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8 September 2006

John MacIlree  
Principal Adviser, Air Service  
Ministry of Transport  
PO Box 3175  
Wellington

Dear Mr MacIlree

**AIR NEW ZEALAND / QANTAS APPLICATION - COUNTERFACTUAL**

- 1 We refer to your letter of 25 August 2006. You have asked for our view of the "counterfactual" scenario in relation to the proposed Tasman Networks Agreement (*TNA*) between Qantas and Air New Zealand (the *Applicants*). That is, what is likely to occur in affected markets in the absence of the TNA.
- 2 Below, we begin by outlining the law regarding counterfactual analysis. We then reiterate our view of the counterfactual, effectively as provided already in our client's submission of 31 July 2006. For ease of reference, the relevant part of Wellington International Airport Limited's (*WIAL*) submission is **attached** as an appendix to this letter.

**Summary**

- 3 The law in relation to assessing the counterfactual for competition law purposes is clear and directly relevant here. The counterfactual is the decision maker's pragmatic and commercial assessment of what is likely to occur in the absence of the proposed arrangement.

- 4 Importantly, the counterfactual is concerned with probabilities, not ephemeral possibilities.
- 5 And crucially, the counterfactual is neither the decision maker's own preferred market structure, nor the applicant's view of the future if it is denied the indulgence it is seeking. In this case, that indulgence would be the exemption of the Applicants, for the TNA, from the Commerce Act constraints and obligations applicable to all other firms and individuals trading in, into or from New Zealand.
- 6 The Applicants themselves have been remarkably coy – at least publicly – about their own view of the future without the TNA. Their application to the ACCC referred to "... *the inherent difficulties associated with postulating a precise view of the future without the TNA beyond one scheduling session (6 months)*". Their subsequent response to the ACCC's demand for more particulars as to the counterfactual has been withheld from the ACCC's public register.
- 7 Meanwhile the Applicants' application to the Ministry does not address the counterfactual. There are however oblique references in the application to the TNA being the only viable means to reduce capacity and to neither Air New Zealand nor Qantas choosing to unilaterally remove surplus capacity.
- 8 Of course, those statements are quite inconsistent, not only with what the Applicants are doing in practice unilaterally to improve their own performance in the Tasman markets (as is shown in the appendix), but also with Air New Zealand's own subsequent statements, including in its 2006 Annual Report.
- 9 That conduct demonstrates and those subsequent statements indicate clearly that, without the TNA, the Applicants will continue to take unilateral action to improve their respective performance on the Tasman in response to moves by each other and other carriers on those routes and in accordance with changing market conditions.
- 10 Put more simply, the Applicants will to continue to compete. That likely future scenario without the TNA is entirely consistent with what WIAL has said already to the Ministry.
- 11 That counterfactual scenario would see continuation of independent, commercial judgement and action by the Applicants, in response to competitive market forces. So long as they remain subject to the same Commerce Act constraints as other firms, it may be assumed that the Applicants will indulge in rivalrous conduct. In the long run, that continued

rivalry will ensure a market structure which incentivises competitive pricing and jockeying for market share.

- 12 In summary, we consider the most likely outcome is to be some ongoing adjustments to capacity by the Applicants in the short term, but no worse than proposed under the code-share. Those adjustments may be mitigated by the following:

12.1 an increase in the deployment of the Jetstar brand by Qantas on more leisure-oriented routes, and potentially the addition of new routes suited to the Jetstar brand. This may lead to lower fares on some routes as a more appropriate product and cost base is introduced; and

12.2 reconsideration by Air New Zealand of arrangements and alliances with airlines other than Qantas.

- 13 We do not foresee any financial difficulties for Qantas or Air New Zealand if the TNA application is declined. The Applicants have confirmed that they are not in financial crisis; and the recent financial results of Air New Zealand confirm Ralph Norris' comments that the airline is financially strong. Although Air New Zealand has sought to downplay those results, analysts seem to agree that it is a good result and that there is plenty of upside for the company in upcoming years.

### **Counterfactual analysis**

- 14 It is well settled that when undertaking a competition analysis in relation to a restrictive trade practice (which the TNA constitutes), a forward looking counterfactual analysis should be used. That involves comparing two hypothetical future situations, one with the contemplated arrangement (the factual) and one without (the counterfactual). Obviously, framing the appropriate scenarios is crucial to the subsequent competition analysis.

- 15 The Commerce Commission's *Mergers and Acquisitions Guidelines* provide some general guidance:

*In framing a suitable counterfactual, the Commission basis its view on a pragmatic and commercial assessment of what is likely to occur in the absence of a proposed acquisition.<sup>1</sup>*

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<sup>1</sup> Commerce Commission *Mergers and Acquisitions Guidelines*, page 21.

- 16 More specifically, the Commission has recognised that it cannot simply substitute its own preferred market structure, or adopt an applicant's view of what the future might bring. Rather, it must exercise its own pragmatic judgment on what is "likely", having regard to the best information available to it:

*The counterfactual is not necessarily the arrangement which might be preferred by the Commission or by others with an interest in the industry. The Commission does not have the mandate, nor the expertise, to be the market designer. The counterfactual is simply the Commission's pragmatic and commercial assessment of what is likely to occur in the absence of a proposed arrangement.<sup>2</sup>*

- 17 The jurisprudence surrounding the term "likely" (as used in the statutory language of the Commerce Act 1986) provide, that, for an occurrence to be "likely", it must be more than a mere possibility. Likely, means a real risk, substantial risk, or something that might well happen.<sup>3</sup> In particular, the Commission (or court) must be wary of adopting any "doomsday" scenario being propounded by an applicant as the only alternative to what it is seeking.
- 18 All this means that, in advising the Minister, the Ministry should make its own pragmatic assessment of *what is likely* in the future, absent the TNA. It cannot simply accept - undisclosed and untested - the Applicant's vision of *what might happen*.
- 19 The courts have recognised that predicting the future for the purpose of framing the counterfactual often involves a high level of evaluation, where there is necessarily scope for differing opinions.<sup>4</sup> In particular, it is perhaps inevitable that the view of the future being propounded by an applicant will have a tone of urgency and content supportive of a pressing need for the particular arrangement which the applicant is proposing. Accordingly, an applicant's actual conduct, or statements an applicant has made in other fora as to its likely future conduct, may provide enlightening context (at least).

#### **What the Applicants' claim**

- 20 In this case, the Applicants themselves have been remarkably coy – at least publicly – about their own view of the likely future without the TNA. The

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<sup>2</sup> Decision 280 *Electricity Market Company Limited*, para 95.

<sup>3</sup> *CC v Port Nelson* (1995) 6 TCLR 406 at 432.

<sup>4</sup> *ANZCO Food Waitera v AFFCO* (2005) 11 TCLR 278, para 150, per Young J (dissenting).

Applicants did directly address the counterfactual in their application to the ACCC, stating (at para 8.3):

*As to the counterfactual, given the highly dynamic nature of the aviation industry and its sensitivity to exogenous shocks and the global economic cycle, there are inherent difficulties associated with postulating a precise view of the future without the TNA beyond one scheduling season (6 months). On any view of the counterfactual, the Tasman routes will continue to be a dynamic marketplace in which Virgin Blue and Emirates operate as vigorous and effective competitors, each with the ability to expand their service offering and competitively respond to the conduct of Qantas and Air NZ.*

- 21 The ACCC requested further particulars of the Applicants' view of the counterfactual and their respective strategies (if it eventuated), but those answers have been withheld from the public register.
- 22 The Applicants' application to the Ministry itself did not expressly address the counterfactual. The application is couched in quite general language and argues in terms of Emirates and Virgin Blue "constraining" the Applicants under the TNA.
- 23 However their implicit view as to an alternative future would seem to be that the TNA is the only "viable" means to reduce capacity. The following extracts from the application illustrate this:

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

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

*Absent the TNA, removing a flight would have two effects: first, it may have a negative effect on aircraft utilisation and hence on unit costs, and second, for the reasons outlined above, it would mean ceding a schedule advantage to the other network airline. Accordingly, this is highly*

*unlikely to be a viable commercial option for either Air NZ or Qantas.*  
(para 4.10)

- 24 Those oblique references to the TNA being the only viable means to reduce capacity and neither airline choosing unilaterally to remove surplus capacity are the only public indications of each airline's likely response in the event that the TNA is not allowed.
- 25 In the absence of anything more, the best evidence available to the Ministry as to the likely future without the TNA is what the Applicants themselves are currently doing in practice to improve their own products and performance in the Tasman markets, together with the Applicants' own subsequent statements in other fora.
- 26 WIAL in its previous submission (as set out in the appendix) has described the unilateral actions already being undertaken by both Air New Zealand and Qantas to improve their respective performances on the Tasman. It also refers to the alternative strategies that the Applicants have said publicly are available to them, and may be pursued, if the TNA is not allowed.
- 27 The Applicants have argued to the ACCC, in their response of 4 July 2006 to third party submissions, that these alternative strategies, which in fact have been offered by the Applicants themselves, should be dismissed as "speculation". That, they argue, is because WIAL has acknowledged that it has no special access to the internal deliberations or views of Qantas or Air New Zealand.
- 28 That acknowledgement, of course, remains true. But, WIAL (and other interested persons) do have access to what the Applicants have been saying or providing publicly as to their future intentions in other fora or for other purposes. These subsequent statements we outline below.

### **Subsequent Statements by the Applicants**

- 29 Rob Fyfe commented at the recent Air New Zealand profit announcement that:

*If we cannot achieve our cost reductions through the code-share proposal with Qantas, then we'll have to look at pursuing cost reduction initiatives on our own account.*

*And that is likely to result in some form of capacity reduction on the Tasman.<sup>5</sup>*

30 Similarly, Air New Zealand's recently released 2006 Annual Report says:

*Without the codeshare, Air New Zealand will be forced to rationalise routes to improve performances in line with what we have done in other markets. This creates a less optimal outcome for the company and New Zealand.*

31 We do not know what view of the future absent the code-share Air New Zealand and Qantas may have provided to the ACCC, or may be providing to the Ministry, under the cloak of confidentiality. But, it is possible that submissions they make to the Ministry may portray a future without a TNA that is bleaker than Air New Zealand has described there. Both those statements indicate a clear intention to take unilateral action in order to compete.

32 Against that possibility, it is apposite to note that, in complying with its legal obligations to send to shareholders and/or file with NZX certain documents and information (annual reports, "continuous disclosure" releases, etc), Air New Zealand is subject to some legal and practical constraints on the extent of advocacy in which directors can safely engage. Those documents could accordingly be expected to more accurately reflect the reality of the company's position and intentions.

33 In the same context, a similar discipline would of course have applied if the Applicants had sought authorisation from the Commerce Commission rather than the Minister. Parties who knowingly misled the Commission are subject to criminal sanctions.

34 As set out in both its profit announcement and its 2006 Annual Report, Air New Zealand shows a clear intention to compete on the Tasman by unilateral improvement, just as the company has had to do in its other markets.

35 And, these subsequent statements by Air New Zealand are entirely consistent with WIAL's earlier submission to the Ministry as to the likely alternative scenario to the TNA. In other words, Air New Zealand itself is repeating the "speculation" it complains of.

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<sup>5</sup> Steve Creedy, Air New Zealand Flights Face Cuts Without Deal, the Australian, August 26, 2006.

- 36 Put simply, that alternative scenario is that the Applicants will continue to compete with each other, and other airlines on the Tasman, by making unilateral rational commercial decisions in anticipation of, and response to, market forces. That is, they will continue to operate as the Commerce Act requires all other firms and individuals engaging in trade in, into or from New Zealand to do.
- 37 In the long run, that continued independence of the two major carriers on the Tasman will preserve a market structure that incentivises a dynamic, competitive process. The Applicants, individually, will explore other options, such as further development of their lower cost product and brand, and pursue unilateral actions to improve performance on Tasman markets. Some of those actions will be of the kinds previously traversed in the appendix. Other actions may be of a kind that are so far only known internally to the airlines themselves (and about which we do not speculate).
- 38 If there is some other future scenario (absent the TNA) which the Applicants have managed to divine, this miracle should be exposed to public scrutiny. But, the Ministry's letter to us of yesterday indicates that the "Ministry has recently met with Air New Zealand in order to receive confidential information". We assume that that information was in relation to the counterfactual. If these claims cannot be properly tested, they must be disregarded – or at least heavily discounted. As a minimum, those claims should be compared with what Air New Zealand is saying elsewhere; and with its current conduct.
- 39 Put bluntly, the Ministry cannot rely simply on the Applicants' self-interested view of a future which they will not allow to be tested.

#### **Further expansion by Virgin Blue or Emirates unlikely**

- 40 As you will be aware, Virgin Blue have already confirmed to the ACCC that, because of the strategy of the Applicants to dump capacity on routes where a competitor enters, there needs to be a "very strong" profitability case for Virgin Blue to enter or expand any route. Emirates is also unlikely to expand due to the marginal cost business model it operates on the Tasman.

#### **The difference is stark**

- 41 The competitive tension created by the two major players acting independently is crucial to the maintenance of a contested Tasman market, and would continue to stimulate competition and innovation in the counterfactual scenario.
- 42 The difference from what would happen in the factual is stark. There would be significant detriments to consumers if the TNA proposal were authorised

(as described already in WIAL's earlier submission of 31 July). We have instructed our economic consultants, LECG, to prepare a detailed response to the Tretheway Report provided by the Applicants. This response will also demonstrate the substantial lessening in competition in the factual. We will provide it to you shortly.

Yours faithfully

Grant David  
Partner