions have focussed on the issue of the correct market definition,³⁸ arguing that the appropriate market definition from a competition law perspective involves a number of discrete geographic markets or that the analysis should focus particularly on routes into and out of Wellington.
49. A consideration of the appropriate market might assist the Minister in assessing the impacts of the TNA on competition and the constraints faced by the Applicants in the Tasman market. In considering the appropriate market, courts and tribunals will treat as persuasive the behaviour of the Applicants and their competitors. While WIAL suggests that no airline would “dream of trying to manage “The Tasman” as one market”³⁹, the commercial reality is that the Applicants do treat the Tasman (including Wellington) as part of a single market and this is evidenced by the following:
- (a) Air NZ's Tasman Express offering (a response principally to Virgin Blue and Emirates), which resulted in fare reductions of approximately [CONFIDENTIAL], was applied Tasman wide.
 - (b) The high level of publicity associated with the pricing of Tasman fares, means it is difficult (if not impossible) to discriminate against Wellington-based passengers or passengers seeking access to Wellington.
 - (c) The importance placed on the marginal passenger in airline markets and the constraint which this imposes throughout the aircraft cabin, together with the fact that such passengers, at least on the Tasman, are price sensitive and exercise a degree of demand substitutability between different destinations, direct/indirect routes (e.g., via Brisbane on Virgin Blue) and different airlines, provides further incentive for the Applicants to ensure that fares into and out of Wellington are comparable with fares into and out of Auckland and Christchurch. The analysis of Air NZ's average fares over the last three years in **Appendix D** demonstrates the Applicants' commercial practice.
 - (d) The Applicants' pricing and marketing practices, which are elaborated upon below.

Price Sensitive Travellers

50. In the Qantas/Air NZ Decision, the ACT identified price-sensitivity as a significant demand characteristic of Tasman passengers. This continues to be the case across all the Tasman routes,

³⁸ WIAL Submission, New Zealand Hotel Council, Wellington Regional Chamber of Commerce and Business Hutt Valley and Hutt Valley Chamber of Commerce.

³⁹ WIAL Submission at 220.

including routes into and out of Wellington⁴⁰ and is illustrated by the mix of fares sold by each of the Applicants in each fare "family" (for Air NZ) or category (for Qantas). Though each Tasman route carries a slightly different passenger mix, which produces variations, Qantas and Air NZ both sell a very high percentage of Tasman fares in their respective low fare classes: **[CONFIDENTIAL]** of total Air NZ Tasman fares are sold in the smart-saver and tactical fare classes. Similarly, **[CONFIDENTIAL]** of total Qantas Tasman fares are sold in the "low" and "other" fare categories.⁴¹

51. As a broad generalisation, the experience of the Applicants is that price-sensitive passengers are often persons travelling for leisure or in order to visit friends and relatives, but also include many business passengers travelling on business. Indeed, Air NZ's market research indicates that the majority of passengers travelling for business regard price as extremely important.⁴²
52. The Applicants provided DoTARS data to the ACCC showing that 29.3% of Qantas' ex-New Zealand passengers and 20.3% of Air NZ's ex-New Zealand passengers cited "business" as their reason for travel.⁴³ This proportion exceeds the "business class" proportion of passengers on the Tasman, as well as the proportion of passengers purchasing economy tickets in higher fare categories.⁴⁴ Air NZ estimates that:
- (a) business class tickets account for **[CONFIDENTIAL]**% (depending on route) of Tasman tickets sold; and
 - (b) business class and fully-flexible tickets account for **[CONFIDENTIAL]**% (depending on route) of Tasman tickets sold.

Qantas estimates that only **[CONFIDENTIAL]**% (depending on route) of Tasman fares are sold in its two highest fare categories, **[CONFIDENTIAL]**.

53. WIAL notes the Applicants' submission to the ACCC that when making decisions in respect of travel, price-sensitive Tasman passengers will examine prices and options within a matrix of factors not in a vacuum. These factors include:
- (a) whether to travel to New Zealand/Australia or elsewhere (in the case of leisure passengers);
 - (b) which destination they fly to in New Zealand or Australia (in the case of leisure passengers);

⁴⁰ Indeed, this is acknowledged by a number of third party submitters, including WIAL.

⁴¹ **[CONFIDENTIAL]**

⁴² See Air NZ's response to Ministry Question 11.

⁴³ See Applicants' response to ACCC Question 6, a copy of which has been supplied to Ministry.

⁴⁴ See Applicants' Response to 3rd Party Submission filed with the ACCC on 4 July 2006.

- (c) which airline they wish to fly;
 - (d) the time at which they wish to travel (i.e., morning, afternoon or evening); and
 - (e) the time the journey takes relative to the price (i.e., direct vs. indirect).
54. In making this submission, the Applicants have not suggested that the marginal passenger⁴⁵ is the passenger whom is indifferent to everything. The Applicants agree with WIAL that most passengers will hold some preferences in relation to some of these factors. However, the vast majority of passengers (whether price sensitive or not) will be indifferent to at least one or more of these factors and some price-sensitive Tasman passengers may be indifferent to almost all of them.
55. This was recognised by the ACT who accepted that this information asymmetry meant that:
- “... low fares offered by Virgin Blue and Emirates in their attempts to gain market share at the expense of the Alliance will flow through to all passengers in the market who wish to take advantage of them”*⁴⁶
56. These varying degrees of demand substitutability between different Tasman destinations, direct/indirect routes and different airlines, coupled with the importance of price-sensitive traffic on the Tasman, means significant pressure is brought to bear on the Applicants to ensure that fares into and out of Wellington are comparable with fares into and out of Auckland and Christchurch.

Tasman Pricing Strategies

57. The fact that the Applicants treat the Tasman as one market is evidenced by their pricing strategies, such as:
- (a) (**Common rating**) Both Applicants generally common rate different Tasman routes. That is, the airlines align the base or year round fares offered in each fare category across all Tasman city pairs. In most cases, the Applicants also common rate the direct and indirect routes operating between the same two ports (for example, Sydney-Wellington and Sydney-Auckland-Wellington).
 - (b) (**Promotional activity**) An analysis of the Applicants' independent approaches to pricing and tactical promotion demonstrates that Wellington routes are consistently promoted at the same (or similar) price level as fares to/from Auckland and Christchurch. This is highlighted in **Appendix B** (Air NZ) and **Appendix C** (Qantas).

⁴⁵ The importance of the marginal passenger is discussed at paragraphs 91 to 94 below.

⁴⁶ Qantas/Air NZ Decision at para. 444/

Supply Side Substitution

58. On the supply side, while the airline industry has some aspects of a network industry, unlike other network industries it is not exemplified by large fixed and immovable infrastructure (but does have high fixed costs). Aircraft are readily available for purchase or lease. Alternatively, airlines can make adjustments to total seat capacity between city pairs in response to competitive activity, demand conditions or other factors (although the ability to do that for a network airline is dependent on other network factors as explained at paragraph 42). This is particularly true for airlines that primarily operate on a point to point basis, such as Virgin Blue, which operates a common fleet (i.e. 737-700 and 737-800 aircraft). This is a key market feature that would not be picked up by an analysis that focuses solely on city pair markets and their current participants.

Conclusion – Geographic Market

59. Accordingly, as a matter of commercial reality, on both the demand and supply sides the Tasman routes to and from all New Zealand cities form part of the broader Tasman air services market. WIAL's submission ignores the factors outlined above and takes an overly narrow focus on current competition in and out of Wellington, as opposed to taking a broader view of the constraints imposed by other destinations, other carriers and passengers' other spending priorities.

ISSUE FOUR: MARKET DEVELOPMENTS, BARRIERS TO ENTRY AND EXPANSION, AND THE COMPETITIVE CONSTRAINT EXERCISED BY VIRGIN BLUE AND EMIRATES

60. The Applicants have consistently stated and the evidence provided in this submission demonstrates that the Tasman market is very competitive. The level and intensity of competition is demonstrated by the analysis of prices outlined in Issue Five below.
61. A number of submitters claim the Applicants will face little, if any, competitive constraint on the Tasman from their competitors, specifically Emirates and Virgin Blue. The broad reasoning underpinning these submissions can be summarised as follows:
- (a) Emirates and Virgin Blue operate on only a subset of the Tasman routes, with fewer frequencies than Air NZ and Qantas, and possess a small market share relative to the Applicants.
 - (b) Emirates and Virgin Blue have not significantly expanded on the Tasman routes since the Qantas/Air NZ Decision.
 - (c) Emirates and Virgin Blue cannot significantly expand their services on the Tasman routes going forward (i.e., they face barriers to expansion).
 - (d) As a result, Emirates and Virgin Blue cannot constrain the pricing, capacity and scheduling decisions of the Applicants under the TNA.
62. A proper review of the facts does not support any of these submissions.

Constraint is not a function of frequency or route presence

63. Some submitters have claimed that Emirates and Virgin Blue's constraint is lessened because they only operate on a subset of routes with fewer frequencies and less capacity than the Applicants.⁴⁷ These same claims were made during the investigation of the previous proposed alliance and the ACT recognised them but concluded that Tasman origin/destination passengers are price sensitive and that Emirates is able to target price sensitive customers by marginal cost pricing, while Virgin Blue (with its very low cost base) acts as a constraint on the routes it serves as well as on Tasman routes it does not serve.⁴⁸
64. The continued price sensitivity of Tasman passengers is evidenced in paragraph 50 above, which indicates that Qantas and Air NZ both sell a very high percentage of Tasman fares in their respective low fare classes.

⁴⁷ WIAL Submission at 267, TAANZ 2.

⁴⁸ Qantas/Air NZ Decision at paras 352, 355, 399, 401, 429 and 444.

65. As the ACT appreciated, the constraint imposed by Emirates and Virgin Blue is not a function of their frequency or the number of routes operated. This is confirmed by the Tretheway Report as explained in Issue Five.
66. A number of third parties identify the current, combined market share of the Applicants as not only an indicium of their market dominance, but as evidence that they cannot be constrained by the conduct of any other Tasman competitors.⁴⁹ In the Qantas/Air NZ Decision, the ACT made abundantly clear the dangers inherent in relying on a firm's existing market share to determine the competitive effects of a merger:

"We emphasise that although there must be recognition given to market share data when considering a merger of the type under consideration, it must also be recognised that significant consideration should be given to predictions of dynamic changes and competitive initiatives in the market in the future by rival firms, albeit with a relatively small market share, but who face no significant barriers to expansion. Market share tells us nothing about future competitive initiatives and outcomes in the market. Nor does it tell us anything about how that market share was arrived at" [emphasis added].⁵⁰

67. New Zealand courts have likewise warned against taking a "snap-shot" view of competition.⁵¹ As Franklin Fisher (a leading anti-trust economist) has said a single frame can give a misleading impression of the movie; others have warned against taking a "snap-shot" view of competition. It is instructive to look at the history of competition and the trend of market shares on the Tasman. There has been a continuing downward trend in the Applicants' origin/destination Tasman passenger share and a concurrent increase in the origin/destination passenger shares of Virgin Blue and Emirates. This trend, at least insofar as the Applicants are concerned, was also identified in the DoTaRS submission, which noted:⁵²

"The statistics illustrate that the combined Qantas (including Jetstar) and Air New Zealand (including Freedom Air) market share of the trans-Tasman dropped from 90.5% to 77.3% in 2 years [December 2003 – December 2005]

68. These identifiable trends show that a focus on static market shares, such as that adopted by WIAL and like submitters, obscures the underlying market dynamics – particularly in a market where a high percentage of operational costs are fixed with respect to passengers carried and the

⁴⁹ See WIAL Submission at 201.

⁵⁰ Qantas/Air NZ Decision at para. 431.

⁵¹ See *TruTone Ltd v. Festival Records Retail Marketing Ltd* (1988) 2 TCLR 542 (CA) where the court said at page 550: "Viewed in relation to product and time the single album definition of market ignores commercial realities. It focuses on short run phenomena. It presents a snapshot rather than a moving picture of continuing commercial activity". See also the comments of Cooke P. in the *Telecom AMPs-A case* [1992] 3 NZLR 429 (CA) at 435/15: "...conditions in a market should not be seen as static or frozen as if in a snapshot".

⁵² DoTaRS submission to the ACCC at page 2. Available at: <http://www.accc.gov.au/content/index.phtml/itemId/744922/display/submission>.

marginal costs of serving an additional passenger is relatively low. Indeed, a focus on static market shares has long been recognised as analytically unsound:

“What does economic analysis tell us about the relation of market share and monopoly power? Well, the one proposition which most people believe is that a small share shows the absence of monopoly power and a large share its presence.... This is not true. The right question is that of what happens to share, or, more generally, to a firm’s business when monopoly profits are sought. The fundamental issue is whether competitors are able to grow.

“... The right question to ask is whether that large share would survive an attempt to charge high price and earn monopoly profits”.⁵³

Slower expansion is the result of a highly competitive market

69. Some submitters have criticised the Applicants’ reliance on the ACT’s decision. A key premise in this criticism is that the ACT predicted that Emirates and Virgin Blue would place a “growing” competitive constraint upon the Applicants and that, because Emirates and Virgin Blue have not rapidly expanded their presence in the intervening period, this prediction has not come to pass.⁵⁴ However, the ACT’s comments and predictions were in relation to how Virgin Blue and Emirates would respond if the previous proposed alliance had been implemented and sought to raise prices or remove more than excess capacity. It did not make particular predictions as to how the market would unfold in the event the alliance did not proceed. The ACT was comparing two future states of the world: one with the alliance and one without. The key focus of the ACT was, therefore, its conclusion that if the alliance proceeded:

“.....in the absence of barriers to expansion for Virgin Blue and Emirates, and given the capacity available to Virgin Blue and Emirates, we expect that the Alliance will be promptly and competitively constrained should it seek to raise fares” (emphasis added).⁵⁵

70. In other words, it was the ability and capacity of Virgin Blue and Emirates to respond to the Applicants, should they seek to exploit their position and raise fares above the competitive level, which created the constraint accepted by the ACT. Simply because the Applicants have not engaged in this hypothetical conduct (i.e., implementing the Alliance and then seeking to raise fares) does not mean the constraint never existed, does not exist today or would not equally exist if the TNA proceeded.

71. A more subdued speed of expansion by Virgin Blue since the Qantas/Air NZ Decision is simply indicative of the degree of surplus capacity, high level of competition and the correspondingly low

⁵³ *Diagnosing Monopoly*, David Kinley Lecture, University of Illinois, 20 October 1978, published in *Industrial Organisation, Economics and the Law, Collected Papers of Franklin M Fisher* (ed. John Montz) at page 6

⁵⁴ WIAL Submission at 297, Wellington Chamber of Commerce 1.

⁵⁵ Qantas/Air NZ Decision at para 445.

prices currently on the Tasman compared to an Australian market where Virgin Blue was able to reap the benefit of Ansett's collapse and the resulting vacuum in airline capacity. The New Zealand Court of Appeal in *Commerce Commission v Southern Cross* warned against inferring that there is a lack of competition in a market when market shares among competitors in the market are slow to change or stable over a given period. The Court went on to note that stable market shares may in fact be the result of a highly competitive market, where participants are competing vigorously.⁵⁶

72. In any event, since June 2004 both Emirates and Virgin Blue have continued to increase their penetration in the Tasman market at the expense of Qantas and Air NZ. This is illustrated by the growth of Emirates' and Virgin Blue's passenger shares and load factors since the Qantas/Air NZ Decision:

(a) (**Virgin Blue**) Virgin Blue has:

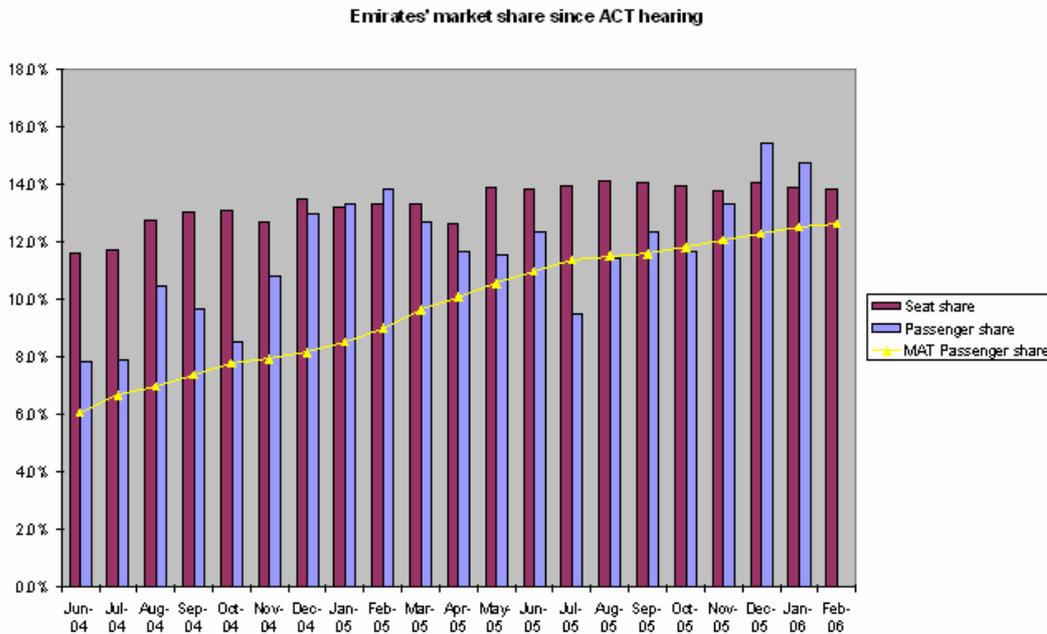
- (i) entered three new routes, Wellington-Brisbane (on which it has a 31.8% capacity share), Auckland-Brisbane and Auckland-Coolangatta; and
- (ii) consolidated its strong market positions on its existing routes (although it withdrew from Wellington-Sydney) – according to DoTaRS, Virgin Blue's Tasman passenger share for the year ended 2005 stands at 7.7%.⁵⁷ In addition, Air NZ estimates that Virgin Blue's Tasman load factor has continued an upward trend, and now exceeds **[CONFIDENTIAL]**.

(b) (**Emirates**) Emirates has continued to grow in the Tasman market. This is illustrated by Figure 1 below. Emirates has also continued to increase its load factor and Air NZ estimates Emirates' Tasman load factor exceeds **[CONFIDENTIAL]**.

⁵⁶ *Commerce Commission v Southern Cross* (2002) 10 TCLR 269.

⁵⁷ See DoTaRS submission to the ACCC, Table 2 at page 2.

Figure 1: Emirates' share since ACT hearing



73. In analysing the competition impacts of the TNA the Ministry should examine the actual market developments on the Tasman since the Qantas/Air NZ Decision and ascertain whether they are broadly consistent with the principles outlined above. As noted by the High Court and the ACT, competition in the market is dynamic and likely to “*move, ebb and flow according to the competitive interplay of market forces of supply and demand, particularly in relation to the marginal passenger*”.⁵⁸

74. Market developments evidence a highly competitive Tasman environment, which only serves to underscore the ACT’s reasoning. As DoTaRS noted in its submission:⁵⁹

“During this time [i.e. year ended Dec 2003 to year ended Dec 2005] the market also experienced: a 30% growth in passenger travel; a 64% growth in the market share of fifth freedom carriers; the emergence of Emirates as the dominant fifth freedom carrier; as well as the entry of Virgin Blue.”

75. Emirates and Virgin Blue are not “niche providers” as submitted by some parties.⁶⁰ One or both of Emirates and Virgin Blue have an established presence on 7 out of the 9 main Tasman routes between Auckland/Wellington/Christchurch and Sydney/Melbourne/Brisbane. Air NZ estimates that, with the exception of Auckland-Sydney where Emirates has an 11.8% capacity share, Virgin

⁵⁸ Qantas/Air NZ Decision at para. 447 and *Air New Zealand v Commerce Commission (No 6)* (2004) 11 TCLR 347 at para 17. See also DoTaRS submission to the ACCC, which notes that: “... the trans-Tasman is a dynamic competitive market that has changed significantly since Virgin Blue and Emirates commenced serious initiatives...” (at page 2).

⁵⁹ DoTaRS submission to ACCC at page 3

⁶⁰ WIAL Submission at 262.

Blue and Emirates together have between 1/5th and 1/3rd of capacity on the routes on which they operate.

Table 1: MAT Capacity Shares to Feb 2006

City Pair	Virgin Blue's capacity shares	Emirates' capacity share	Combined capacity share
Auckland – Sydney	-	11.8%	11.8%
Auckland – Melbourne	-	20.5%	20.5%
Auckland – Brisbane	3.4%	22.1%	25.5%
Wellington – Brisbane	31.8%	-	31.8%
Christchurch – Sydney	10.9%	14.6%	25.5%
Christchurch – Melbourne	18.6%	18.0%	36.6%
Christchurch – Brisbane	33.7%	-	33.7%

There are no barriers to expansion on Tasman routes

76. As noted in paragraph 66 above, the fundamental issue in assessing the level of constraint imposed by the threat of potential expansion is “*whether competitors are able to grow*”. As Justice Miller stated recently in *Commerce Commission v New Zealand Bus Limited*, a case relied on by WIAL:

*“[t]he proposition that a firm’s market power depends substantially on the level of barriers to entry and expansion in the market is well established in New Zealand competition law”.*⁶¹

77. Third party submitters have not provided any meaningful evidence to support a conclusion that Emirates or Virgin Blue face barriers to entry or expansion. Indeed, the entry and successful expansion of Virgin Blue and Emirates to date is evidence that there are no barriers to entry or expansion on any Tasman route. This view is supported by Dr Tretheway who concludes in the Tretheway Report:

⁶¹ *Commerce Commission v New Zealand Bus Limited* (Unreported, 29 June 2006, High Court Wellington CIV 2006-485-585).at para. 146.

"It is my conclusion that there are no significant barriers to entry onto the trans-Tasman market. My opinion also extends to the cumulative height of entry barriers".

78. Notwithstanding the evidence of entry and expansion, WIAL point to the High Court's decision in *NZ Bus* to argue that practical likelihood of entry matters not a theoretical approach. The practical likelihood is that Virgin Blue will expand on the Tasman market if the Applicants give it an opportunity to do so. The ACT recognised this in its decision:

".....in the absence of barriers to expansion for Virgin Blue and Emirates, and given the capacity available to Virgin Blue and Emirates, we expect that the Alliance will be promptly and competitively constrained should it seek to raise fares" [emphasis added].⁶²

79. Various submitters have asserted that Virgin Blue, in particular, is not likely to expand (especially into Wellington).⁶³ However those submitters have provided no evidence to support their contention that Virgin Blue or Emirates would forfeit an opportunity to expand if the Applicants sought to raise prices to supra-competitive levels. As Virgin Blue's CEO has recently stated: "I'm interested in every single route that can make us some money".⁶⁴

80. (**Virgin Blue**) Virgin Blue is not the small fledgling airline which some submitters portray it to be:

- (a) While it is true that Virgin Blue only operates 737 aircraft, a single fleet type is one of the cost advantages that LCCs enjoy and leverage.⁶⁵
- (b) Virgin Blue has approximately 30% of the Australian domestic market⁶⁶ and operates a fleet of 50 Boeing 737s.
- (c) It has an established presence on many Tasman sectors, notably, a capacity share of 31.8% of the Wellington-Brisbane route and
- (d) It has a market capitalisation that exceeds Air NZ's.

81. Virgin Blue has the resources to expand in the event of any price rise. Some submitters have argued that Virgin Blue has shown no desire to expand on the Wellington-Brisbane route despite earning profits. This ignores the fact that Virgin Blue has a capacity share of 31.8% of that route already and the fact that the lure of economic profits drives entry and expansion decisions. The evidence demonstrates that neither of the Applicants is earning at or above economic returns on the Tasman.

⁶² Qantas/Air NZ Decision at para 445.

⁶³ WIAL Submission at 378-388, Wellington Chamber of Commerce 2, Business Hutt Valley and Hutt Valley Chamber of Commerce.

⁶⁴ Brett Godfrey, quoted in "Virgin in no hurry to launch US flights" Sydney Morning Herald, 26 July 2006.

⁶⁵ WIAL Submission at 356.

⁶⁶ A fact accepted by WIAL in its submission.

82. Nothing has occurred since the ACT decision which undermines the comments made under oath by Mr David Huttner to the ACT in respect of Virgin Blue:

“Virgin Blue/Pacific Blue is in a strong position to quickly enter or expand on any trans Tasman city pair. This is because:

- (a) it has a large Australian domestic network to provide feeder traffic to its trans Tasman services;
- (b) Pacific Blue now has strong brand recognition in New Zealand;
- (c) Pacific Blue has received all necessary regulatory approvals to provide these services;
- (d) it has access to sufficient aircraft and financial resources...; and
- (e) Pacific Blue has been able to gain access to slots and facilities...at Wellington, Christchurch and Auckland airports for the purposes of providing trans Tasman services”.⁶⁷

83. WIAL's submission that Virgin Blue will not seek to compete on the Tasman in favour of protecting its Australian domestic market share, or that it no longer has the drive to expand at management level, is simply unfounded.⁶⁸ Virgin Blue will consider entering any route if it can make a profit doing so.

84. (**Emirates**) Similarly there is no evidence that Emirates would not expand. It is not necessary as WIAL suggests that in order for it to expand, Emirates would have to run a new service from Dubai to Australia. Elsewhere in its submission WIAL claims that fifth-freedom operators, of which Emirates is one, operate low load factors on the Tasman. These unsold seats would provide the simplest mechanism for expansion should prices rise to supra-competitive levels.

85. In any event, two of Emirates' flights into Australia do not continue to New Zealand (Perth and Melbourne) and the Melbourne aircraft could be very easily deployed on the Tasman if a profitable opportunity presented itself. Indeed Emirates has sufficient flights into Australia to alter its Tasman route structure by deploying more or less capacity to specific New Zealand destinations in response to demand. In addition, it could deploy its presently unutilised Melbourne capacity into Christchurch or Auckland if prices increased to supra-competitive levels. The potential for Emirates to do so without any barriers is alone sufficient to constrain the Applicants in respect of both those cities.

⁶⁷ Affidavit of David Lee Huttner, 9 May 2004.

⁶⁸ WIAL Submission at 382 - 388.

86. **(No domestic entry)** WIAL states that entry in the New Zealand domestic market should have occurred if the Applicants' hypothesis that entry will occur when there are profits to be made was correct. The Applicants reiterate that it is economic returns that drive entry decisions. Furthermore, WIAL's analysis of fares per kilometre in the New Zealand domestic market compared with five Australian domestic routes is simplistic and cannot be relied upon:
- (a) It uses best available fares rather than average fares. As a result, it is extremely difficult to test the data set used. Average fares provide a more robust measure.
 - (b) The average stage length for domestic Australian sectors is substantially longer than in domestic New Zealand, which would account for the majority (if not all) of any difference in yield.
87. ACCC Commissioner Stephen King has rightly recognised that empirical analysis is only useful in decision making if it satisfied certain high standards.⁶⁹ WIAL's analysis does not meet those standards.

Emirates and Virgin Blue can constrain the pricing, capacity and scheduling decisions of the Applicants under the TNA

88. WIAL has criticised the ACT's analysis of the competitive constraint imposed upon Qantas and Air NZ by Emirates and Virgin Blue via competition for the marginal passenger. The strength of Virgin Blue's and Emirates' competitive constraint lies in the fact that they are each a genuine competitive alternative to the Applicants in the contest for the price-sensitive marginal passenger on the Tasman and the Applicants must respond to their pricing and initiatives.
89. Competition for the marginal passenger has an effect beyond the fares offered to these passengers. The ACT explained and endorsed this effect in the Qantas/Air NZ Decision:⁷⁰

"The competition for the customer at the margin does not stay with that customer, but those fares necessary to attract the marginal customers will be available to all buyers in the market. The competition for an extra 1% of market share has an advantage and benefit for all passengers who are within a similar passenger profile as the marginal passengers. All customers have the ability to get the same advantage and benefit. Therefore, the competition for the marginal passenger spreads throughout the market" [emphasis added].⁷¹

⁶⁹ King S "The Use of Empirical Methods in Merger Investigations" (2006) 34 ABLR 227.

⁷⁰ Qantas/Air NZ Decision at para. 429

⁷¹ It should be noted that though the "marginal passenger" is important to the ACT's decision, its economic analysis places most emphasis on (i) the absence of natural or strategic barriers to entry; (ii) the existence of two committed competitors in the form of Virgin Blue and Emirates; and (iii) the fact that those two competitors were in a position to expand their operations and were considered likely to do so in the face of the Applicants seeking to increase prices above the competitive level or reduce more than excess capacity.

90. In this competition for the marginal Tasman passenger, Virgin Blue and Emirates remain formidable competitors:

- (a) (**Virgin Blue**) Virgin Blue is fundamentally a low cost carrier with features that include point to point service offerings with no, or limited, connectivity with other flights. This means LCCs have a lower cost base than network airlines.⁷² Maintaining a low cost base that can drive affordable airfares continues to be a focus for Virgin Blue. Its "controllable" costs (i.e. excluding fuel) have continued to decline on a c/ASK basis, falling from 6.04c/ASK to 5.92c/ASK in the nine months to 30 June 2006 relative to the same period the year before (falling 2%).⁷³
- (b) (**Emirates**): It is Emirates' position as a fifth-freedom carrier that allows it to operate from a lower (marginal) cost base on the Tasman. The only costs associated with Emirates' Tasman services are those *additional* costs Emirates incurs by adding the Tasman sector to its original service originating from Dubai. Emirates incurs fixed costs irrespective of whether it operates a Tasman sector. As with Virgin Blue, this allows Emirates to offer Tasman services from a lower cost base while also being able to offer business and first class service. Emirates has publicly stated that its break-even Tasman load factor is 40%.⁷⁴

91. Though WIAL has argued that the Applicants' emphasis on the importance of the marginal customer is misplaced, its reasoning is incorrect and without foundation:

- (a) (**Fixed costs**) WIAL's claim that the Applicants do not necessarily face high fixed costs (which drives a focus on marginal cost pricing) is simply wrong. For reasons explained at paragraphs 40 to 42, the Applicants cannot make significant adjustments to their capacity in the short run. On any given schedule, costs are fixed.
- (b) (**Secured passengers**) Contrary to WIAL's suggestion, the Applicants do not have the luxury of ignoring the marginal customer on Tasman routes. WIAL's submission on this point is logically inconsistent and contradicted by a simple glance at the marketplace. Putting all else to one side, WIAL's submission requires acceptance of the proposition that the Applicants would be happy to forego additional profit by not chasing the marginal customer where they have unsold seats.
- (c) (**The marginal passenger**) The marginal passenger identified by the Applicants and acknowledged by the ACT is, quite simply, the price-sensitive Tasman origin/destination passenger. As noted in paragraphs 42 and 50 above, [CONFIDENTIAL] passengers of the Tasman are price sensitive passengers.

⁷² Qantas/Air NZ Decision at paras. 81-91.

⁷³ Virgin Blue's costs (inclusive of fuel) rose from 7.76c/ASK to 8.02c/ASK over the same period

⁷⁴ See n32 above.

- (d) (***Marginal customer is not a small part of Applicants' business***) As the ACT noted in the Qantas/Air NZ Decision,⁷⁵ the marginal customer is not a small part of the Applicants' respective businesses. Indeed the effect of Virgin Blue's and Emirates' entry on fares makes this readily apparent, as explained in the Tretheway Report. As WIAL itself notes, Tasman fares are much lower in 2006 than they were in 2002 prior to Virgin Blue and Emirates entering the market.
- (e) (***Price Discrimination***) The Applicants cannot target only marginal customers when offering airfares to the market at price levels designed to attract the marginal passenger, as these airfares will be available to all passengers.

⁷⁵ Qantas/Air NZ Decision at para. 399

ISSUE FIVE: THE TNA WILL NOT RESULT IN HIGHER FARES

92. For the reasons outlined in response to Issue Four above, the Applicants will not have an ability to increase fares (either headline fares or average fares) above competitive levels if the TNA is authorised by the Minister and the ACCC.
93. As WIAL itself accepts, there is no debate that prices on the Tasman came down a long way in 2003.⁷⁶ Yet WIAL also submits that “*Air NZ and Qantas have dominated the Tasman since its inception*”.⁷⁷ While Qantas and Air NZ have been competing on the Tasman for over 50 years, the critical question to ask is why did fares fall so materially in 2003, why have fares remained low since and what would the TNA change to allow fares to increase in the future?

Entry of Virgin Blue/Pacific Blue and Emirates has resulted in large price decreases

94. The cause of the large fall in fares in 2003 and the subsequent low fares since 2003 was the entry onto the Tasman of Virgin Blue and Emirates. Air NZ and Qantas both pre-emptively and competitively responded to the threat of Virgin Blue/Pacific Blue entry by overhauling their short haul product including introducing one way fares, materially reducing the complexity of their fare structures and lowering fares. In particular:
- (a) Air NZ reduced its headline fares by **[CONFIDENTIAL]**% on average – Tasman Express for example incorporated many of the hallmarks of the low cost carrier model; and
 - (b) Qantas launched Jetstar – a low cost carrier in its own right – in Australia and subsequently on selected Tasman routes and reduced its headline fares. For example, Qantas' lead-in fares on Auckland-Sydney were reduced by approximately **[CONFIDENTIAL]**%.
95. The entry of Virgin Blue and Emirates has also had a significant effect on average Tasman fares. This effect is evidenced by an analysis of the average fares in the main Tasman markets as illustrated in **Appendix D** and the Tretheway Report.

Day to day pricing constraint

96. The constraint imposed by Virgin Blue and Emirates can be seen in the day to day pricing policies of the Applicants. It should also be borne in mind that the threat of entry of Virgin Blue, and to a lesser extent Emirates, was the principal reason why Air NZ deployed the Express model on the Tasman.
97. **[CONFIDENTIAL]**
98. **[CONFIDENTIAL]**

⁷⁶ WIAL Submission at 202.

⁷⁷ WIAL Submission at 260.

99. [CONFIDENTIAL]

Tretheway Report

100. In the Tretheway Report prepared for Air NZ, Dr Tretheway concludes that:

- *"The effect of the presence of Pacific Blue or Emirates was to reduce average fares on trans-Tasman routes. This finding was consistent over variations of the statistical analysis and was highly statistically significant".⁷⁸*
- *"...the impact of Virgin Blue and Emirates is felt in a sizeable way even on routes they do not serve. All of these fare reducing effects are larger than any potential effect from the market concentration measure".⁷⁹*
- *"It is my opinion that the statistical evidence does not support a finding that higher concentration leads to higher fares on trans-Tasman routes. No statistically significant result was obtained".⁸⁰*
- *"Market concentration has little or no impact on average airline fares in markets where an LCC is present. Of far greater importance for the impact of market structure on average airline fares is the presence or absence of a low cost carrier on a route".⁸¹*

101. Dr Tretheway's analysis demonstrates that:

- (a) The presence of Virgin Blue and Emirates on Tasman routes decreases the average one way Tasman fare even on routes on which neither airline operates by A\$24.91 (approximately NZ\$29.64),⁸²
- (b) If Emirates or Virgin Blue operate on a route but have a capacity share of less than 12.5%, then average one way fares are decreased by A\$36.87 (approximately NZ\$43.88);
- (c) If Emirates or Virgin Blue operate on a route and have a capacity share of between 12.5% and 25%, then average one way fares are decreased by A\$42.88 (approximately NZ\$51.03); and
- (d) If Emirates or Virgin Blue operate on a route and have a capacity share of more than 25%, then average one way fares are decreased by A\$66.07 (approximately NZ\$78.62).

⁷⁸ Tretheway Report at 2.2.14.

⁷⁹ Tretheway Report at 2.2.19.

⁸⁰ Tretheway Report at 2.2.15.

⁸¹ Tretheway Report at 2.2.17.

⁸² Converted at NZ\$1 buys A\$0.84 as at 21/8/2006.

102. Air NZ submits that Dr Tretheway's report and the average fare information outlined in **Appendix D** undermine WIAL's suggestions that Emirates and Virgin Blue/Pacific Blue are weak competitors in the Tasman market⁸³ or that their constraint is limited,⁸⁴ or the implication that it was continued competition between Air NZ and Qantas that suddenly caused a dichotomy shift in the method by which airlines compete in the Tasman market and the resulting changes in price structure. Furthermore, for the reasons outlined below, the evidence relied on by WIAL to suggest that the TNA will result in supra-competitive price increases is fundamentally flawed.

No inherent or automatic link between capacity reductions and fare increases

103. A number of submitters have suggested that the capacity reductions associated with the TNA must necessarily lead to increases in average fares.⁸⁵ There is no such inherent link between capacity and average fare levels. In the first place, capacity that is removed under the TNA is surplus capacity. Secondly, as explained by Dr Tretheway in the Tretheway Response to LECG:

“2.4.9 Under the TNA, the joint trans-Tasman operations of Air New Zealand and Qantas will be much larger than their current separate operations, which will enable each airline to more accurately forecast late booking demand. This will lead both carriers' seat management systems to protect fewer seats, and will result in a greater average percentage of seats sold per flight, with the increase concentrated in the lower fare classes.

2.4.10 In simple language, the pooling of traffic under the TNA will allow the carriers to increase their load factors.

2.4.11 This is a well known phenomenon in the industry and among mathematicians who develop seat management systems. It is one of the keys to understanding why the proposed TNA will produce benefits. Under the TNA, capacity, and associated costs, can be removed from the market (creating a public benefit) without a corresponding reduction in consumer demand served. Costs will be reduced and load factors will go up, removing the basis for the argument put forth by LECG that capacity reduction under the TNA must imply higher fares.

2.4.12 The reduction in seat capacity in the market under the TNA does not result in a corresponding reduction in seats sold. This in turn means that the increase in fares as a matter of tautology, which LECG claims will occur under the TNA, is incorrect” [emphasis added].

⁸³ WIAL Submission at 269.

⁸⁴ See for example, WIAL Submission at 366-367, TAANZ 2.

⁸⁵ WIAL Submission, LECG Report, New Zealand Hotel Council, TAANZ 2, and submissions from various members of the public.

LECG's analysis of likely price impacts of the TNA is erroneous

104. LECG also claims that fares on the Wellington-Sydney and Wellington-Melbourne routes will increase by 19% under the TNA. LECG make this claim relying on the Cournot model used by the New Zealand Commerce Commission during its investigation of the previous proposed alliance. As noted by the ACT and the New Zealand High Court, the use of the Cournot model in this context is flawed:

- (a) (**The ACT**) The ACT noted the following regarding the Cournot model presented by Professor Hazledine (Professor Hazledine's model was for current purposes identical to the model used by LECG and the Commerce Commission):

"We have formed the view that Professor Hazledine's modelling did not take account of the actual or potential interactive rivalry between the incumbents, new entrants, and potential entrants, and proceeded mechanistically to its conclusions based on static and structural assumed market share parameters. In such circumstances, we regard Professor Hazledine's evidence as having little probative value" [emphasis added].⁸⁶

105. The accuracy of the ACT's assessment is illustrated by the fact that LECG's analysis assumes that there will never be competition from Virgin Blue on the routes under investigation (Wellington-Sydney and Wellington-Melbourne routes), regardless of whether or not the TNA is authorised or the magnitude of price increases predicted by the model.

- (a) (**High Court**) The New Zealand High Court concluded:

"The limitations of the Cournot model (and its implementation) have been clearly shown. It has been inadequate to deal with the complexities of dynamic markets, particularly the interactions between established FSAs and an LCC newcomer. It has been unable to capture the reactions of players to one another let alone the overall dynamism of the airline industry. In addition, the simplifying assumptions required have severely limited the model's ability to replicate realworld outcomes" [emphasis added].⁸⁷

106. Furthermore, in the Tretheway Response to LECG, Dr Tretheway outlines the problems inherent in using Cournot models for predicting aviation market outcomes in general, and LECG's application of that model in particular. Notably, Dr Tretheway states⁸⁸:

"More importantly, their model assumes that there will be and can be no entry by competitors. This is a critical and fatal flaw in this approach. It essentially assumes the answer they are supposed to investigate. They must find large competitive detriment since

⁸⁶ Qantas/Air NZ Decision at para. 347.

⁸⁷ *Air New Zealand & Others v Commerce Commission & Others* (No 6) (2004) 11 TCLR 347 at paragraph 269.

⁸⁸ Tretheway Response to LECG at 3.5.8.

their model has no alternative. The model cannot allow for any other possibility and thus cannot test for or investigate in any other way, alternative outcomes in the market other than monopoly" [emphasis added].

107. Finally, WIAL claims that LECG's route substitution analysis indicates that the Applicants could increase the lowest available fares from Wellington to Sydney by "at least 46%".⁸⁹ This would amount to a very significant price increase in the lowest available fares (for Air NZ, this would be approximately [CONFIDENTIAL] on a G Smart Saver one way fare) without attracting any entry. All else being equal (including fuel costs), the commercial likelihood of prices rising by 46% and entry not occurring where there are no barriers to entry can safely be assumed to be zero. This constraining impact of the threat of entry was recognised by the Mayor of Porirua in her submission.

Professor Hazledine's analysis

108. The Applicants do not agree with the analysis of Professor Hazledine in his unpublished work, which WIAL has attached to its submission. The Tretheway Report explains why the analysis conducted by Professor Hazledine is wrong and concludes that the statistical evidence does not support a finding that higher concentration automatically leads to higher fares on trans-Tasman routes.⁹⁰ In summary, the analysis is overly simplistic in its approach and does not take account of a number of important features of the market. Dr Tretheway concludes:

"It is my opinion that the statistical evidence does not support a finding that higher concentration leads to higher fares on trans-Tasman routes. No statistically significant result was obtained".⁹¹

And:

"These results are consistent with the findings in the academic/professional literature. That is, a large and seemingly statistically significant impact of market concentration on airline fares can be found with simplistic analysis, but these findings are spurious. But, after controlling for route distance, the presence of a low cost carrier, time trends and seasonal variation, this result disappears. Market concentration has little or no impact on average airline fares in markets where an LCC is present. Of far greater importance for the impact of market structure on average airline fares is the presence or absence of a low cost carrier on a route".⁹²

⁸⁹ WIAL Submission at 465.

⁹⁰ Tretheway Report at 2.2.15.

⁹¹ Tretheway Report at 2.2.15.

⁹² Tretheway Report at 2.2.17.

ISSUE SIX: THE "COUNTERFACTUAL"

109. WIAL proposes a range of alternative scenarios as possible counterfactuals to the TNA. In each case, there is no supporting material provided beyond WIAL's speculation. The discussion of these hypothetical scenarios does not accord with WIAL's requests elsewhere that the Minister should consider practical likelihoods. WIAL's proposed counterfactuals should be dismissed as uninformed speculation made without the benefit of knowledge of the Applicants' internal strategic and financial positions rather than a considered and *likely* "future without" the TNA. However, the Applicants do agree with the comments of the Mayor of Porirua that the issue of sustainability of services is a key issue and note the Tourism Industry Association and Invercargill Airport Limited's acceptance that the status quo is not sustainable.
110. The Applicants each provided a considered analysis of each airline's likely conduct in the event the TNA is not implemented in response to Question 16 from the Ministry and Question 19 from the ACCC (provided to the Ministry).

ISSUE SEVEN: PUBLIC BENEFITS

111. The TNA will provide demonstrable benefits for New Zealand and New Zealand consumers. WIAL have sought to raise concerns in relation to all the benefits identified by the Applicants. The Applicants do not believe that any of the concerns raised are sustainable on the evidence before the Ministry.

Public benefits in general

112. A particular issue raised by a number of submitters relates to the correct approach the Minister should take in assessing the costs and benefits of the TNA. MED notes in its submission that the public interest is the relevant factor that the Minister may take into account. Likewise, the Treasury notes that: "*regulatory policy and enforcement should act in New Zealand's public interest*".

113. The Treasury goes on to note that the public interest test counts all material changes in private interests. The Applicants agree that this is the correct approach. This approach does not take account of distributional transfers within New Zealand; it is the change in New Zealand's total welfare that is relevant. Accordingly, the Applicants note:

- (a) WIAL states in its submission that the CAA requires the Minister to protect consumers and this imposes a higher test than a net public benefit test proposed by the Applicants.⁹³ It is not clear how this statement accords with WIAL's earlier statement that the Minister must exercise his discretion in the public interest.⁹⁴ WIAL's former statement seems to suggest that the Minister should apply a consumer surplus test in determining whether to authorise the TNA. This submission is in contrast to that of the Treasury which states in its submission its position that "*the long term interests of consumers in New Zealand are in fact equivalent to New Zealand public interests*".⁹⁵ The Applicants agree with Treasury's statement and note that this is the approach consistently applied by the courts⁹⁶ and by the Commerce Commission when assessing authorisations under the Commerce Act.
- (b) A number of submitters have asked the Minister to take a regional approach and decline authorisation on the basis that their region might be detrimentally affected. The Applicants note in particular the statement by the Mayor of Porirua that the TNA should be authorised if it "*does not act to the detriment of the interests of the region, compared to viable alternatives*". The Applicants agree with that statement provided the word "region" is read as New Zealand.

⁹³ WIAL Submission at 447.

⁹⁴ WIAL Submission at 22(c).

⁹⁵ Treasury Submission at page 2.

⁹⁶ See *Air New Zealand v Commerce Commission* at 241.

Public benefits not achievable other than through the TNA

114. MED argues that the correct test is whether the TNA is the **only** way the Applicants can achieve the benefits claimed.
115. WIAL argues that the TNA is not necessary for the realisation of the claimed public benefits. The Applicants reiterate that there are demonstrable benefits arising from the TNA that will not be realised if the TNA does not proceed.
116. It is always possible to theorise on the potential ways in which these benefits could be otherwise achieved, but the commercial reality is that these benefits will not be achieved absent the TNA. In much the same way as WIAL urges the Minister to focus on the practical likelihood of entry,⁹⁷ the question is whether there is practical likelihood that these benefits would arise absent the TNA. In that respect the Applicants submit that the MED's insertion of the requirement that benefits **only** be achieved via the TNA should be read as the benefits are only commercially viable and likely way the Applicants can achieve those benefits. The benefits would not otherwise be realised. The TNA and the package of benefits flowing from it is the only commercial deal negotiated between the Applicants.

National interest and New Zealand's connectivity with the world

117. The airlines agree with WIAL's submission that improving New Zealand's connectivity to the rest of the world is an important factor in New Zealand's ongoing national growth. It is difficult to reconcile that statement with WIAL's later submission that New Zealand's national interest is not served by the TNA.⁹⁸
118. Air NZ is the major promoter of New Zealand worldwide and, in this way, contributes significantly to New Zealand's economic growth and prospects. Air NZ agrees with and supports the comments of the Tourism Industry Association that a strong national carrier is critical to continuing to promote New Zealand as a tourist destination.⁹⁹ In turn, this will have positive effects on the New Zealand economy.

WIAL's other specific concerns

119. The Applicants consider that WIAL's concerns with respect to the public benefits arising from the TNA are unfounded:
- (a) **(Increased efficiency via cost reduction)** WIAL submits that the cost savings identified by the Applicants will be achieved if the TNA does not proceed.¹⁰⁰ In addition, WIAL states

⁹⁷ WIAL Submission at 352.

⁹⁸ WIAL Submission at 436-437.

⁹⁹ Tourism Industry Association Submission.

¹⁰⁰ WIAL Submission at 413-414.

that the payment of NZ\$98m by Air NZ to Qantas undermines Air NZ's cost savings argument.

For the reasons outlined at paragraph 40 above, unilateral capacity reductions can only be achieved up to a point before a network airline suffers significant damage to its wider network. Unilateral capacity reductions of the extent contemplated in the TNA will not occur in the counterfactual.

The issue of the payment by Air NZ to Qantas has been dealt with above at paragraph 46.

- (b) (***Better schedule spread for consumers – removal of wing-tip flying***) Although WIAL acknowledges that a reduction in wingtip flying would be of benefit to consumers, it also submits that the proposed TNA schedules show an increase in wingtip flying out of Christchurch and that removal of wingtip flying has costs for consumers. WIAL state that “airlines fly wingtip to wingtip in part because those are at the times when consumers most want to fly”.¹⁰¹

The Applicants operate at certain peak times because it is at those times that there is the greatest amount of high-yield traffic. The majority of passengers in the Tasman markets are leisure passengers who are willing to trade price for time of departure.¹⁰² That is a 0600 departure might gain the passenger travelling on business wishing to commute to Sydney for a day's business, but it would not ultimately deter a leisure passenger provided the price was right. These passengers will benefit from the greater spread of flights which will result from the reduction of wingtip flying. For example, a passenger would be able to catch an afternoon departure instead of an early morning departure.

Individually the Applicants will not alter these high-yield flights because in doing so they would cede these high yielding passengers to the other airline. While they might pick up more leisure passengers who prefer a more convenient departure time, this increase in patronage is unlikely to offset the revenue decrease from removing the early morning departure.

In addition, the Applicants would be unlikely to introduce a mid to late morning departure in Christchurch or Wellington because it would have a negative effect on aircraft utilisation. An early morning New Zealand departure allows the carrier to achieve two return Tasman flights per day (four sectors). A mid-morning departure would reduce utilisation (particularly given the single class domestic configuration offered by both Applicants).

¹⁰¹ WIAL Submission at 418.

¹⁰² Indeed WIAL in its email to the Ministry dated 27 April 2006 notes that early morning departures are not good for leisure passengers.

The benefits of reduced wing-tip flying are accepted by the Mayor of Porirua in her submission.

- (c) (**Connectivity/seamless travel experience**) WIAL have submitted that the Applicants already do a good job of providing connectivity on the Tasman. This is true for a passenger travelling from one of the main centres in New Zealand or travelling to either Sydney, Melbourne or Brisbane. Nevertheless the TNA will greatly improve the product able to be offered to a customer travelling from outside of Auckland, Wellington or Christchurch to an Australian destination other than Sydney, Melbourne or Brisbane. These benefits were fully set out in the Applicants Application for Authorisation at paragraphs 7.10-7.13.

The benefit of greater seamless travel was accepted by the Commerce Commission and the High Court in the context of the previous proposed Alliance. The High Court accepted that in that context there were “substantial online benefits” and that they should be given: “considerable weight in the final analysis”.¹⁰³

- (d) (**Greater flexibility for consumers to change itineraries**) This is a real benefit for consumers and is closely aligned with the better schedule spread that the Applicants will be able to offer under the Alliance. The TNA will not reduce overall choice as submitted by WIAL.¹⁰⁴ A passenger wishing to change flights on a particular day will have a greater range of flights to choose from. The business passenger travelling from Wellington to Sydney depicted in WIAL's submission would have the option of returning to Wellington during the day rather than at the extreme ends of the day as is currently the option.
- (e) (**Frequent flyer benefits**) Contrary to WIAL's submission¹⁰⁵ there is no incentive for the Applicants to agree a reciprocal arrangement for their respective frequent flyer programmes absent the TNA. The TNA will increase the number of Air NZ coded flights on which New Zealand members of Air NZ's Airpoints programme, and the number of Qantas coded flights on which New Zealand members of Qantas' frequent flyer programme, can earn and redeem points. In Air NZ's case this increase amounts to 63% over current schedules.
- (f) (**Reduced fuel burn and carbon emissions**) The figure of 15.87m litres of fuel, which would not be burned if the TNA proceeds, is compared to the Applicants' counterfactual schedules.

¹⁰³ *Air New Zealand v Commerce Commission* at 410.

¹⁰⁴ WIAL Submission at 424-425.

¹⁰⁵ WIAL Submission at 427.

TNA will not result in public detriments

120. The TNA will not result in any net public detriments. The Applicants do not consider that they will be able to increase prices to supra-competitive levels if the TNA proceeds due to the constraint imposed by Emirates and Virgin Blue.

Incentives in the revenue sharing mechanism

121. WIAL submits that the revenue sharing mechanism in the TNA will encourage the Applicants to reduce costs and capacity at the expense of the travelling public.¹⁰⁶ LECG also submits that the Applicants would race to offer minimum quality and would minimise the marketing of New Zealand as a destination.¹⁰⁷ There will not be any such incentives under the TNA because:

- (a) (**Variable cost adjustment**) The TNA Payment Model contains a variable cost adjustment for flight variable costs (i.e., the incremental cost of carrying an additional passenger). This means that if either Applicant (the **Operating Carrier**) carries a load disproportional to its historical load (because the other airline (the **Marketing Carrier**) has been selling actively on the Operating Carrier's flights), then the Marketing Carrier is required to compensate the Operating Carrier for this adjustment in cost.
- (b) (**Tasman market only**) The TNA covers the Tasman market only. Both airlines are fundamentally network airlines and operate in extremely competitive global markets. A key competitive driver for the Applicants is to deliver a consistent and compelling service and product offering across the network. The Applicants would have no incentive to simply neglect the Tasman or allow poor service to pervade its Tasman offering as this would most likely result in a loss of custom on other routes. This point was also recognised and accepted by the ACT in the context of productive efficiencies, although it is equally applicable to LECG's argument:

"...being a network carrier, Qantas cannot have x-inefficiency on one route without it spreading to all routes. It would not, therefore, be commercially rational for Qantas to let costs rise on the trans-Tasman routes".¹⁰⁸

- (c) (**There is actual competition on the Tasman**) Of the ten main Tasman routes (including Auckland-Adelaide), there are only three on which the Applicants are the only current operators. All Tasman routes will remain competitive and contestable under the TNA such that any reduction in service standards or marketing would only tend to encourage competitive entry or expansion (particularly if combined with the massive price increases WIAL is predicting). Whatever incentives might theoretically exist (and the Applicants

¹⁰⁶ WIAL Submission at 74.

¹⁰⁷ LECG Report at 5.1 and 5.2.

¹⁰⁸ Qantas/Air NZ Decision at para. 484.

believe there are none), the ability for the Applicants to manipulate service levels to ensure that service standards are maintained on seven routes but reduced on two is non-existent.

- (d) (**Net revenue includes commissions**) At a more practical level, revenue in the TNA Payment Model is Net Revenue. Because of this, the Applicants will continue to compete for travel trade (or travel agent) business because these deals tend to be struck on a “network wide” basis and are not specific to the Tasman.
- (e) (**Reduced marketing incentives**) There is quite simply no reason to believe that Air NZ will promote New Zealand any less under the TNA. As noted by Dr Tretheway:

“...[LECG’s] ‘analysis’ is dependent on a single hypothetical example with outlandish numbers. Other hypothetical examples could be created with other numbers which would lead to opposite conclusions....Hypothetical answers do not constitute evidence as to what is likely to happen in the trans-Tasman market if the Alliance were to be approved” [emphasis added].¹⁰⁹

Spill-over into domestic market

122. A number of submitters have raised concerns that authorisation of the TNA will provide a platform for the Applicants to reach an agreement or understanding to compete less actively in the domestic market.¹¹⁰ Qantas and Air NZ will continue to compete on all services other than the Tasman – including domestic New Zealand routes and internationally. The TNA does not enhance the incentives for either airline to reach a collusive agreement in domestic New Zealand or on any other market as compared to the counterfactual. It does not enhance any of the factors listed in the Commerce Commission’s mergers and acquisitions guidelines as being likely to lead to collusion.¹¹¹

¹⁰⁹ Tretheway Response to LECG at 3.2.3 – 3.2.4.

¹¹⁰ WIAL Submission, Rotorua Airport Submission, Ministry of Economic Development.

¹¹¹ See Commission’s Mergers and Acquisitions Guidelines at section 9.

Schedule 1: Applicants' response to clarifications sought by the Ministry

Fundamentally, the Applicants have developed the TNA as a method to reduce the unsustainable cost associated with surplus capacity currently operating on the Tasman, but in a way that advantages both the Applicants and their customers. All of the provisions in the TNA facilitate, or are required in order to give effect to, the contract by which this fundamental objective can be achieved. Specific clauses cited by the Ministry, which are discussed below, fall into this category of clauses and, accordingly, directly or indirectly relate to the fixing of tariffs or capacity. These clauses simply provide examples of how all the clauses of the TNA must be viewed in the context of the entire agreement.

Fixing of capacity

At the core of the TNA is a free-sell code-share agreement between Air NZ and Qantas supported by scheduling, revenue and pricing arrangements, where the parties sell onto each other's flights without preference as to which carrier is operating the flight. This allows the Applicants to operate a combined network that improves the spread of flights throughout the day, provides more same day return options and an improved range of connecting services (**clause 2.2**).

Achieving "sales without preference" requires each airline to be comfortable that irrespective of which carrier is operating the flight, customers will enjoy a consistent and relatively seamless level of service. This in turn will enable capacity deployment under the TNA to be planned effectively. From an operational standpoint this requires the Applicants to agree:

- the minimum standard of in-flight service a customer can expect (food, entertainment, seating);
- the minimum customer service standards that will be provided (both generically, and for specific customer types) including:
 - how baggage will be managed and lost baggage recovered (**clause 7, schedule 1**);
 - how high value tier customers (for whom consistency of service is key) will be managed and what privileges they are entitled to (**clause 6.10**); and
 - how staff should be treated and what privileges they should have access to (**clause 3.2**).

From a selling perspective, achieving sales without preference requires that:

- **[CONFIDENTIAL]**
- Sales teams do not remain biased to flights operated by their carrier and that those teams are incentivised to sell the benefits of the combined network irrespective of which carrier operates which flights (**clause 6.1, schedule 2**).

From a regulatory perspective, the carriers need to clearly understand under the codeshare, where responsibilities lie. This includes responsibilities for operating aircraft, maintaining aircraft, managing crew, managing disrupts, conducting adequate security checks (e.g., **clause 4.4, schedule 1**).

Jetstar and Freedom form part of the combined network, and their deployment is key to its optimisation. While not part of the code-share (for systems, business model or customer expectation reasons) the parties have expressly agreed that their FSAs will promote the services of the LCCs (**clause 6.8**), to ensure that the network in its entirety benefits from the combined selling power generated by capacity sharing under the TNA. This will:

- mean provincial services (with thin demand) may become viable;
- improve the potential for capacity to be deployed onto new routes; and
- allow the parties to increase their deployment of the LCCs through the network, if and where appropriate.

Each of the aspects of the TNA noted above is therefore indirectly related to the setting of capacity.

Fixing of Tariffs:

The TNA contains a number of clauses with regard to the setting of tariffs, including:

- **[CONFIDENTIAL]**
- **Clause 5.3 (g) schedule 2** – Marketing and Tactical Advertising plans: this clause is indirectly related to the setting of tariffs, as it provides the ability for the Applicants to formulate both tactical and year round pricing initiatives and as part of that programme, agree both the most effective timing of, and basis for, communicating these to customers.
- **Clause 3.2** – Staff and Duty Travel: this clause directly relates to the setting of tariffs, as it contemplates both the valuation and the mix of fares sold to staff of either airline (for personal or business reasons).

Appendix A: List of Submitters

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|--|-------------------------------|
| Business Hutt Valley and Hutt Valley Chamber of Commerce | ▪ Letter dated 31 July 2006 |
| Hamilton International Airport | ▪ Letter dated 25 July 2006 |
| Invercargill Airport Limited | ▪ Letter dated 9 May 2006 |
| Jumpjet Airlines Limited | ▪ Letter dated 12 May 2006 |
| Mayor of Porirua | ▪ Letter dated 14 August 2006 |
| Mayor of Rotorua | ▪ Letter dated 8 May 2006 |
| Members of the Public | ▪ Letter dated May 2006 |
| | ▪ Letter dated 1 May 2006 |
| | ▪ Email dated 3 May 2006 (x4) |
| | ▪ Letter dated 5 May 2006 |
| | ▪ Email dated 5 May 2006 |
| | ▪ Email dated 8 May 2006 |
| | ▪ Email dated 13 May 2006 |
| | ▪ Letter dated 28 July 2006 |
| | ▪ Letter dated 11 August 2006 |
| Ministry of Economic Development | ▪ Letter dated 28 July 2006 |
| New Zealand Hotel Council | ▪ Letter dated 31 July 2006 |
| Positively Wellington Tourism | ▪ Letter dated 31 July 2006 |
| Private Company | ▪ Email dated 28 April 2006 |
| | ▪ Letter dated 1 May 2006 |
| Rotorua Regional Airport | ▪ Letter dated 28 July 2006 |

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| South Australian Minister for Transport | ▪ Letter dated May 2006 |
| The Treasury | ▪ Letter dated 2 August 2006 |
| Tourism Industry Association | ▪ Letter dated 26 July 2006 |
| Travel Agents Association of New Zealand
(TAANZ) | ▪ Letter dated 20 June 2006
▪ Letter dated 31 July 2006 |
| Wellington Chamber of Commerce | ▪ Letter dated 18 April 2006
▪ Letter dated 18 May 2006
▪ Letter dated 31 July 2006 |
| Wellington International Airport Limited (WIAL) | ▪ Email dated 27 April 2006
▪ Letter (Chapman Tripp) dated 24 May 2006
▪ Letter (Chapman Tripp) dated 1 June 2006
▪ Letter (Chapman Tripp) dated 19 June 2006
▪ Letter (Chapman Tripp) dated 30 June 2006
▪ Submission dated 31 July 2006 |
| Wellington Mayoral Forum | ▪ Letter dated 4 August 2006 |

This submission also responds to the draft papers of Professor Hazledine, which have been submitted to the Ministry.

Appendix B: Air NZ Tactical Activity on Main Tasman Routes¹ (Dec '05 – May '06)

Sale	New Year Sale	Aussie Beach Break	Worldwide Sale	48 Hour Sale	South-East Queensland Sale
Sale Period	26 Dec – 24 Jan	29 Jan – 14 Feb	22 Feb – 24 Mar	26 Mar – 27 Mar	18 Apr – 5 May
AKL-BNE	189	189	189	159	189
AKL-MEL	189	-	189	159	-
AKL-SYD	189	-	189	159	-
WLG-BNE	189	189	189	159	189
WLG-MEL	189	-	189	159	-
WLG-SYD	189	-	189	159	-
CHC-BNE	189	189	189	159	189
CHC-MEL	189	-	189	159	-
CHC-SYD	189	-	189	159	-

1. Advertised NZ\$ fares ex-NZ one way including fuel surcharge

Appendix C: Qantas' sale fare activity (December 2005 – May 2006)

Sale	Red e-Sale		New Year Sale			Red e-Sale	Red e-Sale	Red e-Sale	Red e-Sale			Red e-Sale	Red e-Sale
	01/12–07/12	08/12–16/12	29/12–02/01	03/01–04/01	05/01–06/01	10/02–15/03	28/02–15/03	17/03 – 21/03	22/03 – 09/04	10/04 – 16/04	22/03 – 19/03	20/04 – 30/04	08/05 – 19/05
BNE-AKL	-	-	-	-	-	-	137	117	137	137	-	137	130
MEL-AKL	160	137	159	140	125	169	140	-	-	-	140	140	133
SYD-AKL	156	127	149	135	120	159	134	-	-	-	134	134	127
BNE-WLG	137	137	159	137	122	169	137	117	137	137	-	-	130
MEL-WLG	160	137	159	140	125	169	140	-	-	-	140	-	133
SYD-WLG	156	127	149	135	120	159	134	-	-	-	134	134	127
BNE-CHC ²	-	-	-	-	-	-	-	-	-	-	-	-	-
MEL-CHC ²	-	-	-	-	-	-	-	-	-	-	-	-	-
SYD-CHC ²	-	-	-	-	-	-	-	-	-	-	-	-	-

1. Advertised A\$ fares one way (base fares only – i.e. excludes taxes, levies and charges), POS Australia

2. The Christchurch routes do not have Qantas sale fare activity, as they are predominantly flown by Jetstar

Appendix D: Air NZ's average Tasman fares [CONFIDENTIAL]

