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**AIR NEW ZEALAND LIMITED
AND
QANTAS AIRWAYS LIMITED**

**SUBMISSION TO THE AUSTRALIAN COMPETITION & CONSUMER COMMISSION
IN SUPPORT OF THE APPLICATION FOR AUTHORISATION**

DATED: 9 DECEMBER 2002

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EXECUTIVE SUMMARY

Application for Authorisation

This submission is made by Qantas Airways Limited ABN 16 009 661 901 ('**Qantas**') and Air New Zealand Limited ABN 70 000 312 685 ('**Air NZ**') (together, the '**Parties**') in support of applications for authorisation pursuant to sub-sections 88(1) and 88(9) of the *Trade Practices Act 1974* (Cth) ('**TPA**') of:

- (a) the acquisition by Qantas of ordinary shares comprising up to a 22.5% voting equity interest in Air NZ (the '**Equity Proposal**'); and
- (b) the collaborative arrangements between the Parties (the '**Strategic Alliance Proposal**'),

(together the '**Transactions**' or the '**Alliance**').

The Aviation Environment

The arrangements between Air NZ and Qantas are proposed at a time of unprecedented turmoil and mounting pressure for restructuring and consolidation in the international aviation industry.

Losses

2001 was only the second year in the modern history of civil aviation in which international air traffic declined. In 2001, member airlines of the International Air Transport Association ('**IATA**') recorded a collective loss of some US\$18 billion. The prospect for 2002 is for significant losses to continue. The events of 11 September 2001, which resulted in the United States Government providing some billions in loans and grants to the United States industry, only exacerbated already significant pressures on the long-term profitability of the aviation industry. The European industry has experienced similar pressures. Together those two markets have already seen the bankruptcy of Sabena, Swissair and US Airways. There is still substantial fallout to follow, with United Airlines expected to file imminently for Chapter 11 bankruptcy protection. Other countries have been forced to provide substantial financial support in order to maintain the viability of their flag carriers, including New Zealand (NZ\$885 million to date). Air NZ's re-capitalisation was a direct result of these global pressures and the failure of Ansett, but was not directly related to the events of September 11. In this global environment, Air NZ and Qantas

are individually small players; even together they represent less than 4% of the global aviation market.

Value Based Airlines ('VBAs')

The ultimate failure of Ansett is an example of the pressure full service airlines ('FSAs') are facing from the dramatic growth of low cost, "no frills", point to point airlines such as Southwest, easyJet, Ryanair and Virgin Blue, operating on short haul routes.

Airlines such as Air NZ and Qantas operate a network business, in which impacts on individual routes have flow-on effects throughout the entire network. The network generally comprises a profitable "core" with less profitable fringes that are maintained because of the contribution they make to the "core". These "network effects" make traditional network airlines particularly susceptible to VBA entry, because the VBA enters as a "greenfield" operation with no legacy costs, "cherry picks" the most profitable and busiest routes and, with very low costs, commences competition with the incumbent FSA.

Despite best efforts by FSAs to reduce costs in order to compete with the VBA model, they have generally been unsuccessful; many costs are entrenched and others are essential to compete on long haul routes and maintain a full network. The FSA finds itself losing market share on the very routes that are integral to the viability of its overall network.

The VBA has become an extremely successful business model in Europe and North America and also in Australia where Virgin Blue's entry precipitated the failure of the incumbent, long established and well-branded Ansett.

In summary, the lesson to be taken from the global experience is that the VBA model will inevitably find its way onto the trans-Tasman and New Zealand domestic routes. The low barriers facing VBA entry into or expansion in Australasia, particularly in the context of the Single Aviation Market, undoubtedly support this message. Further, absent the Alliance, in a battle between two FSAs and a VBA, the Ansett experience graphically demonstrates that in Australasia, the weaker FSA will quickly surrender its position in the market – it is not possible to fight the battle on both fronts.

Australasia

In September 1996 the Australian and New Zealand Governments entered into an "open skies" Memorandum of Understanding creating a Single Aviation Market for Australasia. As a result,

the airlines that operate within Australasia see their home market as encompassing Australia, New Zealand and the trans-Tasman. However, this market is relatively small and cannot sustain two FSAs. Despite Air NZ recently restructuring its domestic operations in New Zealand as “NZ Express”, Air NZ still remains overall a full service airline and NZ Express is still in many respects a full service operation, but with some costs taken out. Any attempt to remove the remaining costs, ie to downsize “NZ Express” to a full VBA model, would be totally incompatible with the remainder of Air NZ’s international network, rendering that remainder unsustainable. From a business perspective, the international network is reliant on the domestic network. In that circumstance, and despite its cost base being relatively efficient by international standards, Air NZ would cease to be the flag carrier promoting and supporting New Zealand’s tourism (6.6% of GDP) and export industries – both crucial to New Zealand’s economy.

The Transactions

Under the Transactions, Qantas will subscribe for up to 22.5% of Air NZ's voting equity.

The Alliance creates a Joint Airline Operation network (the 'JAO Networks') which, once fully implemented, will be commercially managed by Air NZ. However, the day to day flying operations will remain the responsibility of each airline. All Air NZ flights will be part of the JAO Networks, together with all Qantas flights into, within and departing from New Zealand. There are also extensive reciprocal rights for codesharing on each others’ services. By way of example, this will enable Air NZ to obtain feeder traffic from codesharing on connecting flights on Qantas' Australian domestic and international networks.

In respect of the JAO Networks, the Parties will co-ordinate pricing, capacity and all other aspects of the normal business operations of an airline. The two airlines also agree, as part of the Alliance, that where it is effective and efficient for them to do so they will co-ordinate on their non-JAO networks.

Air NZ’s management of the JAO Networks will be supported by a Strategic Alliance Advisory Group that comprises three representatives appointed by each airline. The decisions of that group are required to be unanimous. In simple terms, a recommendation of the Strategic Alliance Advisory Group will only result in a change in management direction when both Air NZ and Qantas agree that such a change should take place.

After taking into account the capacity of Air NZ and Qantas, each airline’s net financial performance for the JAO Networks is compared to allow for the equitable allocation of benefits.

Associated with the Transactions is the right for Qantas to have up to two directors on the Board of Air NZ. In turn, Air NZ will be entitled to have one director on the Board of Qantas, even though it is not subscribing for shares in Qantas. This recognises that the Alliance will require clear and open communication between the Parties. It also indicates the willingness of both airlines to take all steps to achieve the best outcome from their shared vision for the future.

Why the transaction?

Qantas and Air NZ, absent the Alliance, face a lengthy war of attrition for supremacy of the New Zealand based networks (ie, domestic and key international routes from New Zealand, including the trans-Tasman). Air NZ is of the view that it cannot afford to surrender its domestic network without facing ultimate failure. Its domestic base is the core of its profitability, with most of its international routes feeding traffic to that domestic network. However, the international routes are inadequately profitable other than as part of the overall network. Absent the Alliance, a war of attrition would be unavoidable. While Air NZ's domestic New Zealand routes are profitable (assisted by international feed), those of Qantas presently are not (on a standalone basis). In order to reverse that position, Qantas must increase its capacity in domestic New Zealand in order to provide frequency for the higher yield passengers – expansion by Qantas is commercially rational.

The increase in capacity and resulting battle for customers will ultimately result in one of the two full service carriers leaving the market. There is an insufficient customer base to allow two network FSAs to survive. Air NZ is not well placed to win that battle nor does it have the financial resources to credibly signal to Qantas that it can successfully engage in a long-term fight for market share.

The Alliance, while undoubtedly having competitive impacts in domestic New Zealand and on the trans-Tasman routes, will avoid the need for, and the consequences of, a war of attrition. The Alliance will enable Air NZ to maintain its operations both domestically and internationally. It will place both carriers on a more secure foundation from which to manage external "shocks", ranging from international conflicts to fuel price increases or foreign exchange fluctuations.

A one-off equity injection, absent a robust strategy that resolves the industry problems for Air NZ, does not provide an answer. Nor does an alliance with another airline, which simply expands Air NZ's international network outside of Australasia. The problem lies much closer to home. The Alliance provides the only solution. The Alliance avoids a wasteful duplication of

resources and achieves substantial and demonstrable benefits for New Zealand. In contrast, the war of attrition and its consequences deny New Zealand the major benefits that flow from the Alliance. Those benefits include the retention of a viable New Zealand majority owned and controlled flag carrier.

Qantas sees itself vulnerable to pressure exerted on its markets by other international airlines, and by the VBA impact that it is already experiencing in the Australasian market. Despite Qantas' strong performance relative to industry peers at the moment, there is a risk of its being marginalised by failing to recognise the extreme pressures on the global aviation industry, and also by failing to participate in global industry developments and to compete effectively beyond the immediate region. For Qantas, the Transactions represent a unique opportunity to establish a significant airline grouping within Australasia and an important step towards securing Qantas' long-term position as an Australasian based global network carrier.

From the perspective of both airlines, the Transactions provide a one-off window of opportunity to combine two strongly branded, locally based international airlines into a sustainable regional airline group. If they do not achieve that combination now, it is unlikely that the opportunity will remain for the future. Damage from the ongoing battle to develop sustainable networks will substantially erode the benefits of an alliance now available to New Zealand and Australia.

For the Australian and New Zealand economies, the Transactions will maintain dedicated flag carriers with strong international networks which are sustainable in global markets and committed to advancing each country's important tourism and export industries. The Transactions will allow the airline industry to play a key role in developing and enhancing those industries.

Benefits

The Transactions will result in a number of substantial, transaction specific, demonstrable public benefits including:

- (a) cost efficiencies;
- (b) scheduling efficiencies;
- (c) increased tourism to Australia;
- (d) improved freight operations;

- (e) increased international competitiveness of Qantas and Air NZ;
- (f) preservation of a commercially viable full service Australasian airline and network; and
- (g) furtherance of the national interest.

Limited Competition Concerns

There will be some detriment associated with the Transactions as a result of the potential for the Transactions to lessen competition in the relevant markets. However, the Transactions will create substantial and demonstrable net benefits overall, taking into account the proposed undertakings and the competitive constraints from existing and future competitors in the relevant markets.

The Transactions therefore clearly satisfy the authorisation tests set out in sub-sections 90(6), 90(8) and 90(9) of the TPA and ought to be authorised.

Economic Analysis

The Application is supported by rigorous and extensive independent economic analysis, documented in a report prepared by Network Economic Consulting Group ('NECG') dated 8 December 2002 ('NECG Report'). The NECG Report models the competitive effects and benefits of the Transactions and concludes that there are substantial net benefits to Australia flowing from the Transactions. The table below summarises the results and shows an aggregate net benefit outcome, at the end of Year 5, nearing A\$900 million.

Summary of net annual public benefits to Australia, A\$'000 (NPV)

	Benefits					Detriments		Trade-off
	Cost Savings	Scheduling	New Direct	Tourism	Freight	Dead-weight	Net Transfer	Total Welfare Test
1	-\$13,844	\$2,501	\$11,299	\$33,980	\$418	\$7,502	-\$22,055	\$48,908
2	\$58,552	\$2,360	\$10,660	\$77,082	-\$14	\$5,048	-\$6,021	\$149,612
3	\$121,960	\$2,226	\$10,057	\$111,281	\$1,113	\$17,526	-\$11,772	\$240,883
4	\$119,486	\$2,100	\$9,487	\$105,181	\$1,113	\$16,840	-\$10,909	\$231,436
5	\$112,815	\$1,981	\$8,950	\$98,758	\$1,113	\$16,335	-\$10,410	\$217,693
5yr Total	\$398,968*	\$11,168	\$50,453	\$426,283*	\$3,743	\$63,251	-\$61,168*	\$888,532

* represents rounding error

This table excludes substantial public benefits which cannot be readily quantified.

Undertakings

The Parties believe that enforceable undertakings will assist the ACCC's consideration of the Application. The Parties will discuss details of these undertakings with the ACCC as soon as possible. The undertakings will be designed to achieve the following objectives:

- to facilitate and protect new entry on trans-Tasman and domestic New Zealand routes, including (if necessary) access to terminals, ground services and engineering facilities;
- to ensure that the Alliance does not take unreasonable actions relating to capacity and prices on routes where the Parties will be the sole operators; and
- to ensure the delivery of certain of the public benefits identified in this Application.

Any undertakings will take into account the remedies commonly accepted by overseas regulators.

1. INTRODUCTION

Application for Authorisation

1.1 This submission is made by Qantas Airways Limited ABN 16 009 661 901 ('**Qantas**') and Air New Zealand Limited ABN 70 000 312 685 ('**Air NZ**') (together, the '**Parties**') in support of applications¹ for authorisation pursuant to sub-sections 88(1) and 88(9) of the *Trade Practices Act 1974 (Cth)* ('**TPA**') seeking authorisation of:

- (a) the acquisition by Qantas of ordinary shares comprising up to a 22.5% voting equity interest in Air NZ (the '**Equity Proposal**'); and
- (b) the collaborative arrangements between the Parties (the '**Strategic Alliance Proposal**'),

(together the '**Transactions**' or the '**Alliance**').

1.2 A copy of the Strategic Alliance Agreement ('**SAA**') between the Parties is attached as Confidential Appendix 1. The SAA is conditional (inter alia) upon authorisation being granted for the Equity Proposal and the Strategic Alliance Proposal by the Australian Competition and Consumer Commission (the '**ACCC**') and the New Zealand Commerce Commission (the '**NZCC**') (together the '**Commissions**') (SAA, clause 8.1(a)).

1.3 Implementation of the SAA and the Subscription Agreement (attached as Confidential Appendix 2) is also subject to:

- (a) Approval by the relevant overseas competition regulators where necessary (SAA, clause 9).
- (b) The Treasurer of Australia consenting to the Transactions under the *Foreign Acquisitions and Takeovers Act 1975 (Cth)* or the Treasurer becoming unable to make any order under Part II of that Act because of lapse of time (SAA, clause 8.1(b); Subscription Agreement, Schedule 2, paragraph (b)).
- (c) The Subscription Agreement becoming unconditional (SAA, clause 8.1(d)).

- (d) Air NZ obtaining Air NZ shareholder approval (SAA, clause 8.1(e); Subscription Agreement, Schedule 2 paragraph (c)).
 - (e) Obtaining Kiwi Shareholder approval (as required by Air NZ's Constitution) (Subscription Agreement, clause 2.1(a) and Schedule 2, paragraph (d)).
- 1.4 Implementation of some aspects of the Subscription Agreement is also subject, among other things, to:
- (a) Completion by the Parties of their obligations under clause 2 of the Subscription Agreement (Subscription Agreement, Schedule 2, paragraph (e)).
 - (b) All conditions to the SAA, other than the Subscription Agreement becoming unconditional, having been satisfied or to the extent they are capable of waiver, waived (Subscription Agreement, Schedule 2, paragraph (f)).
 - (c) The consent of the Minister of Finance and the Minister of Lands under the *Overseas Investment Regulations* 1995 (New Zealand) (Subscription Agreement, Schedule 2, paragraph (g)).
- 1.5 Qantas has a 46.32% shareholding in Air Pacific Limited. Qantas does not operate between Australia and Fiji other than by codesharing on Air Pacific aircraft.² Under section 47(3) of the *Commerce Act* 1986 (NZ), the NZCC will consider Qantas to be an associated person of Air Pacific and treated as "one head" for the purposes of the NZCC assessment. This submission takes the same approach.
- 1.6 In substance, the Parties seek:
- (a) Authorisation of the acquisition of shares by Qantas in Air NZ, under which Qantas will subscribe for a "cornerstone" shareholding in Air NZ of up to 22.5%. This acquisition is a pre-condition to the SAA.

¹ Together, referred to throughout this submission as the '**Application**'. There are 3 separate applications: one covering the Equity Proposal under section 88(9) and two for the Strategic Alliance Proposal under section 88(1).

² During December 2002 and January 2003 only, Qantas is operating a weekly service between Melbourne and Nadi.

- (b) Authorisation of the SAA between Air NZ and Qantas, which will, amongst other things:
- (i) Involve co-ordination and co-operation in relation to the Joint Airline Operations networks, being all Air NZ flights and those Qantas flights which operate to, from and within New Zealand (referred to in this submission as the 'JAO').
 - (ii) Involve the co-ordination of all business activities undertaken by Air NZ and Qantas under the JAO, including the scheduling and pricing of all services.
 - (iii) Involve the co-ordination of non-JAO business activities, where the Parties consider it efficient and beneficial to do so.
 - (iv) Include a formula to allow for the equitable allocation of benefits.

1.7 The Transactions are described in more detail in paragraph 2.24 and the paragraphs following.

1.8 The Transactions raise competition issues in respect of certain aviation and related markets, which are described in section 5 of this submission, as implementation of the SAA would involve a breach of section 45 of the TPA (including through the operation of sections 45A and potentially 4D) and implementation of the Equity Proposal would involve an actual or potential breach of section 50 of the TPA. However, the Parties consider that the benefits to the public which result from the Transactions will materially outweigh any detriment resulting from the lessening of competition.

1.9 The Application is supported by independent economic analysis documented in a report prepared by Network Economic Consulting Group ('NECG') dated 8 December 2002 ('NECG Report'). A copy of the NECG Report is attached as Appendix 5.

1.10 Copies of the Air NZ Annual Report for 2002 and Qantas Annual Report for 2002 can be obtained from <<http://www.airnz.co.nz/aboutus/investorcentre/publications/annualreports/default.htm>> and <<http://www.qantas.com.au/info/about/investors/annualReports>>, respectively.

- 1.11 In this submission, the Parties demonstrate that substantial and demonstrable public benefits will be generated directly by the Transactions and that to the extent that the Transactions give rise to competitive detriment, this is substantially outweighed by the public benefits.
- 1.12 The Transactions therefore clearly satisfy the authorisation tests set out in sub-sections 90(6), 90(8) and 90(9) of the TPA.
- 1.13 In addition, the Parties believe that undertakings will assist the ACCC's consideration of the Application. The Parties will discuss details of these undertakings with the ACCC as soon as possible. The undertakings will be designed to achieve the following objectives:
- (a) to facilitate and protect new entry on trans-Tasman and domestic New Zealand routes, including (if necessary) access to terminals, ground services and engineering facilities;
 - (b) to ensure that the Alliance does not take unreasonable actions relating to capacity and prices on routes where the Parties will be the sole operators; and
 - (c) to ensure the delivery of certain of the public benefits identified in the Application.

Any undertakings will take into account the remedies commonly accepted by overseas regulators.

- 1.14 Given the structural nature of the Transactions, the Parties submit that the authorisation should not be limited with respect to time. A time limitation on the authorisation would restrict the ability of the Parties to drive for long-term efficiencies.

2. DESCRIPTION OF THE PARTIES AND THE TRANSACTIONS

2.1 This section describes the parties involved in the Transactions and describes the Transactions in greater detail.

The Parties

Air NZ

2.2 Air NZ (ABN 70 000 312 685) was incorporated in New Zealand in 1940 and is New Zealand's only international and principal domestic airline. Air NZ currently operates a fleet of 83 aircraft, linking 48 destinations in 16 countries. Air NZ operates an average of 1,470 domestic flights and 194 international flights per week and employs more than 9,500 people worldwide. Air NZ is ranked as the 33rd largest airline worldwide, on the basis of annual revenue passenger kilometres ('RPKs').

2.3 Air NZ is an international and domestic group and one of New Zealand's largest companies. Air NZ is listed on the New Zealand and Australian Stock Exchanges. Its principal activities are the operation of international and domestic air passenger and cargo transport services throughout New Zealand and the South West Pacific, and to Australia, the United States and the United Kingdom. Other activities extend to business units providing engineering and ground handling services. Subsidiaries extend to travel wholesaling and retailing services.

2.4 Freedom Air is a wholly owned subsidiary of Air NZ.

2.5 In 1996 Air NZ acquired 50% of Ansett Australia Limited ('Ansett') and, indirectly, 24.5% of Ansett International Limited ('Ansett International'). In 2000 Air NZ acquired the remaining 50% of Ansett and thereby a further 24.5% of Ansett International. However, as a result of unsustainable losses on its operations, Ansett was placed into voluntary administration on 12 September 2001.

2.6 Air NZ holds 1.97% of the shares in Air Pacific.

2.7 Air NZ was 100% owned by the New Zealand Government until April 1989, when it was privatised and listed on the New Zealand Stock Exchange. When privatised, Air NZ had two separate classes of shares. A Ordinary Shares could be held only by New Zealand

nationals and B Ordinary Shares could be held by New Zealand nationals or other persons.

- 2.8 In addition, the Crown retained one fully paid special rights convertible share of NZ\$1.00 (the 'Kiwi Share'). Only the Crown may hold the Kiwi Share. While the Kiwi Share does not carry any general voting rights, the consent of the Crown as holder is required for certain prescribed actions by Air NZ or its directors. For example, under the Kiwi Share, Crown consent is required for an airline to acquire shares in Air NZ or for an overseas person or company to hold 10% or more of the shares in Air NZ. In addition, there are a significant number of provisions in Air NZ's Constitution (generally those provisions that are concerned with capital structure, ownership and composition of the Board) that may not be varied without the consent of the Crown. The Kiwi Share carries no dividend entitlements.
- 2.9 Initial investors in Air NZ were Brierley Investments Limited (35%), Qantas (20%), Japan Airlines (7.5%), American Airlines (7.5%) and the New Zealand public and institutional investors (30%). In 1992 and 1994, American Airlines and Japan Airlines sold their shares in Air NZ. In 1997, Qantas sold its shareholding to institutional investors. By May 1999, Brierley Investments Limited's shareholding had increased to just over 47%.
- 2.10 In April 2000, Singapore Airways purchased 8.3% of Air NZ and in August of that year purchased most of Brierley Investments Limited's B Ordinary Shares to increase its shareholding to 25%. Brierley Investments Limited continued to hold 30% of the shares in Air NZ.
- 2.11 Following the placing of Ansett into voluntary administration, Air NZ was recapitalised in January 2002 to secure its ongoing viability. The recapitalisation was enabled through the support of the Crown and began with the Crown advancing Air NZ a loan of NZ\$300 million in October 2001. This loan provided working capital to meet the immediate needs of Air NZ.
- 2.12 Following shareholder approval in December 2001, the second stage of the recapitalisation was completed on 18 January 2002. This involved the repayment of the NZ\$300 million loan plus accrued interest through the issue of 1,279,866,438 unlisted convertible preference shares (at NZ\$0.24 per share) to the Crown. These shares carry a

cumulative 5% dividend and full voting rights. They convert to ordinary shares in Air NZ on a one-for-one basis on 31 January 2005, or such earlier date as the Crown elects.

- 2.13 At the same time, a further 2,166,666,667 ordinary shares were issued to the Crown by Air NZ at NZ\$0.27 per share resulting in additional proceeds of NZ\$585 million. Post-recapitalisation, Air NZ has 4,203,354,290 shares on issue, with the Crown becoming the largest shareholder, owning 82% of the voting stock in Air NZ. The issue of shares to the Crown diluted the shareholdings of existing owners. Brierley Investment Limited's and Singapore Airline's shareholdings were reduced to 5.5% and 4.5%, respectively.
- 2.14 The proceeds from the issue of ordinary shares were used to repay all outstanding unsecured borrowings of Air NZ – approximately NZ\$600 million.
- 2.15 In 1999, Air NZ became a member of the marketing alliance known as Star Alliance. The Star Alliance offers customers access to seamless international travel, co-ordinated schedules and for qualifying customers access to reciprocal frequent flyer privileges and airport lounge access.
- 2.16 The members of the Star Alliance network are Air Canada, Air NZ, All Nippon Airways, Austrian Airlines, British Midland, Lauda Air, Lufthansa, Mexicana, SAS, Singapore Airlines, Thai Airways International, Tyrolean Airways, United Airlines and Varig.

Qantas

- 2.17 Qantas was incorporated in Queensland in 1920 and is Australia's only international and principal domestic airline. Qantas operates a domestic and international fleet of 194 aircraft linking 142 destinations in 32 countries. Qantas operates an average of 5,300 domestic and 540 international flights per week and employs more than 33,000 people worldwide. Qantas is ranked as the 12th largest airline worldwide, on the basis of RPKs.
- 2.18 Qantas is one of Australia's 30 largest companies and is listed on the Australian Stock Exchange. Qantas' main business is the transportation of passengers and air freight. In addition to the core airline and Australian Airlines, the following Qantas subsidiaries operate regional airline services under the brand QantasLink: Eastern Australia Airlines Pty Limited, Southern Australia Airlines Pty Limited, Sunstate Airlines (Qld) Pty Limited, Airlink Pty Limited and Impulse Airlines Pty Limited. Qantas Flight Catering Limited, Caterair Airport Services (Sydney) Pty Limited, Caterair Airport Services Pty Limited and

Snap Fresh Pty Limited operate inflight catering businesses. Qantas Holidays Limited operates holiday, tour and travel businesses.

- 2.19 Qantas holds 46.32% of the shares in Air Pacific.
- 2.20 In March 1993, British Airways Plc ARBN 002 747 597 ('BA') acquired a 25% shareholding in Qantas from the Australian Government. Subsequently, during the first half of 1995, the Australian Government sold its remaining 75% shareholding in Qantas through a public offer and Qantas listed on the Australian Stock Exchange on 31 July 1995. BA's current shareholding in Qantas is 18.93%.
- 2.21 In 1995, the (then) Trade Practices Commission granted authorisation to Qantas and BA to enter into an agreement (the '**Joint Services Agreement**' or '**JSA**') which provided for the co-ordination of various aspects of their airline services between Australia and Europe, Australia and South East Asia, and South East Asia and Europe. The authorisation expired on 11 May 2000 and allowed Qantas and BA to:
- (a) agree prices on all routes between Australia and Europe, Australia and South East Asia, and Europe and South East Asia (the '**JSA routes**');
 - (b) co-ordinate scheduling of flights on JSA routes;
 - (c) share profits or losses arising from operation of the JSA routes; and
 - (d) co-ordinate sales and marketing activities.
- 2.22 In 2000, the ACCC granted authorisation to a subsequent authorisation application lodged by Qantas and BA in respect of an amended version of the JSA (the '**Restated Joint Services Agreement**' or '**RJSA**'). The RJSA provided for similar co-ordination of airline services and prices between Qantas and BA as the original JSA. The RJSA, however, contemplated that the parties may, by agreement, extend this co-ordination and profit sharing to any part of their networks. The current authorisation of the RJSA expires on 5 July 2003. Qantas and BA intend to apply to the ACCC for reauthorisation of this agreement.
- 2.23 On 21 September 1998, founding oneworld member airlines agreed to form the oneworld marketing alliance and on 1 February 1999, the oneworld members commenced operating

the alliance. The members of the oneworld alliance are Qantas, BA, American Airlines Inc, Cathay Pacific Airways Limited, Aer Lingus, Finnair, Iberia and Lan Chile.

The Transactions

The Equity Proposal

- 2.24 The Parties propose that Qantas will subscribe for redeemable convertible notes equivalent to 4.99% of the equity in Air NZ on receipt of Kiwi Shareholder approval. On receipt of authorisation by the NZCC and ACCC and consent of Air NZ shareholders, the convertible notes will convert to ordinary shares and Qantas will subscribe for such number of Air NZ ordinary shares as would result in Qantas holding, in total, 15% of the equity of Air NZ. In addition, Qantas must, either then or at the end of a 3 year period, subscribe for such number of Air NZ equity securities as would result in Qantas holding up to 22.5% of the voting equity of Air NZ. Qantas will be entitled to maintain this level of shareholding pursuant to "top up" arrangements with Air NZ.
- 2.25 Under a Reciprocal Board Representation Deed (see Confidential Appendix 3), Qantas is entitled to nominate for appointment to the Air NZ Board:
- (a) one Qantas Nominee (an 'SAA Director') while the SAA remains in force;
 - (b) one Qantas Nominee (an 'Equity Director') if Qantas holds 10% or more of the voting securities of Air NZ; and
 - (c) a further Qantas Nominee (an additional Equity Director) if Qantas holds 20% or more of the voting securities of Air NZ (at which time the SAA Director is deemed also to be this Equity Director so that the maximum Board representation for Qantas at any one time is two directors (at the current Board size)).
- 2.26 Air NZ is required to procure that each Qantas Nominee is appointed to fill a casual vacancy on the Air NZ Board and that the Qantas nominated directors are recommended to the Air NZ shareholders for re-election as and when appropriate (provided that the Air NZ Board must recommend the initial SAA Director and Equity Director for appointment at the shareholders meeting at which Air NZ seeks Air NZ shareholder approval for the Transaction).

- 2.27 Qantas is entitled to have an "attende" attend and speak (but not vote) at Air NZ Board meetings in circumstances where it does not have, but is entitled to have, a representative on the Air NZ Board.
- 2.28 Where the SAA terminates but Qantas retains an equity interest in Air NZ, Qantas must procure that any Equity Director who is an executive or employee of Qantas is replaced with a Qantas nominee who is not a Qantas executive or employee.
- 2.29 Under the same deed, Air NZ is entitled to nominate an SAA Director for appointment to the Qantas Board.

The Strategic Alliance Proposal

- 2.30 The primary provisions of the proposed SAA contain an agreement by Air NZ and Qantas to co-ordinate pricing, scheduling, marketing, sales and customer service activities for the JAO. The JAO includes all Air NZ-operated flights, all domestic New Zealand flights operated by Qantas and Qantas-operated international flights arriving in, departing from or transiting through New Zealand ('JAO Networks'). The benefits generated through the Alliance and the JAO will be allocated equitably between the Parties in accordance with a specified formula (SAA, clause 4.4 and schedule 3).
- 2.31 Once fully implemented, under the SAA Qantas will have the right to codeshare on all Air NZ flights and Air NZ will have the right to codeshare on all Qantas flights in the JAO and to codeshare on those other Qantas flights that reasonably connect to any flight on the JAO Networks (SAA, clause 5.5). The Parties will co-ordinate capacity and pricing on the codeshare flights.
- 2.32 Once certain operational conditions are satisfied, Air NZ will manage the commercial aspects of the JAO Networks in accordance with agreed governance principles set out in the SAA. However, each Party remains responsible for the day-to-day flight operations of its respective network that forms part of the JAO Networks. Qantas will participate in the management of the JAO Networks through its representation on a Strategic Alliance Advisory Group ('SAAG') and 4 to 6 Qantas secondees to Air NZ commercial management teams. The SAAG will consist of 3 representatives from each Party and will review and endorse for reference to the Chief Executive Officers of each Party the commercial planning, operations and performance of the JAO Networks. All decisions of the SAAG require the unanimous agreement of those representatives from each airline

present at each meeting. A quorum requires a minimum of two representatives from each airline (SAA, clauses 4.2 and 4.3).

- 2.33 The SAA includes certain restrictive covenants whereby the Parties will not compete with each other (SAA, clause 10.1).
- 2.34 Air NZ and Qantas also undertake to co-operate in respect of non-JAO operations and services (such as sectors outside the JAO Network and other administration and operational matters) (SAA, clauses 2(b) and 6.1(b)).
- 2.35 The SAA is for a term of not less than 5 years, (the 5 year period commencing as defined in clause 11.6 of the SAA as varied by the letter dated 27 November 2002).
- 2.36 Further details of the Transactions can be found in the SAA (Confidential Appendix 1).

Other Transactions

- 2.37 The Parties have also entered into a:
 - (a) Subscription Agreement;
 - (b) Co-ordination Agreement;
 - (c) Voting and Sell Down Deed;
 - (d) Transition Deed;
 - (e) Reciprocal Board Representation Deed; and
 - (f) Top-Up Deed.
- 2.38 Copies of the Subscription Agreement and other related agreements are attached as Confidential Appendices 2 and 3 respectively.

3. BACKGROUND TO THE TRANSACTIONS

- 3.1 This section describes the background to the Transactions, including the strategic and commercial reasons for the Parties' decision to enter into, and objectives in pursuing, the Transactions.
- 3.2 By way of background and for the assistance of the ACCC, Appendix 6 provides a description of various industry practices and information relating to:
- (a) freedoms and bilaterals;
 - (b) open skies arrangements;
 - (c) codesharing;
 - (d) IATA and international tariff co-ordination;
 - (e) airline booking systems;
 - (f) airline and airport codes;
 - (g) aircraft description and relevant information; and
 - (h) sales methodology and yield management.
- 3.3 The global aviation industry and its impact on the Australasian aviation industry are discussed in detail in the NECG Report.
- 3.4 The Australian domestic aviation industry was for many years a two airline market as a consequence of the two airline policy enacted as legislation in the *Civil Aviation Agreement Act 1952* (Cth). The two airline policy prevailed in various forms for 38 years until 1990 when domestic airline deregulation commenced.
- 3.5 Over the next decade a number of airlines promoting low fare, no-frills travel on trunk routes entered domestic Australia only to collapse financially as a result of under-capitalisation and following discounting wars with the incumbent carriers. Despite deregulation, there continued to be two airlines, Qantas and Ansett.

- 3.6 Through the 1990s, Ansett steadily lost ground in the market and by 1996/1997, Qantas had achieved a higher market share.³ Ansett's market position was further threatened by the entry of Impulse Airlines on 5 June 2000 (which subsequently failed on 22 May 2001) and Virgin Blue, which commenced operations on 31 August 2000.
- 3.7 While Ansett's market share steadily decreased, its media profile increased with the CASA groundings over the Christmas period of 2000⁴. Across the Tasman, Air NZ announced a profit fall of 94% to NZ\$3.7 million on 21 February 2001. Recapitalisation plans for the Air NZ-Ansett group filtered into the media over the next few months. Air NZ engaged in talks with Singapore Airlines, Virgin Blue, Qantas, and the Australian and New Zealand Governments in attempts to agree a reconstruction plan.
- 3.8 By early September 2001, Air NZ revealed that Ansett was losing \$1.3 million daily.
- 3.9 On 12 September 2001, the Australian Government rejected a proposal to inject cash into Ansett to support a restructuring plan. The New Zealand Government on the other hand announced a rescue package for Air NZ on 13 September 2001.
- 3.10 On 12 September 2001, Ansett was placed into voluntary administration and on 14 September the Voluntary Administrators ceased operations. Ansett subsequently re-entered the market under voluntary administration (as Ansett Mark II) on selected routes and at reduced capacity whilst new ownership talks ensued. The most promising proposal was from the Fox-Lew consortium (the Tesna proposal). However, on 27 February 2002, the Tesna proposal was withdrawn. Ansett's last commercial flight was made on 5 March 2002.
- 3.11 Today the Australian domestic scene is characterised by one full service network airline and one VBA.

³ A90791 *International Air Transport Association (IATA) Passenger Agency Program*, 13 November 2002 ('IATA PAP'), page 29.

⁴ In December 2000, CASA grounded seven Ansett 767s because of safety concerns. On 18 January 2001, CASA grounded three of Ansett's 767s (there were three of the seven grounded in December 2000). Ansett's misfortunes continued in April 2001 culminating in CASA grounding ten 767s indefinitely.