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Dear Mr Grimwade

**Applications for authorisation lodged by Qantas Airways Limited and Air New Zealand Limited**

Thank you for the opportunity for the Department of Industry, Tourism and Resources to comment on the applications by Qantas Airways Limited and Air New Zealand Limited for closer commercial arrangements.

The Department supports the application made by Qantas and Air New Zealand to form a strategic alliance and the inclusion of enforceable undertakings by the airlines. By itself, the alliance stands to reduce the level of competition on routes between Australia and New Zealand. However, there are some compensatory effects of increased marketing effort and a strengthened Qantas would provide a higher degree of confidence that Australia will continue to be serviced by a strong competitive Australian-based carrier. On balance, there appears to be marginal positive tourism benefits.

It is suggested that the undertakings proposed by the airlines be strengthened to provide greater confidence concerning opportunities for the sustainable entry by new airline entrants and to ensure there will be no diminution of marketing expenditure, including co-operative marketing with the Australian Tourist Commission. Furthermore, it is proposed that the airlines make commitments in relation to exercising price restraint and that the agreement be reviewed after a three year period.

Further aviation liberalisation would help to create the preconditions for building a more competitive environment over time.

Yours sincerely

Patricia Kelly
Head of Tourism Division

19 February 2003

SUBMISSION TO

THE AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

IN RELATION TO

THE APPLICATION BY QANTAS AIRWAYS LIMITED AND
AIR NEW ZEALAND
FOR AUTHORISATION OF A
STRATEGIC ALLIANCE PROPOSAL

DEPARTMENT OF INDUSTRY, TOURISM AND RESOURCES

February 2003

## SUMMARY

The Department supports the proposal on the condition that an approval require:

- Adoption of rigorous enforceable undertakings by the airlines that would allow for sustainable entry by new airline entrants and ensure there will be no diminution of marketing expenditure including co-operative marketing with the Australian Tourist Commission;

- Commitments by the airlines in relation to exercising price restraint; and

- A further review of the agreement after a 3 year period, given the rapid changes in the tourism and aviation sectors.

In the difficult and uncertain trading environment faced by international airlines a strengthened Qantas would benefit the tourism industry – particularly through providing a higher degree of confidence that Australia will continue to be served by a strong competitive Australian – based carrier over the long run.

It is difficult to make a precise assessment as to the net effects of the alliance on tourism given the range of factors which affect tourist travel decisions and the confidential nature of aspects of the alliance submission. Prima facie, the alliance standing alone will reduce the level of competition on routes between Australia and New Zealand. While there will be some compensatory effect of increased marketing effort, on balance there appears to be only a marginal positive impact on Australian tourism. The uncertainty around resolution of the composition of the global alliances under the proposal (whether both parties will become members of either Oneworld or Star) also makes a precise assessment of tourism benefits more difficult to make.

The Department is of the view that acceleration of aviation liberalisation on affected routes would minimise downside risks to Australian tourism and create good prospects for continued tourism market growth.

## INTRODUCTION

The Department of Industry, Tourism and Resources offers this submission in respect of the application made by Qantas Airways Ltd (**Qantas**) and Air New Zealand Limited (**ANZ**) for authorisation pursuant to the Trade Practices Act 1974 to formation of a strategic alliance and in relation to the airlines' undertakings regarding this application.

### Assessment Criteria

The overall impact of the proposed alliance on tourism is assessed by its potential impact on:

- Sustainability of air services;
- Competition and airfares;
- Tourism volume and expenditure (yield);
- Regional issues.

As the airlines acknowledge, the effective combination of the two largest carriers on the trans-Tasman route and their broader operations will restrain competition and put upward pressure on airfares. The potential overall impact of the proposal on tourism will largely depend on the ability of new airline entrants to enter the affected airline routes, and in that context the effectiveness of enforceable undertakings adopted by the airlines, as well an enhanced marketing effort compared to that expected if the alliance was not approved.

An overview of the tourism industry in Australia is at Attachment A.

Australia is a medium to long haul destination for the majority of our tourism markets and airfares constitute a substantial proportion of the cost of travel.[1] Progressive liberalisation of the bilateral system of regulating international airlines has facilitated competition and growth in inbound tourism and export opportunities for Australia.

The possible price and market creation effects of competition are underlined by developments during the mid-1990s on the trans-Tasman route. The commencement of the New Zealand airline Kiwi International (which later failed) and its Air New Zealand subsidiary competitor Freedom Air, corresponded with a significant recovery of the market in growth terms; over a 12 month period visitor arrivals increased by around 25 per cent [2]. This followed an extended period of stagnation.

In this context, facilitating entry by new carriers will be critical to supporting growth from this market if the alliance goes ahead.

### Sustainability - The need for an Airline Alliance

There is an insufficient body of research to form a definitive view on the impact of alliances on tourism. However, they are clearly an important means of improving airline sustainability and maintaining services to tourist destinations which otherwise might not be possible. Alliances vary considerably, and their impact on tourism depends on their individual characteristics and the tourism markets/segments served.

Code-sharing is an important element in almost all alliances, including that proposed by Qantas/ANZ. The Department observes that codeshare can provide greater commercial flexibility for airlines in serving particular markets. This can translate into greater choice of services, improved product quality and consequent growth in inbound tourism.

A review of the existing literature on alliance tourism effects[3] suggests that in general alliances between carriers operating *overlapping* networks, such as Qantas' and ANZ's operations from New Zealand and the United States are more likely to negatively impact tourism (compensatory marketing initiatives aside).

There are significant economy-wide public benefits from having strong and competitive Australian-based airlines. Qantas plays a major role in assisting the development of

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[1] According to the Bureau of Tourism Research's International Visitor Survey (year ending June 30 2002), international airfares represented, on average, 66 per cent of the cost of a non-package tourist's trip. The proportion for New Zealand visitors is around 45 per cent. Australia's competitiveness as a tourist destination is therefore heavily reliant on an efficient and price competitive transport sector.

[2] The market creation occurred despite the small size of the new airline as the larger airlines engaged in price competition with the newcomer. Australian Bureau of Statistics (ABS) data indicates a significant fall-off in growth rates following the withdrawal of Kiwi Air from the route.

[3] The effects of international airline alliances on tourism and consumers' A report prepared for the Department of Industry, Science and Resources, Sport and Tourism Division. April 2001 Clive Morley RMIT.

inbound tourism to Australia through its substantial direct services operated from major tourism markets, and their integration with an extensive domestic network.

This Department agrees with the proposition that the alliance would strengthen Qantas and assist its long-run sustainability in what is a very difficult international trading environment characterised by low yields, increasing competition, high costs and demand volatility. There would be clear advantages in achieving a combination of two strongly-branded locally based international airlines into a sustainable regional airline Group – with a relatively stronger commitment to sustaining services to Australia and its immediate region than other international airlines.

Qantas' and ANZ's submission is based on the premise that without the alliance ANZ would be likely to exit the market under intense competition from Qantas and possibly low cost carriers. While this is a worst case scenario, it is a possibility in the current international aviation environment. The alliance would reduce the potential downside risk for tourism flows of likely aviation instability and capacity fluctuations, over the medium term, similar to those which impacted Australia post-S11 and Ansett.

## DIRECT EFFECT ON TOURISM

It is likely that more tourists are visiting Australia as a result of alliances due to air fare[4] and enhanced service effects. However, given that airline alliances are largely a response to overcoming regulatory restraints (which are being gradually liberalised) and neither their form nor their nature is stable, the net benefits/costs to travellers may change substantially over time and are not certain.

In particular, assessment of the implications of the proposed deal is complicated by potential consequential developments in the major airline alliances of which both Qantas (Oneworld) and ANZ (Star) are a part. For example, if ANZ were to exit or downgrade its membership of Star – Oneworld would move from around 40% to over 50% of Australian international airline capacity – with a further diminution of Star's competitive counter balance.

That said, the economic analysis by the *Network Economic Consulting Group* (NECG) commissioned by Qantas in support of the application appears reasonably robust and tends to be conservative in its assumptions. It appears to provide plausible outcomes and benefit estimates within the framework of its assumptions.

In relation to tourism, it reports a total tourism benefit of $426 m to Australia over the first five years of the alliance. This yield is attributed to a net gain in inbound tourism to Australia which is estimated at 27,600 in year 3 of the alliance[5]. This is largely attributed to enhanced marketing and dual destination travel[6]. The majority of tourism benefits accrue to New Zealand, being the main beneficiary of the proposed changed marketing and promotion arrangements.

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[4] Airfares charged by airlines in complementary alliances compared to non aligned carriers (p33, Morley, 2001, reference footnote 3 above).

[5] The year in which the alliance is expected to be fully operational.

[6] The airlines ascribe the major net tourism benefits from the proposal to undertaking (in conjunction with Qantas Holidays and Air New Zealand Holidays) substantially increased expenditure on advertising programs and new product offerings designed to increase tourism to Australia and New Zealand. The greater scope for triangulation of itineraries (and avoiding 'backtracking') would also provide for more convenience and time-saving schedules – and assist those markets such as Korea which are inclined toward dual destination travel.

Qantas is a major long standing partner of the Australian Tourist Commission (ATC) in the overseas marketing of Australia as a tourist destination[7]. Australia benefits from having a strong locally-based international and domestic carrier in Qantas, which has an incentive to promote Australia as a destination. We do not detect any aspects of the proposal which would see that incentive being substantially diminished. *The ATC will provide, inter alia, separate analysis on the proposal's estimation of the increased promotional effect on tourism.*

The *Tourism Futures International* (TFI) analysis commissioned by Qantas is provided in support of the proposal's claim that Qantas Holidays initiatives will account for 18,000[8] of the 27,600 extra visitors to Australia the alliance will generate. As the analysis points out, this rests largely on the potential for overseas visitors attracted to New Zealand to also visit Australia and that the extra visitors would be more likely to do so (rising from the current 35% to 50%) than current visitors, by virtue of the fact that they will be travelling on Qantas Holiday packages.

The TFI analysis looks at the estimates from a number of quantitative and qualitative perspectives and suggests that the estimates are conservative. It makes the point that the estimates do not include a number of possible positive factors. For example, they do not include any extra visitors who might come directly to Australia without also visiting New Zealand. Also, the calculations are based on 2001-02 figures and do not take into account future increases in the base numbers.

The study does not make an entirely convincing case, however, that the increased level of dual destination travel might not come at the expense of growth in mono-destinational travel to Australia (that would have occurred in the counterfactual anyway). There would seem to be some potential for a reduction in average lengths of stay – particularly for markets such as Korea and China which are time-constrained and those which are mainly mono-destinational (and unlikely to change significantly in the medium term) such as Japan. However, these effects need to be kept in context – particularly as the estimated switching effect is highly uncertain and difficult to predict.

Even if the estimates were subject to a degree of inaccuracy, overall the reported net benefit to tourism flowing from an increase in arrivals is very small relative to total tourism flows (the 27,600 extra visitors equates to 0.5% of total visitor arrivals forecasts for 2006)[9]. In yield terms, they would consume a total of around \$100 million worth of goods and services (out of a total of over \$17 billion currently). This small net benefit is clearly very sensitive to the study's demand response assumptions from increased marketing effort and promotional synergies as well as impacts from, inter alia, subsequent changes to alliance arrangements mentioned above.

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[7] Marketing, irrespective of travel prices, is also clearly demonstrated as a major factor inducing tourist travel particularly when combined with the introduction of new services. One estimate suggests that each \$1 spent by the Australian Tourist Commission (ATC) in promotion would generate an additional \$11-\$16 in tourism export income per annum – from a study by Access Economics for the ATC, The Economic Value of Tourism for Australia (May 2002).

[8] From this must be subtracted some 14,000 additional Australian arrivals into New Zealand.

[9] The NECG report suggests a net increase to Australia of around 27,000 international tourists in year 3. Year 3 is assumed to be 2006. The Tourism Forecasting Council (December 2002 forecasts) expects international visitor arrivals to grow by 5.6% in 2006, or around 315,000 visitors. This suggests the NECG figure would account for around 9% of visitor growth in 2006. Overall, the NECG figure would account for 0.5% of total visitor arrivals forecasts for 2006.

The potential for tourism increases and benefits for Australia of the magnitudes claimed in the submission may also be limited by a number of other factors including:

- The relative balance given to direct promotion to Australia (see enforceable undertakings comments below) versus the dual destination and New Zealand as a destination in its own right.
- The extent to which the benefits of redirection of marketing to joint rather than competing promotional effort are garnered more by the airlines themselves in terms of cost savings; and
- The extent to which direct services to New Zealand might replace those coming via Australia over time.

In summary, Qantas and ANZ make a reasonable case that there may be small positive benefits to tourism overall. However, the quantum of benefits and the range of uncertainties that could affect them do not make this a convincing case in its own right for supporting the alliance. The more relevant factor is the need to retain a strong, sustainable, Australian based carrier, focused on effective service and marketing of Australia and the region.

## Competition effects

The operation of open and competitive aviation markets has helped build inbound tourism growth to Australia over recent decades. This has been in large part due to Australia's pursuit of a liberal international aviation policy which includes the negotiation of 'open skies' agreements when in the national interest.

The submission recognises a significant detriment to competition in the market,[10] by combining the major two competitors, which together account for some 85% and 63 % of capacity on the Australia-NZ route and Australia-US route respectively.[11] It argues that this will be minimized, on the New Zealand route, by the presence of significant and expanding 'fifth freedom'[12] carriers and the assumption that other new carriers, particularly Virgin Blue, will enter the market.

Unlike the 'Kangaroo route', the Trans-Tasman and North America routes have only a limited presence of other carriers;[13] with the only major competitor, United Airlines, in financial difficulties and set to suspend its US-New Zealand flights.

### *Trans-Tasman*

The Single Aviation Market and 'open skies' agreement between Australia and New Zealand provides a helpful environment whereby the potential for new airline entry, *of either country*, is maximized. Apart from other potential barriers to entry - such as capital costs and infrastructure access - this helps minimise the risk that the major airlines might subsequently exploit their market position to the detriment of inbound tourism.

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[10] NECGs modelling estimate allow for increases in airfares and capacity reductions reducing inbound tourism to Australia in year 3 by around 10,700.
[11] Excluding various codeshared services.
[12] Fifth Freedom: the right to uplift/discharge revenue traffic between two foreign nations.
[13] The Qantas British Airways alliance faces 'Sixth freedom' carriers on the route such as Singapore Airlines, Malaysian Airlines and Thai Airways, Cathay Pacific and Emirates. These airlines offer competitive services on a range of routes that have a high degree of substitution for direct services.

While acknowledging that the Commission has no jurisdiction in this area, this Department is of the view that further liberalisation would be beneficial. In particular, a number of *third country* international carriers exercise traffic rights on services beyond Australia to New Zealand. While a credible catalyst for competition, the operational rights of such airlines continue to be constrained.[14]

#### *Trans-Pacific*

The implications for competition on the US route and ultimately tourism are somewhat underplayed in the proposal. The effective combination of carriers on this important tourism route, along with the United Airlines situation, also suggests the need to examine the means of encouraging third country entry on this route through a faster pace of international air services liberalisation.[15] Examples include, finalisation of 'open skies' with Singapore and the United States as well as the trading of 'beyond rights' on this route with other countries such as Hong Kong. In the case of Singapore the finalisation of an 'Open Skies' agreement is within reach. This would allow Singapore Airlines to increase flights to Australia; beyond Australia across the Tasman, and on the Australia – US route.

### Impact on airfares and availability of discount fares

The submission recognises upward pressure on airfares if the proposal is approved. On the information available to us, it is difficult to comment on the submission's claims in relation to the quantum of impact on airfares – on the relevant routes - and the availability of discount tickets[16]. Commitments from the airlines in terms of exercising price restraint, similar to those imposed at the outset of the approval of the Qantas/British Airways alliance in 1995[17], might be useful, particularly if a third airline entrant on the Trans-Tasman did not materialize.

The availability of genuine opportunities for entry by new carriers, in a competitive market, remains the most effective means of ensuring fares continue to be affordable.

### Regional Effects

The Government has a broad objective of encouraging the dispersal of international tourists and consequent economic benefit beyond the major gateways. Australia continues to be vulnerable to cuts to regional air services both by international airlines and by smaller domestic operators. The airlines' commitment to introduce new direct services to Adelaide, Hobart and Canberra is therefore welcomed.

Smaller carriers are highly dependent on 'feed' from larger carriers to make their operations more viable. The implications for a possible decline in 'feed' of international tourists to Australia's smaller carriers, particularly those unaffiliated with Qantas/ANZ also deserve recognition.

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[14] In the relevant bilateral air services agreement.
[15] Also contingent on the rights that such carriers have been granted by the US and Canada.
[16] We understand that deeply discounted seats account for some 30% of tickets sold on the trans-Tasman.
[17] In approving this alliance on the 'Kangaroo route the applicants agreed with the Trade Practices Commission to exercise price restraint such that certain fares would not increase in real terms for three years.

## AUTHORISATION WITH ENFORCEABLE UNDERTAKINGS

In their submission to the ACCC, Air New Zealand and Qantas outlined their intention to negotiate a range of enforceable undertakings designed to achieve the objective of allowing for viable entry by airlines to the market. Given the suggested scope of the alliance, and the rapidly changing nature of the global airline industry, the Department supports the application of enforceable undertakings with the Commission.

These will be important as any new domestically based carrier faces significant barriers to entry, not least of which would be limitations on access to airport infrastructure and take-off and landing slots. It would also face less access to feeder traffic (except perhaps one operating from a hub of its own), and is unlikely to be able to offer the same frequency of service (at least initially) and an attractive frequent-flyer program. It may also face intense competitive reaction from the alliance's low cost operators Freedom Air and Australian Airlines. The Department would support any undertakings running for the life of the approval and being reviewable after three years. This time frame allows for the current uncertainties in the aviation environment to work themselves through. Our suggestions for further specification of the airlines' undertakings are as follows:

**Entry Facilitation and Protection:** ***Comment*** **-** The time limits imposed on *facilities* availability and *capacity increases* (beyond natural growth) would appear to be unreasonably short in view of the long lead times necessary to develop airport infrastructure and establish viable airline operations. The suspension of the capacity increases undertaking during periods of 'abnormal demand' needs more explanation. We assume it would refer to scheduling of supplementary flights during peak holiday periods.

**Removal of Threat of Misuse of Market Power:** ***Comment*** - Again time frames appear to be too short. Termination undertakings relating to the *capacity decreases* would appear to be too easily triggered by even minimal third carrier entry e.g. an international carrier exercising it rights to launch one extra service per week. It is not clear on what basis lower load factors or a 'material reduction' in demand will be interpreted. These triggers therefore would need greater specification. It is also not clear how legitimate capacity reductions and fare increases estimated in the NECG study could be delineated from deliberate restriction of output to extract higher prices.

**Public Benefits (New Services and tourism marketing):** ***Comment*** **-** Undertakings in relation to introduction of *new services* and increased expenditure on *tourism* marketing are encouraging – particularly for assisting regional tourism dispersal. While recognising airlines need to operate profitably, some degree of confidence that new routes would endure beyond the one year specified and beyond 'temporary adverse financial performance' would be useful. The marketing undertaking should be strengthened to ensure that there is no diminution of marketing expenditure for Australia including cooperative marketing with the ATC.

## CONCLUSION

The Department supports the application made by Qantas and Air New Zealand to form a strategic alliance and the use of enforceable undertakings regarding this application. The tourism industry is highly reliant on a strong and sustainable Qantas. The alliance would help that remain the case over time.

While the formation of alliances on routes with few competitors generally reduces competition and contestability and leads to lower capacity and higher air fares, the effects on tourism can be compensated for by increased economies of scale and scope through marketing, product innovation and new route development. The initial benefits to Australian tourism as estimated are relatively small and possible alliance changes make the longer term tourism impacts difficult to predict. However, further aviation liberalisation would help create the preconditions for building a more competitive environment over time.

# ATTACHMENT A

## Tourism Overview

Tourism is an important growth industry with major flow on benefits to employment, national output and the balance of trade. In 2000-01 tourism directly accounted for 4.7 per cent of expenditure of Australia's Gross Domestic Product (GDP) and was directly responsible for employing 551,000 people or 6 per cent of total employment. In 2000-01 international tourists to Australia consumed $17.1 billion worth of goods and services, accounting for 24% of tourism consumption[18] and representing 11.2 per cent of total export earnings[19].

The tourism sector currently operates in a volatile market. The events of September 2001, together with continuing fears of terrorism and war, have significantly affected tourism patterns globally and domestically. Overall, Australia's international tourism, after falling significantly following 11 September 2001, has started to show signs of a recovery, which the Tourism Forecasting Council (TFC) expects to continue.

Over the last two years, New Zealand has experienced strong growth in international visitor arrivals compared to Australia. In 2002, international visitor arrivals to New Zealand grew by 7.1 per cent (compared to -0.7 per cent for Australia) and 6.9 per cent growth in 2001 (compared to -1.5 per cent for Australia). These figures are in contrast to the trend for much of the 1990s, were Australia generally experienced higher annual growth rates in international arrivals than New Zealand.

## Tourism from New Zealand

New Zealand is Australia's largest inbound market, and accounts for 16 per cent of total international visitor arrivals. New Zealand visitor arrivals for 2002 declined 5.3 per cent on the previous year (815,000 to 772,000 visitors). The Tourism Forecasting Council expects New Zealand arrivals to increase 3.0 per cent in 2003. The average annual growth rate for total arrivals from New Zealand for the period 2002-2012 is expected to be 2 per cent, with the Tourism Forecasting Council expecting almost 1 million arrivals in 2012. New Zealand is a very mature market, with a small population which means that it is unlikely to sustain extended periods of high growth.

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18 Applying this figure to employment suggests that international tourism to Australia supports 132,000 employed persons. International visitor arrivals in 2000-01 totalled 5.062 million. This suggests 38 international visitors are required to generate one tourism employed person.

19. In the year ended June 2002, 4.4 million international visitors came to Australia and on average stayed for 28 nights and spent $2,532 (Bureau of Tourism Research) on Australian goods and services (excluding pre-paid packages and international airfares).