



McGregor & Company

ADVISERS & ANALYSTS SPECIALISING IN CIVIL AVIATION AND AIR TRANSPORT

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John Macilree
Principal Adviser
Air Services Team
Ministry of Transport
89 The Terrace
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WELLINGTON

Dear Mr Macilree

**International Air Carriage Competition
Application by Air New Zealand & Qantas concerning Trans Tasman Air Services**

This concerns the application by Air New Zealand and Qantas to combine their international air services and agree on air fares *et al* between Australia and New Zealand. It is generally accepted that competition is good for consumers (users) but not necessarily so good for airlines. It is also widely accepted that cartels or collusive oligopolies are not necessarily good for consumers but good for suppliers (airlines). So that any combination of or reduction in air services and any agreement on prices could (will) be to the detriment of consumers and to the benefit of the colluding or collaborating airlines. In turn, if the application is an arrangement to lessen competition then this may very well be such a case and the proposed collaborative arrangements would likely only benefit the applicant airlines.

Since its filing on 18th April 2006 a number of submissions have been made by interested parties to either support or oppose the application. In particular there have been submissions by experts [economists] supporting or refuting various claims made by the applicants or made by an interested party. Interested parties include airports, the general public, lobby groups or industry associations, local governments, *etc*. The government is a substantial securities holder in Air New Zealand with its 80% ownership and so is also an interested party; the government (Minister of Transport) is also the licensing (authorising) authority for this application.

Naturally claims made by the applicants, interested parties and their supporting 'experts', in one way or another, are aimed at either preventing the dilution of wealth (revenue and profit) from themselves to others or arguing that there will be a diminution of competition to the detriment of consumers or alternatively current market power will be unaffected. Much of the claims concern whether or not air



fares will increase. It has already been stated by the applicant airlines that capacity (services) will be reduced; this is part of the application.

Despite these claims and counter claims one can never be certain what actually will happen as a result of a particular decision or course of action. The best attempts by 'experts' to model what actually goes on in a market can be thwarted because the way things happen in practice are too complex to analyse in complete detail. The point is assumptions are made and 'an orderly loss of information' occurs in the construction of theoretical economic models to explain market behaviour. In particular assumptions are made about the behaviour of individuals, groups of individuals and firms. This usually concerns concepts of optimisation, maximisation and minimisation dealing with well-being for individuals and groups, profits or costs for firms and, for governments, welfare or national benefit. Furthermore, the assumption of 'all other things being equal' is commonly made because in practice some 'things' [influencing factors] cannot be isolated and controlled. The result is a reasonable assessment or picture of what the story is, but no more than that – even though observation of cartels and similar arrangements generally leads to the conclusion that prices tend to increase, often for no apparent reason, and capacity is held 'in check' or otherwise withheld. Regardless it cannot be claimed for certain that this or that will happen even though it is more likely to than not.

This brings us to the question of setting prices (air fares). In practice there are only three ways of setting prices: *cost-plus* approach, *competitive* approach and *value-added* approach. The cost-plus approach tends to be common in regulated markets or in the absence of competition, where prices are based on (own) costs with a mark-up that is either arbitrary or what the market will bear (target rate of return is merely a variation of this as internal costs are its basis). The competitive approach simply matches or betters competitors' prices and makes the assumption that competitors' operations and costs are similar in all ways (not unreasonable for airlines). This is what currently happens in the trans Tasman air transport market. The value-added approach bases prices on the value consumers place on the service (or product). This can be a more difficult and sophisticated method of pricing but is sometimes used for package tours and promotional fares; low-cost airlines tend towards this approach.

So, if competition is diluted or absent Air New Zealand and Qantas would naturally move to increase prices (towards cost-plus) while reducing capacity (services), which they have already stated they will do (*ie* capacity).

This brings us back to the application by Air New Zealand and Qantas to effectively combine their international air services and agree on air fares. Claims, counter claims and counter-counter claims are made by reputable experts; in all but one case they represent firms with vested interests. There is more or less merit on both sides of their arguments. So who do you believe? And, if the 'experiment' or collaborative arrangement is successful for Air New Zealand and Qantas, what next ... the New Zealand domestic air transport market?

As we have said, who do you believe, which arguments and claims are closer to the truth of the matter? As we have also said, there is no way of telling what will actually happen. So, if the Minister and his advisers are unable to make a clear



judgement as to what is in the best interests of New Zealand (as opposed to consumers or the airlines or both) then the authorisation of a short (12 month) probationary arrangement might be considered. This would grant the airlines the opportunity to prove their claims and enable those with opposing interests to closely observe whether such a test proves their respective claims. Furthermore matters of tariffs, capacity, traffic and yields be recorded throughout this period after which a decision can be made on what happens in practice rather than what it is claimed will happen. Depending on what happens the airlines could then be authorised for another 12 months or not, and so on.

Yours sincerely

A handwritten signature in blue ink that reads "M E Murray".

Michael Murray
Principal