



Australian Competition & Consumer Commission

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Our Ref: C2002/1774
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29 January 2003

Mr Aldo Nicotra
Blake Dawson Waldron
Locked Bag N6
PO Grosvenor Place
Sydney NSW 2000

Mr Michael Gray
Freehills
GPO Box 4227
Sydney NSW 2001

Dear Mr Nicotra and Mr Gray

**Trade Practices Act 1974
Applications for authorisation A30220-2 and A90862-3
lodged by Qantas and Air New Zealand**

Following a more detailed examination of the above applications there are number of further questions, as attached, which the Commission wishes to raise in order to improve its understanding of the proposed conduct and its effect on competition in relevant markets.

I would be grateful for a response on these matters by 19 February 2003.

If you have any queries in relation to the above requests please contact Greg Outzen on 02 6243 1227.

A copy of this letter will be placed on the Commission's Public Register. It is open to you to seek confidentiality for information supplied in response to this letter.

Yours sincerely

Tim Grimwade
General Manager
Adjudication



QUESTIONS FROM ACCC ON APPLICATIONS FOR AUTHORISATION A30220-3 AND A90862/3.

Estimates of Public Benefits

Q1. Cost savings to Australia attributable to the Alliance are estimated to account for 49% or A\$122m in year 3 of total public benefits. What are the specific details of the cost efficiencies estimated by route group and country?

- Illustrate the building blocks in the computation of the estimates for the four routes with the largest efficiency savings:
 - North America
 - Singapore
 - Domestic New Zealand
 - Tasman

Q2. How are the efficiency gains (as described in Question 1) estimated to be shared between:

- capital, labour, and other inputs;
- producers and consumers;
- in total and for the four routes listed in Q.1.

Q3. How can the sustainability of the cost efficiencies be ensured? What are the major risks to achieving the cost efficiencies? What is their degree, and how will they be minimized? What is the extent to which Qantas and Air New Zealand will be accountable for the delivery of cost efficiencies?

Q4. What prevents “new direct services” (for example, AKL-ADL) being operated by one carrier now? Why is the Alliance essential to the commencement of the identified new direct services?

Q5. The Commission notes that the Applicants claim efficiency advantages from equity participation. What are the demonstrable relative efficiency gains and joint optimisation achieved by the proposed arrangements between Qantas and Air NZ compared to the arrangements under the JSA between Qantas and British Airlines?

[Please quantify the differential of gains achieved due to the integrated (equity) alliance structure and the translation of these to public benefits.]

Tourism

Q6. Net tourism benefits to Australia are claimed would account for 45% of total public benefits of A\$246m in year 3, however, there is limited analytical detail given to support this major benefit.

- Is the specific empirical evidence for the substantial increase in international tourist *arrivals* due to increased influence or marketing effectiveness of Qantas Holidays and other promotions limited to the revenue pax-km/promotion effectiveness elasticity of 0.17 as estimated for the trans-Tasman by the econometric demand model in Box 1 of the NECG report?

- What is the analytical basis and specific components of the underlying model of marketing effectiveness/promotion?
- What can be said about additional tourist arrivals:
 - to Australia from New Zealand?
 - to Australia from other countries?
 - to New Zealand?

Q7. Why is the stated 10% increase in marketing effectiveness attributable to, and only profitable under, the Alliance? What are the specifics of the (\$12m p.a.) cost side of this increased marketing effort? Is this amount included as a cost of the Alliance?

Q8. What is the distribution of the associated estimated net welfare increases (stemming from additional overseas tourist arrivals) that remain in the recipient country:

- Australia;
- New Zealand; and
- other countries?

Q9. What is the justification for setting the net social valuation of additional tourism exports at its associated gross increase in tourist expenditure based on a simulated rise in GNP assuming unemployed labour?

- What is the sensitivity of the public benefit estimate to this assumption?
- What is the evidence for setting a low shadow wage for labour that would be employed to serve demands from additional overseas tourists?
- What is the labour input share of total costs of tourists' local purchases?

Airline Cost, Pricing and Market Structure

Q10. What categories and associated percentages of airline total costs are “fixed” and “variable” over the five year period of the proposed Alliance?

Q11. What are the airlines' views on the respective role of price(s) as well as capacity as a strategic variable? How do these views compare with the modeling of competition in airline markets used in the NECG report and the findings?

Q12. What is the actual empirical evidence for the effective competition and contestability of the JAO Network markets, taking into account market shares on trans-Tasman routes and the exercise of 5th freedom rights? [This should incorporate fares and capacity analysis of Qantas, Air NZ & 5th freedom operators over the past 3 years.]

- How does this compare with routes to North America and Asia (ex Australia and New Zealand) and the Kangaroo route?
- What are the likely dimensions of the competitive impact of the Alliance given the capacity and scheduling changes?
- What if any competitive response is anticipated on these routes?
- What is the likely impact of the withdrawal of United Airlines from AKL – on capacity, services and the United Airlines – Air New Zealand Alliance Expansion Agreement?

Q13. What is the extent of cooperation envisaged for services beyond the JAO and in what circumstances will the parties consider it efficient and beneficial to do so?

Q14. How will airlines assure that the proposed Alliance is principally quarantined to JAO routes?

Q15. What are the expectations for the long term movement to sales/IT commonality of systems and co-location of offices? What impact will this have on business structure and employment?

Basic Market Performance Data

Q16. Under the Alliance, what impact will the Air NZ domestic passenger feed have on the Australian domestic market shares? Which routes will be the most significantly affected?

Q17. How are airline costs and profitability by route/route group estimated by QF and Air NZ, including directly attributable costs and any allocation of overhead costs?

(This should be illustrated specifically for the following route groups:

- North American
- Singapore
- Trans-Tasman)

Q18. What is the time series (by quarter, for years 1997 – 2002) for capacity in weekly seats operated by each of Qantas and Air NZ for all common route groups (as listed in the NECG report at Table 17)?

- What are corresponding route average load factors by carrier for the same period, by quarter?
- What are corresponding revenue per ASK by carrier for the same period, by quarter?

Q19. Regarding sales and distribution, what have been the recent trends in commissions and rebates, particularly since the Ansett collapse?

The Counterfactual

Q20. What is specifically assumed about each airline's capacity decision-making process for years 1 to 5? What are the corresponding outcomes for QF and Air NZ predicted profitability by year 5?

Q21. What are the key elements of the each carrier's existing business model for the next 5 years, setting aside the proposed Alliance strategy?

Q22. What accounts for the much higher capacity of Air NZ in the factual given Air NZ's cost levels, and how does this influence cost efficiency gains and price levels to *Australian* passengers?

Q23. Given the incentives for, and disposition towards, establishing wide cooperation between Qantas and Air NZ, what are the compelling reasons for summarily dismissing the

counterfactual of a “cosy duopoly”? Do any of these reasons represent risks with the actual achievement of the benefits of the Alliance?

The NECG Cournot Model of Competitive Air Service Markets

Q24. How can the assumptions and industry equilibrium comparative statics of the Cournot oligopoly model that are used to compare the factual and counterfactual be reconciled with the description of the history of aggressive competition on several Australasian (trans-Tasman and domestic NZ) routes, especially involving the Parties?

Q25. What is the difference (in market share and profit prospects) *for a VBA entrant* (on trans-Tasman routes) between the outcomes predicted under the factual and confidential counterfactual?

Q26. How do independent (exogenous to the NECG model) estimates of the order of magnitude of the Parties (and possibly other carriers’) marginal costs on main routes compare with estimates endogenous to the NECG model (estimated via market shares)?

Q27. What is the sensitivity of the welfare detriment estimates to alternative oligopoly models (such as positive conjectural variations and Stackleburg Leader – Follower or tacit collusion)? (Notwithstanding the apparent large difference in relative magnitudes of the detriment and public benefit.)

Alliance Agreement and Structural Issues

Q28. Outline the implications of this basis of capacity allocation on the Australian operations (Clause 5(c)).

Q29. How will the Alliance partners resolve the situation where an underperforming sector results in ‘network benefits’ for one party, however, the other party’s preference would be to cease this service (Clause 7(b))?

Q30. What additional joint ventures are envisaged (Clause 6.12)?

Q31. What is the quantum of equity and debt funding that Qantas will provide to NZ and the impact this will have on the sustainability of the NZ financial position?

Q32. What is the Ownership structure pre- and post-transactions for all related companies/airline operators?

Q33. Regarding global alliance strategy, is it the intention of Qantas and Air NZ to be members of the same global alliance? How is this to be achieved, what are the key drivers of the decision and what is the likely timing?

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