

SUBMISSION TO THE MINISTER OF TRANSPORT ON THE APPLICATION FOR AUTHORISATION OF THE QANTAS AND EMIRATES MASTER COORDINATION AGREEMENT

19 OCTOBER 2012

1. INTRODUCTION

- 1.1 This submission is provided by the New Zealand Airports Association ("**NZ Airports**") in relation to the application made to the Minister of Transport ("**Minister**") by Qantas Airways limited ("**Qantas**") and Emirates (together "**the Applicants**") seeking authorisation to coordinate their operations ("**Proposed Conduct**") pursuant to a Master Coordination Agreement ("**Coordination Agreement**") under Part 9 of the Civil Aviation Act 1990 ("**CAA**").
- 1.2 NZ Airports wishes to thank the Ministry for the opportunity to submit views on the Qantas and Emirates application for authorisation of their proposed master Coordination Agreement. We note that both Qantas and Emirates have contributed significant economic benefit to New Zealand, and their ongoing operational health and viability remain important to national tourism and trade interests. NZ Airports acknowledges the Ministry's recognition of this significance by providing the proposed Agreement application to members of the industry for comment.

2. CONTEXT

- 2.1 Air travel accounts for 99 % of New Zealand's international passenger movements, enabling 8.6 % of GDP through the direct and indirect contributions of tourism to the economy. Air cargo, carried primarily in the holds of passenger airliners, comprises over 22 % of imports and 14 % of exports by value. The sustainability and functionality of the air transport markets delivering this activity are therefore critical to airports, the cities and communities which they serve, and to the economic prospects of our remote country as a whole.
- 2.2 The trans-Tasman aviation market delivers the vast majority of this activity. In 2011, the routes connecting New Zealand with Australia, our largest trading partner delivered 75% of the total volume of international passenger traffic.
- 2.3 We are committed to ensuring that the New Zealand travel market remains competitive, accessible, and viable for consumers and stakeholders, and with sufficient capacity to deliver essential travel and trade growth to support New Zealand's economic interests. NZ Airports is not, in principle, opposed to alliances of airlines where each alliance can demonstrably improve or retain consumer, supplier and economic benefits that would otherwise not exist in the competitive market, and which do not create market power that affects the sustainability of markets and competitors.

- 2.4 NZ Airports recognises that airlines today operate under very significant economic pressures and constraints and in the context of an international industry that hosts a network of strategic alliances and alignments set up between carriers and amongst groups of carriers as airlines look for ways to introduce operational efficiencies that will reduce operating costs, streamline services and ensure continued viability. In their application to the Minister the Applicants provide details of the proliferation of such alliances and make the submission that today such airline cooperation is a “legitimate and essential way for airlines to remain viable in the face of rising costs and intense global competition”.
- 2.5 NZ Airports has a direct interest in a sustainable and prosperous travel industry – internationally and domestically in New Zealand – and is committed to ensuring that the travel market remains competitive, accessible and viable for all stakeholders. For that reason, NZ Airports is generally very supportive of airlines endeavouring to improve their products and services in ways that will result in real public benefits such as lower fares, increased competition, or improved air links supporting increased tourism and provision of improved opportunities for trade.

3. AIRPORTS POSITION

- 3.1 NZ Airports’ views on the application can be summarised as follows: NZ Airports would not be strongly opposed to the proposed Coordination Agreement provided that it was accompanied by a quantification of the claimed consumer benefits, appropriate controls to ensure these are realised, and an analysis of the potential impact on the trans-Tasman market. In the absence of these features, it is clear that the proposal presents risks for the growth of trans-Tasman traffic in particular and we are of the view that these risks need to be adequately addressed if any authorisation is to be progressed to the next stage.
- 3.2 We note that the proposal is lacking detail on the claimed benefits that would accrue to consumers, and the withholding of these details makes it difficult for NZ Airports to provide more informed comment on the application. We also note that the proposed Agreement is for a 10 year period. While the capacity commitments contained in the proposed Agreement are welcome, the significant Agreement period proposed means that the capacity of today may not align with the market demand and requirements in 10 years from now or during that 10 year period. We suggest that the Minister carefully consider how the market might respond in the event of significant growth, such as the potential for rapid growth associated with the Christchurch rebuild and the inevitable peaks and troughs in demand over that time.
- 3.3 NZ Airports also notes that the Agreement, should it be approved, would effectively create a duopoly on the trans-Tasman market. Put together, the Qantas Group with Emirates, and Virgin with Air New Zealand, provided a combined total of almost 97% of the seats in the trans-Tasman market for the year ended September 2012 and 100% of all seats in all trans-Tasman markets other than Auckland. It is expected that this will continue to be the case in the coming year. Furthermore, Qantas has a codeshare agreement with LAN Airlines on the Auckland-Sydney sector and sells seats trans-Tasman journeys on these flights operated by LAN.
- 3.4 Consideration of the proposed Agreement must take into account the potential impact of this outcome on the trans-Tasman market, which is the most important market for New Zealand consumer interests. We believe the analysis of the competitive impact on trans-Tasman markets is very different to that required for long-haul routes.
- 3.5 While it is not an express requirement of section 88(2) of the Civil Aviation Act 1990, NZ Airports considers that the Ministry should carry out a comprehensive, robust and transparent cost-benefit analysis of the likely effects of authorising the Proposed

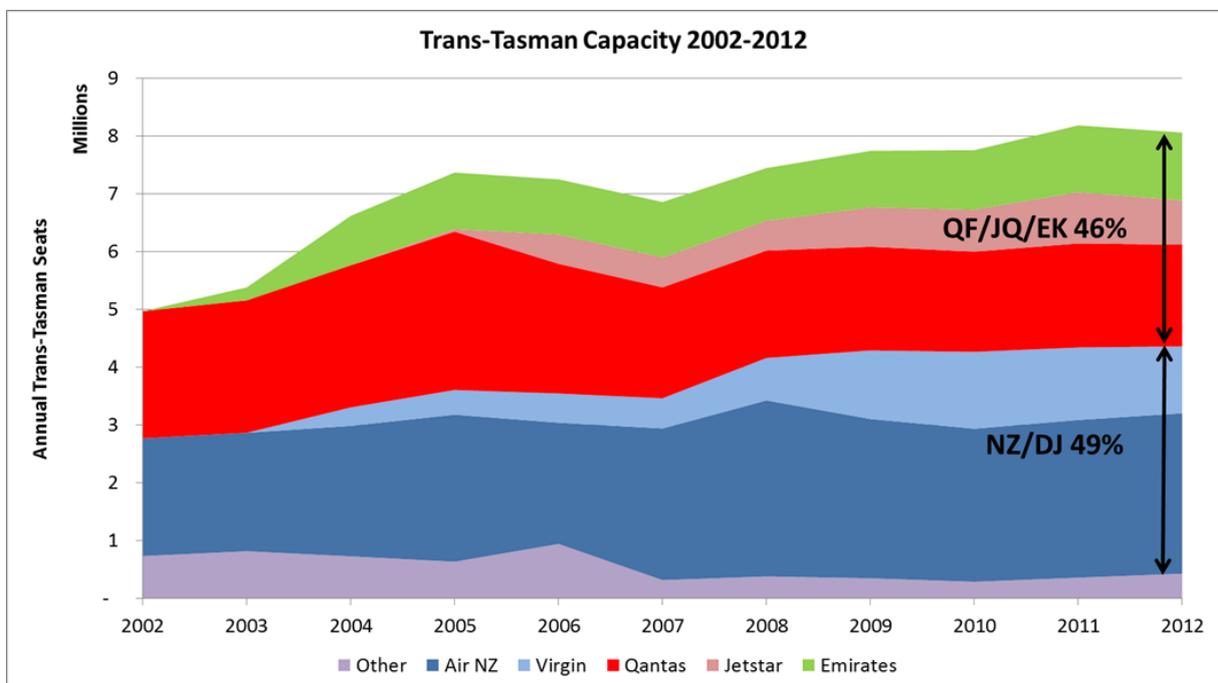
Conduct. The imperative for a comprehensive, robust and transparent analysis, which has recently been recognised by the Productivity Commission, particularly arises given the detriments that naturally flow from inhibiting the competitive dynamics that would otherwise exist on the affected routes.

- 3.6 NZ Airports is particularly concerned to ensure that, if the Minister—after due consideration—is minded to authorise the proposed Coordination Agreement, the authorisation is granted subject to appropriate conditions that will ensure the realisation of any claimed benefits. Any authorisation should also be appropriately time-limited.
- 3.7 The Minister's powers under section 88(2) are limited to authorising (if appropriate) the particular provisions of the proposed Agreement that relate to international carriage by air and that relate, whether directly or indirectly, to the fixing of tariffs, the application of tariffs, or the fixing of capacity. The Minister must therefore analyse the individual provisions of the proposed Agreement carefully to ensure that any authorisation granted relates only to those provisions that fall within section 88(2).

4. SIGNIFICANCE OF EMIRATES ON THE TASMAN

- 4.1 The introduction of Emirates capacity to New Zealand has had a significant impact on the workings of the trans-Tasman market for air services. To borrow a quote from Air New Zealand and Virgin Australia in support of their 2010 Alliance application: "Emirates, in particular is committed to the Tasman and provides competitive pressure on routes out of Auckland and Christchurch... Emirates' financial strength and enormous fleet are indisputable."¹ This competitive pressure has resulted in capacity growth, lower fares, product differentiation, additional frequencies and other benefits.

- 4.2 The table below illustrates the impact of Emirates capacity on trans-Tasman routes:



- 4.3 Since 2002, total capacity on the Tasman has grown by around 3 million seats with Emirates accounting for 40% of that growth. Emirates now provides 15% of the total

¹ Air New Zealand and Virgin Blue, 30 July 2010 – Applicants' response to views expressed by third parties.

seat capacity on the Tasman and has succeeded in earning market share by delivering an attractive product at competitive fare levels.

- 4.4 The presence of this competitive influence should not be underestimated, particularly in the context of the currently authorised Australasian Airline Alliance in place between Air New Zealand and Virgin Australia.

5. MEASURE OF MARKET POWER

- 5.1 The Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration, and is calculated by summing the squares of the market shares of each firm within a competing market to provide an index. For a market with only one firm the index is 10,000 (100^2), for 2 firms of equal size it is 5,000 (50^2+50^2) and for 10 firms of equal size 1,000 (10 times 10^2). The United States Department of Justice (USDOJ) uses the HHI as an indicator, and based on their experience generally classify markets into 3 types based on the level of market concentration:

- Unconcentrated markets: HHI below 1,500
- Moderately concentrated markets: HHI between 1,500 and 2,500
- Highly concentrated markets: HHI above 2,500

- 5.2 For the calendar year 2012, the trans-Tasman would be classified as a “moderately concentrated market” with an HHI of 2,237 when the existing airline alliances are not taken into account. This supports the airlines’ view that the trans-Tasman is competitive with 7 airline operators.

- 5.3 Once the existing trans-Tasman airline alliances (Air New Zealand with Virgin, Qantas with Jetstar) are allowed for, the level of competitiveness significantly falls, with the HHI increasing to 3,738 and falling within the definition of a “highly concentrated market”.

- 5.4 The USDOJ also provides standards where competitive concerns are raised around the market types they have defined. For highly concentrated markets the standard they have provided is:

“Highly Concentrated Markets: Mergers resulting in highly concentrated markets that involve an increase in the HHI of between 100 points and 200 points potentially raise significant competitive concerns and often warrant scrutiny. Mergers resulting in highly concentrated markets that involve an increase in the HHI of more than 200 points will be presumed to be likely to enhance market power.”

- 5.5 The partnership between Qantas and Emirates will result in the Applicants controlling around 46% of the trans-Tasman capacity (including Jetstar as a member of the Qantas Group), and will increase the HHI by 923 points (to 4,661); significantly higher than the 200 point trigger standard adopted by the USDOJ as the point at which market power will likely be enhanced. (See the table below).

Current Market Competition			With Partnership Market Competition		
Airline Alliance	Capacity Share	HHI	Airline Alliance	Capacity Share	HHI
NZ/DJ	50.3	2,526	NZ/DJ	50.3	2,526
QF/JQ	31.5	990	QF/JQ/EK	46.1	2,128
EK	14.7	215	LA	2.1	4
LA	2.1	4	CI	1.5	2
CI	1.5	2			
Total	100	3,738	Total	100.0	4,661
				Difference	923

6. IMPACT OF MARKET POWER

- 6.1 An increase in market power has the effect of reducing the competitive tension in a market, resulting in an equilibrium price higher than would be produced prior to the change. As an illustrative example, a market with 100,000 seats supplied by two air carriers each with 50% market shares would be expected to result in a price at a higher level than a market with three competitors supplying a third of the total capacity each. This market feature is a product of the respective competitors working independently to innovate their offer to the consumer with a view to attracting a higher market share.
- 6.2 The increased likelihood of higher prices relating to trans-Tasman air services is a potential detriment of the proposed Coordination Agreement which must be carefully considered by the Minister in evaluating the proposal. To emphasise the materiality of the potential effects of the authorisation, NZ Airports draws attention to the following example:
- (a) Qantas research indicates that the price elasticity of demand for air services is approximately -1^2 . That is, a 1% increase in air fares can generally be expected to reduce demand for those services by 1%. The proposal would result in a highly concentrated market with 96% of the capacity controlled by two groups. If this level of market concentration and resultant market power produced an average price at a level only 5% above the current average the number of return passengers using those services over that 10-year period would be 1.4 Million fewer.
- (b) Passengers in this scenario would be paying \$1 Billion more in airfares over the 10 years, and 700,000 fewer overseas visitors would come to New Zealand (assuming a 50:50 inbound/outbound split).
- (c) These visitors would have spent \$1 Billion within the New Zealand economy (based on \$1,500 spend per Australian visitor) and would have contributed additional activity in indirect economic contributions.

The following table sets out these potential future impacts.

Year	Average Sector Fare			Trans-Tasman Sectors			Additional Fare Paid	Lost Visitors (4)	Lost Visitor Revenue (5)
	Current (1)	With Partnership	Difference	Current (2)	With Partnership (3)	Difference			
2012	\$ 376	\$ 376	\$ -	6,048,185	6,048,185	-	\$ -	-	\$ -
2013	\$ 376	\$ 380	\$ 4	6,203,321	6,142,529	- 60,793	\$ 23,111,264	- 15,198	-\$ 22,797,205
2014	\$ 376	\$ 384	\$ 8	6,362,436	6,237,733	- 124,704	\$ 46,938,938	- 31,176	-\$ 46,763,907
2015	\$ 376	\$ 388	\$ 11	6,525,633	6,333,779	- 191,854	\$ 71,492,534	- 47,963	-\$ 71,945,103
2016	\$ 376	\$ 391	\$ 15	6,693,015	6,430,649	- 262,366	\$ 96,781,270	- 65,592	-\$ 98,387,326
2017	\$ 376	\$ 395	\$ 19	6,864,691	6,528,321	- 336,370	\$ 122,814,045	- 84,092	-\$ 126,138,701
2018	\$ 376	\$ 395	\$ 19	7,040,771	6,695,773	- 344,998	\$ 125,964,226	- 86,249	-\$ 129,374,159
2019	\$ 376	\$ 395	\$ 19	7,221,366	6,867,519	- 353,847	\$ 129,195,208	- 88,462	-\$ 132,692,606
2020	\$ 376	\$ 395	\$ 19	7,406,594	7,043,671	- 362,923	\$ 132,509,065	- 90,731	-\$ 136,096,171
2021	\$ 376	\$ 395	\$ 19	7,596,573	7,224,341	- 372,232	\$ 135,907,922	- 93,058	-\$ 139,587,038
2022	\$ 376	\$ 395	\$ 19	7,791,426	7,409,646	- 381,780	\$ 139,393,961	- 95,445	-\$ 143,167,446
Total				75,754,013	72,962,147	- 2,791,866	\$ 1,024,108,433	-\$ 697,966	-\$ 1,046,949,662

(1) Source Sabre ADI Calendar Year 2011

(2) Based on existing 75% load factor, grown by average Australian/New Zealand GDP of 2.6% over 10-years
Source: Global Insight, January 2012

(3) Based on trans-Tasman fare elasticity of -0.98

Source: "The Impact of Australia-New Zealand Aviation Border Simplification", Qantas Economics, October 2009, Figure 43

(4) Assumes a 50:50 split between overseas visitors and NZ residents

(5) At current Australian Visitor Spend of \$1500 per Visit

- 6.3 NZ Airports submits that this is a credible potential outcome of an authorisation which would have the effect of reducing the number of material competitors on trans-Tasman routes to two. Given the significant and wide reaching nature of the potential multi-Billion dollar economic impact it is essential that the Minister carefully considers the proposed benefits in the context of the potential detriments and if, after due

² The Impact of Australia-New Zealand Aviation Border Simplification, Qantas Economics, October 2009, Figure 43.

consideration the proposal is authorised, appropriate conditions are put in place to protect consumers from the disbenefits associated with increased market power.

7. PURPORTED BENEFITS

7.1 The Applicants argue that:

- (a) far from reducing competition on the relevant routes, the Coordination Agreement will, by arresting the terminal decline of the international operation of Qantas (“**Qantas International**”), support continued effective competition on all these routes, the counterfactual being a withdrawal of further Qantas International services;
- (b) in terms of the trans-Tasman routes, the Proposed Conduct is “pro-competitive” because the Applicants will commit to maintaining existing levels of capacity and the Proposed Conduct is expected to provoke more competitive fares and product/service offerings from rival carriers on the trans-Tasman, particularly Air New Zealand and Virgin Australia; and
- (c) they operate largely complementary networks and, where this is not the case, they operate overlapping, direct services (from Auckland to Sydney, Melbourne and Brisbane and from Christchurch to Sydney) so there will be no competitive detriment resulting from the Proposed Conduct because it will prompt a further round of competitive responses from competitors.

7.2 In addition to their argument that the Proposed Conduct will have no effect on competition, the Applicants are of the view that it will result in substantial benefits to New Zealand consumers including:

- (a) a significantly expanded global network, improved connectivity and greater choices for Qantas passengers and freight customers to seamlessly travel trans-Tasman and internationally;
- (b) improved connectivity for Emirates’ passengers and freight customers to the Qantas Group’s domestic, trans-Tasman and other international services;
- (c) materially and instantly enhanced benefits for members of both parties’ frequent flyer programs;
- (d) the establishment of a long term business model to optimise the operating performance of both Qantas and Emirates including by reducing operating costs; and
- (e) generation of a number of other public benefits including enhanced customer experience and increased product innovation, tourism and employment, promotion of international trade and enhancement and acceleration of Emirates’ growth in New Zealand and Australia.

7.3 NZ Airports would certainly welcome each and all of the above benefits. But, in line with comments made in its submission to the Minister on the (then) proposed Virgin/Air New Zealand Alliance, it is important to remember that there is no guarantee that these claimed benefits will materialise and that, if they do, there is no guarantee of the extent to which they would be passed on to the end consumers.

7.4 It is notable that many of the stated benefits would be expected primarily to enhance the market positioning and market share of the Applicants as opposed to delivering market growth above that which would be expected in the absence of the proposed activity.

Furthermore, it appears that no attempt has been made to quantify the extent to which these enhancements would deliver benefits to the market which would serve to offset any potential increase in price.

- 7.5 We suggest that, if the Minister decides to approve the application, it may be appropriate for the Minister to ask the Applicants to quantify the expected benefits to enable the effects of these to be balanced against the potential detriment and the relevant counterfactual. In the event of an authorisation being granted, it may also be appropriate for the Applicants to be required to regularly update the Minister on the progress being made towards achieving the substantial benefits throughout the term of the authorisation.

8. CAPACITY COMMITMENT

- 8.1 NZ Airports is pleased to see the Applicants offering in the application a formal commitment not to reduce their combined trans-Tasman capacity throughout the period of the Proposed Conduct from that existing as at the Base Year (the 12 month period from 1 July 2011 to 30 June 2012).
- 8.2 We note that the Applicants envisage that by offering a commitment in respect of the total trans-Tasman capacity, rather than specific city pair routes, they may be able to offer potential new direct services between Auckland and Adelaide and that this would be a material and direct result of the Proposed Conduct. We would welcome the Minister seeking more detail on this.
- 8.3 We also note that the draft formal commitment to maintain trans-Tasman capacity, in addition to exempting the Applicants from compliance with that commitment in the event of Exceptional Circumstances (as these are defined in the draft commitment), would allow the Applicants to seek a variation from the Minister of the conditions attached to the authorisation in the event of "Material Change in Market Conditions" or "Material Adverse Financial Performance"; and would permit the Applicants to effect a Proportionate Capacity Reduction if, in relation to a particular route, a carrier other than Virgin Australia or Air New Zealand increased its capacity on that route (either by new entry or expansion). As indicated above, because the agreement period proposed – ten years - is significant it is almost certain that the capacity of today will not align with the market demand and requirements that will develop over the period.
- 8.4 For example, over the last 10 years capacity on the Tasman has increased by around 3 million annual seats. If a similar level of growth was achieved over the next 10 year period, the Applicants would have to increase their joint capacity by over 1.5 million seats to avoid constrained capacity and fare increases given their current market share. Based on the recent authorisation of the Air New Zealand/Virgin Australia Australasian Airline Alliance, NZ Airports understands that the Minister is well aware of the need to ensure that an appropriate measure of market growth is accommodated in any capacity commitments to ensure that organic growth does not provide an opportunity for the exercise of market power through capacity constraint.
- 8.5 Given the close relationship between the demand for air travel and GDP growth, we suggest that it would be appropriate for any capacity condition associated with an authorisation to be linked to growth in economic activity. In this way the benefits of the proposal could be realised whilst retaining the level of capacity growth which would be reasonably expected in the absence of the proposed activity.

9. SCOPE

- 9.1 The Applicants state that the exact scope of the Proposed Conduct will “evolve and may be altered from time to time”. We would also welcome the Minister seeking more detail on this.

Please do not hesitate to contact us for any clarification or further assistance.

Kevin Ward
Chief Executive

New Zealand Airports Association
PO Box 11 369
Manners Street
Wellington 6011