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**Report on the Competitive Effects and Public Benefits Arising from the  
Proposed Alliance between Qantas and Air New Zealand**

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## Executive Summary

This report sets out an economic analysis of a proposed alliance between Air New Zealand and Qantas. The proposed alliance involves Air New Zealand and Qantas entering into a Strategic Alliance Agreement (the “Alliance”), which will regulate their respective airline operations on all routes operated by Air New Zealand and those operated by Qantas to, from and within New Zealand. As a condition of the Alliance, Qantas will acquire up to a 22½% shareholding in Air New Zealand.

The crucial issue for competition policy authorities in both Australia and New Zealand in respect of the Alliance is whether it yields net benefits to each country – that is, whether the benefits the Alliance brings outweigh any detriments it is likely to cause. This is the essence of the test for authorisation, for which the parties are applying, as set out under the **Australian Trade Practices Act, 1974** and the **New Zealand Commerce Act, 1986**. This report sets out the reasons why the Alliance meets that test. This Executive Summary summarises those reasons and presents the main results of the analysis contained in our full report.

In summarising these reasons, we start by setting out the wider context in which the Alliance occurs – that is, by analysing the commercial logic underpinning the Alliance. To understand this logic, it is important to understand the changing environment for international aviation, and its implications for the parties. This is consequently the focus of the first section of this Executive Summary.

While the commercial logic underpinning the Alliance is essential to any proper evaluation of its effects, the authorisation test does not look at matters from the standpoint of the parties. Rather, it asks whether society as a whole is better off in the future with the Alliance than it would be in the future were the Alliance not to proceed. In the second section of this Executive Summary we therefore identify and wherever possible quantify the benefits and costs that the Alliance would give rise to. We show that the Alliance will help secure for both Australia and New Zealand the benefits of an efficient, internationally competitive aviation industry; and that these benefits substantially outweigh the Alliance’s potential social costs.

A third, final section concludes.

## The commercial context

In 2001, the world's major airlines incurred losses of some US\$18 billion, measured in terms of operating profits before interest and tax. Since then, despite some recovery in traffic, losses have continued to mount, increasing debt levels and pushing some of the industry's largest firms to the verge of collapse. Faced with the real possibility of further serious disruption to the industry, stock markets have dramatically written down the value of aviation as a whole. This, in turn, makes it ever more difficult for airlines to finance needed investments, so that immediate problems risk becoming on-going structural weaknesses.

The dangers this environment poses inevitably weigh heavily on firms' decision-making. But serious and immediate as these risks are, there are also long term opportunities in aviation that remain substantial and will increase further in the years to come. Over the longer run, a more integrated world economy, achieving and maintaining high income levels, will encourage sustained demand for air travel, both for passengers and for freight. So long as airlines can find a viable business model – that allows needed investment to be funded – the world aviation industry ought to be well capable of offering extensive, safe and affordable service to its customers, reasonable returns to shareholders, highly skilled and secure jobs to its employees, and to the community as a whole, the gains that come from efficient domestic and international transport.

Preserving and realising these opportunities is a challenge for countries and carriers world-wide. That challenge is of special relevance, however, to our part of the world. Geographically, Australia and New Zealand are 'at the end of the line.' For example, Australia and New Zealand are four times as remote as the UK and Germany and twice as remote as the US and Hong Kong, where remoteness is measured by the weighted average distance of a country from its 10 major trading partners. An internationally competitive aviation industry, with a strong attachment to serving both countries, is indispensable if the Australian and New Zealand economies are to prosper.

Indeed, there are many opportunities the Australian and New Zealand economies can **only** secure if the aviation industry is placed on a sound footing. Central among these is tourism. Over the last decade, the tourism industry has become one of the largest sectors both in the New Zealand economy and in Australia's. In 2002, the travel and tourism industry accounted for 5.3% of GDP in Australia and 6.6% of GDP in New Zealand. The contribution travel and tourism makes to our economies is already substantially greater than that in other advanced economies, and has scope to increase further. Especially in Asia, rising income levels over the next decade will be reflected in growing tourism outlays. At the same time, in the OECD countries, demand for ecologically oriented tourism is likely to rise, putting a premium on destinations that are less spoiled than most by industrial development. Australia and New Zealand are especially well-placed to benefit from these trends.

For this potential to be realised, the airline industry must continue to play a leading role in actively promoting Australia and New Zealand as tourist destinations. Additionally and crucially, the industry must develop new services, capable of attracting repeat tourists, as the pool of potential first-time visitors becomes too small to sustain the scale of our tourism infrastructure. More flexible fares, that offer greater opportunities for 'dual destination' visitors to see the best of both Australia and New Zealand, are one important element in this regard.

Just as the continued prosperity of our tourism industries depends on aviation so too, and increasingly, will the movement of goods. In recent years, both Australia and New Zealand have developed substantial industries that rely on air freight. These industries can and should continue grow as rising incomes internationally increase the demand for high value perishables, and for other goods with high ratios of value to weight. Without efficient, reliable air transport – be it in dedicated freighters or in the belly of passenger planes – this growth opportunity too will be lost.

Both Australia and New Zealand therefore have a compelling public interest in efficient air transport. Precisely for this reason, both countries have been among the world leaders in liberalising aviation and exposing it to the full constraints of market forces. Aviation markets in Australia and New Zealand are now among the most lightly regulated in the world, and constraints on entry and competition have been largely removed.

There is a marked contrast here with many countries in the region, which retain a wide range of *de jure* or *de facto* constraints on the operation of market forces. Carriers from these countries do not really need to adjust to commercial realities – and in some cases show few signs of doing so. However, this is not a luxury carriers from Australia or New Zealand have. That this is ultimately a source of strength hardly needs saying; but it also means that if things go wrong, the 'end game' can be rapid and the consequences severe – as the collapse of Ansett so dramatically showed.

Securing the future of aviation in Australia and New Zealand should therefore be a crucial concern of policy-makers in both countries. In the immediate future, this requires ensuring that carriers in both countries can withstand the pressures of a volatile and in many respects extremely threatening international environment. But it is not a short term 'fix' that is required; rather, what is needed is to allow an industry structure to emerge that responds to the longer term changes that are reshaping aviation worldwide. It is against the backdrop of these longer term changes that the Alliance and its impacts need to be viewed.

### ***The longer term trends***

The single most important long term factor altering the structure of aviation markets internationally is liberalisation. As previously highly regulated markets have been opened to

competition, airlines have been forced to develop more efficient ways of providing service, both domestically and internationally. Consumers have benefited greatly, as fares have been reduced and the range of services on offer expanded.

Great as these consumer gains have been, there is little doubt that adjusting to a more competitive environment has placed very substantial pressure on airlines, and most notably on incumbent Full Service Airlines ("FSAs"), also often referred to as **Network Carriers** – that is, carriers such as Qantas and, historically, Air New Zealand that operate a network service, based on inter-connectivity across a wide range of routes, and seeking to provide the full range of service traditionally associated with passenger air travel. Two factors dominate the picture in this respect.

### **Globalisation and the rise of alliances**

To begin with, wider changes in the industrial economies – most notably, ever closer international economic and social integration – have created a rising demand among consumers for wide reach: for airlines that can provide essentially seamless travel on a global basis. At the same time, liberalisation has made it possible for airlines to respond to this trend, albeit within the confines of regulatory arrangements that continue to impede full industry rationalisation.

A key element here has been the development of international marketing alliances. These allow network carriers, individually and through the alliances themselves, to compete by offering customers a greater degree of connectivity and interlining than has ever been available in the past. Groupings such as Star and oneworld have thus made it possible for participating airlines to extend the scope of their services well beyond what regulatory and commercial barriers would otherwise permit.

Valuable though they are, these marketing-oriented groupings nonetheless fall well short of securing the full efficiencies that can come from integrated operation and indeed themselves impose substantial transactions costs. Although they may be the best that can be achieved in markets where restrictions on foreign ownership and control remain substantial – so that full cross-border mergers cannot occur – such loose groupings are ultimately a second best solution that is not sufficient to meet airlines' needs as competition becomes ever more intense. They can and do allow more seamless ticketing and travel to be made available; but they do not provide a framework in which cost efficiencies can be achieved, joint investments planned and executed, and new product development effectively coordinated.

It is consequently unsurprising that more recently, a substantial movement has occurred worldwide to closer links between airlines, based on equity participation and fuller integration of operations – with the recent turmoil in the industry adding impetus to this trend towards

'integrated alliances'. In 2002 alone, 7 international alliances have been granted regulatory approval or re-approval.<sup>1</sup>

These integrated alliances provide for coordination far beyond that secured within the marketing groupings. This was noted by the ACCC in its determination regarding the Restated Joint Services Agreement between Qantas and British Airways ("RJSA determination"), where it contrasted integrated alliances from marketing alliances in the following terms:<sup>2</sup>

Integrated alliances ... typically involve a high degree of integration of the airlines concerned, including coordination of fares, schedules, service levels and yield and capacity management... integrated alliances contemplate that the alliance carriers operate as a single competitive entity across part or all of their networks.

Marketing alliances offer the consumer the benefits of broader networks, more seamless travel and expanded loyalty programs. However the alliance airlines generally continue to offer their fares, schedules and services independently, and airlines within the same marketing alliance may compete with each other if on the same route.

In addition to the types of coordination identified by the ACCC, integrated alliances may also involve joint purchasing of fuel, catering services, and possibly aircraft, as well as rationalisation of ground handling services. By all of these means, the scope to secure efficiencies is enhanced well beyond that offered by looser groupings.

Whether these efficiencies are indeed obtained also depends on ensuring that each of the parties involved in an integrated alliance has incentives to act in ways that maximise benefits to the integrated alliance as a whole. Equity participation plays an important role here, as it provides the investing airline with a direct interest in the residual income of the airline it is investing in. This

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<sup>1</sup> Delta–Air France–Alitalia–Czech Airlines, American Airlines–Finnair, Lufthansa–Austrian Airlines, Delta–Korean Airlines, United–British Midland, Northwest–KLM, United–Lufthansa–SAS.

<sup>2</sup> See ACCC, 2000, *Application for Authorisation: Joint Services Agreement between Qantas Airways Limited and British Airways Plc*, 10 May. Authorisation No: A30202, File No: C1999/767 ("RJSA determination"), p. 27.



creates greater and more effective incentives for joint optimisation, for example of scheduling and aircraft selection, as the gains accrue to both parties.

The emerging pattern, therefore, is one in which integrated alliances, generally involving equity participation and full coordination of operations, are emerging in parallel to the looser marketing alliances. Over the longer term, it is these integrated alliances that define the basis for global competition among airlines; for network carriers, participation in these alliances will play an important role in securing scale and scope economies that continued regulatory restrictions on international mergers would otherwise rule out.

### **The rise of low cost airlines**

The pressure for network carriers to secure these scale and scope economies, and more generally to achieve far higher levels of efficiency in their operations, has been greatly increased by a second trend – the rise of low cost airlines. More specifically, network carriers now face a threat that was under-appreciated, if not substantially overlooked, only a few years ago: namely, the emergence of aggressive, highly successful, airlines operating on a “value based” model (hence the term “Value Based Airline” or “VBA”).

It is true that the initial liberalisation of international service had seen the emergence of discount carriers such as People Express.<sup>3</sup> These first wave entrants, however, were not able to establish viable operations, partly because of management weaknesses but also because the systems needed for low-cost service were not yet available. They therefore seemed to pose little durable threat to long-established incumbents. By the mid-1990s, however, the situation had changed dramatically. SouthWest Airlines in the US demonstrated the viability of a business model based on high frequency direct flights using a very limited set of aircraft types, with a single, rather basic class of service, no or extremely little interlining, a strong regional focus (at least initially) and very low marketing, ticketing and revenue management costs. Imitators rapidly followed and made major inroads into airline markets in virtually all the jurisdictions where airline service is open to competitive entry.

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<sup>3</sup> People Express was one of many airlines that entered following the deregulation of the United States airline industry, offering no frills flights at very low prices. Excessive borrowing and overexpansion contributed to its demise.

VBAs come in many different shapes and sizes. They evolve as they grow, and the management models and route networks they adopt to handle greater traffic volumes and market shares differ significantly. Even so, it is perhaps the most important feature of low cost carriers that they do not seek to provide full network interconnectivity; this allows them to avoid the complexities and high costs inter-lining imposes in terms of ticketing and revenue management, scheduling and flight operations. The result is that they provide a very focussed form of competition that is especially able to offer low fares to travellers with essentially point-to-point travel needs.

Experience shows that the competitive effects of low cost airlines are far greater than the extent of their market share gains would suggest. The Australian experience, in which Ansett, a carrier with over 50 years of operation, a strong brand and an extensive and loyal customer base, was driven into administration, is telling in this respect.<sup>4</sup> So too are the results of economic analysis, surveyed in section 2.1.3, which show that competition between a VBA and a FSA leads to fares significantly below those that result from competition between two or more FSAs.

These competitive effects are not confined to the routes directly served by low cost airlines. Evidence from the impact of Virgin Blue's entry into Australia, also discussed in section 2.1.3, shows that fares have declined even in areas where entry has not yet occurred. Consistent with experience in other jurisdictions, the fact that Virgin Blue has entered on some routes, and forced fares down on those routes directly, has had significant spill-over effects in the domestic market as a whole. This is not merely because the threat of entry acts as a constraint on pricing on those routes not yet served by the low-cost airline; it is also because the low-cost airline redefines passenger expectations of fare levels (most visibly through fares set, even if only temporarily, at extremely low levels), and makes it more difficult for incumbent airlines to stimulate or maintain traffic at traditional price points.

The competitive success of VBAs reflects, to at least some extent, the fact that especially on short haul flights, many airline customers prefer reductions in fares to what are only marginally higher levels of service. The recent strategy undertaken by Air New Zealand to operate as a VBA+ domestically within New Zealand is testament to the credibility FSAs place on this message that emerges from experience with value-based competition internationally. Having said that, experience internationally highlights the difficulties full service operators have in converting

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<sup>4</sup> After over 60 years of operation, Ansett ceased flying in early March 2002. See ABC Online, 2002, 'Emotional end to Ansett's demise', *Lateline* transcript, 4 March, <http://www.abc.net.au/lateline/s496184.htm>.

themselves to the VBA model, and hence the vulnerability of even the newly-adopted Air New Zealand model to displacement by a value-based alternative.

### **The challenge in summary**

Looking to the longer term, network carriers therefore face a dual challenge:

- International trends give great competitive significance to attaining the scale and reach needed to remain among the world's leading airlines, and thus secure access to worldwide networks on favourable terms. Although scale and wide reach brings benefits, it also entails substantial costs – for example, in the systems and processes needed to make complex connectivity possible.
- At the same time, however, any excess costs can and in time must create an exposure to displacement by low-cost, essentially short-haul, point-to-point airlines – with the demise of Ansett demonstrating just how vulnerable even well established brand names, with extensive frequent flyer programmes, can be.

The immediate pressures of a volatile and threatening international environment only make the difficulties and urgency this dual challenge involves all the greater.

### ***Implications for the parties***

There can be little doubt that these challenges, which define the commercial context for the Alliance, are especially acute for Air New Zealand. The reality is that since the 1990s, Air New Zealand has rarely even been able to cover the opportunity cost of the capital invested in it. Since 1997, its realised rate of return has been substantially below its Weighted Average Cost of Capital. Even excluding the impact of the Ansett acquisition, since 1997, investors in Air New Zealand have accumulated a loss, in economic terms, of some NZ\$560 million at today's prices. As these losses occurred, a wide range of shareholders have invested and then withdrawn. At the same time, the strategies adopted to turn the situation around have failed to provide Air New Zealand with a viable, much less secure, base – the acquisition of Ansett being the most spectacular case in point.

This is not to say that we believe that Air New Zealand faces near term disappearance absent the Alliance. Air New Zealand now has a strong and committed shareholder in the New Zealand Government. It also has the advantage of a loyal customer base, a deep knowledge of and presence in domestic New Zealand, and greater connectivity, particularly at Auckland, than could

readily be obtained by a competitor. Given these advantages, it is our view that Air New Zealand could continue to operate, at least for some time, were the current structure to persist.

That said, we believe it is crucial to appreciate the constraints that bear on Air New Zealand. Three are especially important.

The first is scale. Although New Zealand is not insubstantial as a base for operations, it is small in international terms. For a carrier that needs to operate on extremely long routes, covering a very wide geographical area, New Zealand's small size as an economy, combined with its location, makes it extremely difficult to secure efficient capital utilisation. Related and importantly, the small scale and dispersed route structure mean that expansions in output impose major strains in terms of capital requirements, with Air New Zealand having a structurally high incremental capital output ratio.<sup>5</sup> As a result, it is difficult, if not impossible, for Air New Zealand to grow out of its difficulties – as the experience of the 1990s made clear.

Second, Air New Zealand's domestic revenue base – both for its operations within New Zealand and for its international network – has been affected by relatively low long term economic growth. More recently, there have also been changes in New Zealand's socio-demographic characteristics that adversely affect Air New Zealand's revenue base, most particularly, a shift from large businesses as the primary source of business travel to highly price-sensitive smaller firms and at the same time, a shift in the leisure travel market to more price-sensitive segments such as retirees. These changes have imposed significant constraints on Air New Zealand's income potential and, more generally, kept its margins low. This has accentuated the effects of small scale, as it has meant that incremental output has not been highly profitable: expansion is consequently not self-financing but rather imposes added burdens on the airline's providers of capital, further limiting the scope to grow out of structural problems.

Last but not least, the New Zealand market-place is far from being a sinecure. In its **international** network, Air New Zealand faces sustained competitive pressure from a wide range of airlines. Some of these operate on an essentially non-commercial basis, with access to capital underwritten by national governments – Malaysian Airlines (whose debt has essentially been written off by the Government) being a case in point. Even putting subsidies aside, for many Asian airlines, the segment to New Zealand is an add-on, that can be and is priced at marginal cost to use aircraft

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<sup>5</sup> The incremental capital output ratio ("ICOR") measures the percentage change in assets required to sustainably increase output.

that would otherwise sit on the ground in Australia prior to their return flight to an Asian hub. The difficulties this creates for Air New Zealand are heightened by its lack of beyond rights through Asia to Europe, which prevents it from accessing what is now the major direction of travel between Europe and our part of the world. Overall, the profitability of Air New Zealand's long haul network, which accounts for a substantial share of its costs, is thereby seriously constrained.

The domestic situation is also marked by serious competitive challenge. The fact of the matter is that domestic New Zealand has never been sufficient to support two network carriers. Over the last decade, competition between network carriers has invariably resulted in serious losses being incurred, and ultimately, in the disappearance of the weaker player. For the reasons noted above – the loyalty of its customer base, its deep knowledge of the local market-place, the greater extent of its international connections – Air New Zealand has been and in some respects remains relatively well-placed to meet each of the successive challengers; but its current contest with Qantas is nonetheless one which could impose very severe strains on its sustainability and growth prospects.

Although New Zealand aviation outlays are relatively small, a New Zealand presence is of considerable significance to Qantas, not only given its geographic proximity, but also in terms of securing economies of network reach and as a means of strengthening its ability to compete relative to current or potential 'mega-carriers' from other parts of the world. Over the long run, Qantas needs a presence in New Zealand not so much because of the direct revenue potential in New Zealand, but as a part of its wider network – as a way of achieving the efficiencies that can come from interconnecting the routes within, to and from New Zealand into its wider system.

This fact – that Qantas' presence in New Zealand forms part of the commercial logic underpinning its overall network – has two significant implications. The first is that Qantas will have a greater degree of commitment to its presence in New Zealand than did Air New Zealand's previous challengers. Second, and perhaps even more important, it means that Qantas, if it is to meet its objectives in New Zealand, must operate in New Zealand as a network carrier – that is, a carrier that provides full interconnectivity within its operations, as well as the other services necessary to attract high yield traffic. For this strategy to be successful, Qantas' New Zealand operations must appeal not only to the leisure segment, but also to the business traveller. This does not only imply offering lounges and frequent flyer programs, but also and perhaps most importantly, providing a relatively high level of flight frequency on the main trunk routes.

Given this, there is, in our view, little doubt that Qantas will continue to expand its frequencies domestically, so as to approach a closer to 50/50 capacity split with Air New Zealand, while at least matching Air New Zealand's capacity on the Tasman.

More specifically, based on planning information confidential to each party, we believe that absent the Alliance, Qantas will substantially increase its capacity both in domestic New Zealand and across the Tasman (combined by nearly 30% relative to current capacity)<sup>6</sup>. We would expect Air New Zealand to also increase the capacity it deployed (on the Tasman and domestic New Zealand combined of 5%), as it could not afford to be accommodating on these routes which account for so large a share of its operations. The result would be to significantly increase costs, reduce load factors and/or yields and cut profits. Air New Zealand would remain cash positive, but absent continued underwriting by the New Zealand government (which would come at the expense of other uses of public funds), its long term financial position would not be such as to allow major investments to be financed on an economic basis.

The modelling we have done suggests that the risks inherent in this situation are very substantial. In domestic New Zealand, with an even split of capacity between the airlines, Air New Zealand will have a slightly higher share of revenues and passengers, reflecting the greater connectivity it can provide out of Auckland and some customer loyalty. Even so, the likely increase in Qantas capacity will significantly reduce the contribution Air New Zealand secures from its domestic operations, placing further pressure on the airline's already strained profitability.

As for the Tasman, given capacity costs and load factors, prices are already too low to allow an economic rate of return to be earned. Based on the financial accounts of each airline for the year to June 2001, the Tasman operations of both Qantas and Air New Zealand were unprofitable. For the year to June 2002, Air New Zealand continued to operate unprofitably on the Tasman, while Qantas achieved a small accounting profit before tax equal to 2% of total revenue. Here, with an even split of capacity, it is Qantas that will attract the higher revenue share, as its domestic base supports higher fares and attracts somewhat more feeder traffic than does Air New Zealand's. As capacity expands, a high share of the incremental losses will likely be borne by Air New Zealand.

The contributions Air New Zealand can secure from its domestic and Tasman operations are therefore uncertain at best, while to date, the long haul operations have not been able to cover their economic costs.

Obviously, this does not mean that Air New Zealand lacks strategic options. It is clear that, to date, it has deployed a range of strategies aimed at improving its competitiveness. Some have not

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<sup>6</sup> This is the percentage change, on an ASK basis, between current capacity and capacity in year 3 of the Alliance.

worked – the Ansett debacle being the most obvious of those. Others, such as the recent move to a VBA+ operation within New Zealand, are considered promising. However, these strategies do not and cannot fully address the underlying problems – that is, the broad structural forces primarily associated with the small scale of its market and New Zealand’s geographical position. These make it difficult for the airline, as a network operator, to attain the scale and scope economies that could reduce its vulnerability and allow it to more fully achieve long term expansion opportunities.

What then are the options open to Air New Zealand? One possibility is that of converting Air New Zealand as a whole into a VBA. We do not believe this strategy to be credible. Air New Zealand is fundamentally a network carrier. For its long haul operations to be viable, they must be based on interconnectivity with its domestic network, and be able to draw on a customer base that includes the higher yield segments. Conversion into a VBA would prevent this, and hence would force Air New Zealand’s withdrawal from long haul operations. It may or may not be that Air New Zealand could survive on this basis; but it certainly would not provide the kinds of benefits to New Zealand – in terms of tourism, freight and connectivity with the wider world – that impelled the Government’s decision to devote to Air New Zealand’s survival scarce public funds.

Another possibility would be that of seeking an alliance with some carrier other than Qantas. We note that this possibility has been explored, and not been found to be viable. This is not surprising, when account is taken of the position of the obvious candidates: United (which at the time of writing is on the verge of bankruptcy) is hardly well placed to consider underwriting substantial losses going forward; while Singapore Airlines has had little difficulty in increasing its market share despite the loss of Ansett, and has no interest in bearing the costs involved in the Tasman and domestic New Zealand routes that are of marginal significance to its global strategy. As a result, we see no reason why any such option would exist as a matter of commercial reality – and even less so, why it would be attractive.

In contrast, the proposed Alliance can address the structural issues that have impeded Air New Zealand’s growth in the past. It is obvious that the Alliance will make Air New Zealand far less vulnerable than it now is. But even more importantly, through the coordination of the parties’ New Zealand operations, the airline will be able to achieve significant cost savings and improve its capital efficiency, hence making it substantially easier for it to grow over the longer term.

Qantas’ position is plainly different from that of Air New Zealand. Qantas is currently one of the world’s most profitable airlines. In part, this reflects the strength of the Australian economy, and to that extent Qantas is vulnerable to the economic conjuncture. It also reflects the strong market position that Qantas acquired following the collapse of Ansett. Looking to the future, that position will be weakened as Virgin Blue develops, and possibly as further entry into the Australian

markets for domestic and international airline travel occurs. Having said that, it is clearly the case that Qantas, at least at present, seems well placed to tackle the challenges ahead.

This has obvious implications for a continued, and indeed possibly even intensified, contest between Qantas and Air New Zealand. Qantas would go into such a contest in a position of strength. Given this, it may seem that the Alliance provides no real advantage to Qantas that it could not eventually obtain even if the Alliance did not proceed.

The fact of the matter, however, is that in any such contest Qantas has much to lose. Despite its current strength, Qantas faces a substantial, steadily growing, challenge from an aggressive low cost carrier in its home market. To meet that challenge, it must reduce costs further and secure efficiency improvements wherever it can. The risk of further severe disruptions to global aviation, related to international terrorism and the world political situation, makes it all the more important that opportunities to increase efficiency be exploited quickly and fully. After all, recent years have shown how carriers that seemed strong and highly profitable – such as United and British Airways merely three years ago – can find their position drastically weakened in a very short space of time. When this happens, the restructuring they engage involves substantially reducing capacity and reach (as both United and BA have done in recent years), compromising long-term competitiveness.

Seen in terms of these imperatives, a prolonged war of attrition with Air New Zealand would potentially be very costly. Substantial economic waste would be incurred as the inefficient use of capacity was prolonged and intensified. Waste on this scale would make Qantas less rather than more competitive over the longer run. In contrast, securing a close alliance now with Air New Zealand would help Qantas reduce costs and allow the development of a wide range of new fares and services, including new direct routes between Australia and New Zealand. Importantly, it would also provide valuable additional traffic for Qantas' hub in Singapore, increasing the viability of direct Qantas flights to Rome, Paris and Frankfurt – flights which are now very marginal indeed. Over the longer term, the greater passenger volumes could support new direct routes internationally, for example to the United States and South America. The overall effect would be to increase the long term prospects for a successful global operation that brings together two very strong brands based in this region of the world.

In short, though Air New Zealand and Qantas are differently placed, the opportunity associated with the Alliance is substantial for both parties. In considering the importance of this opportunity, it is fair to ask whether it would not remain, say until stronger competition to the two carriers had emerged in the various markets in which they operate. In other words, is it not reasonable to wait until greater competition has developed before proceeding with the Alliance as proposed?



It may indeed be possible to wait. But postponing the transaction would mean incurring costs in the present that could be avoided, while the entity that eventually emerged could be materially weaker than the two parties now are. The scope to bring together two strong, internationally recognised, brands would be compromised if not foregone, and with it, the ability to use a combined base on the two sides of the Tasman as a long term asset in an ever more integrated global aviation industry.

In particular, there must be a significant risk that there would be relatively little value left in Air New Zealand, and hence less scope for the New Zealand shareholder – effectively, the New Zealand community – to secure terms in any future arrangement that ensured the fullest benefit to New Zealand. Put in the language of financial markets, Air New Zealand, and the New Zealand community generally, holds an option now – to secure an arrangement that underpins the longer term sustainability of the national flag carrier – that may well expire in future and in any event will be worth less than it is today. While the risk of this option expiring will obviously be reflected in the terms on which any arrangement can be struck in the present, far fewer benefits might be available to New Zealand if a transaction of this kind was being considered at a time when further substantial weakening of the national carrier had occurred.

New Zealand would therefore face the prospect of seeking to compete in a globalised world economy without a strong nationally-based airline. At the same time, advantages that could have been secured for both airlines and economies now would be placed at substantial risk, and quite possibly lost.

### ***The basis for the Alliance***

In contrast, proceeding with the Alliance would allow the parties to secure a competitive future in the face of continuing and profound changes in industry structure.

A key feature of the Alliance is that it will allow the parties to achieve very substantial cost efficiencies. As we show at section 5.1, by the third year of the Alliance the parties combined are estimated to reduce costs by \$281 million annually compared to the level of costs they would incur in the absence of the Alliance. These efficiencies are both a real saving from the point of view of the community as a whole and are crucial to allowing the parties to face emerging competition from lower cost operations. At the same time, by combining their planning, the parties will be able to improve their scheduling and route planning, thus again enhancing their ability to remain competitive both in their full service operations and in the operations they undertake as a VBA+.

In addition to these efficiencies, the Alliance will make it possible for the parties to offer a fully integrated operation covering Australia and New Zealand. This first of all strengthens their

domestic base, and allows them to more effectively supply travel both within that base and from that base to the rest of the world. It also increases their ability to develop packages and more generally service offerings that make travel to this part of the world attractive from places in other regions. Further, by having a fully integrated home base, spanning both sides of the Tasman, and with an enhanced capacity to market that base overseas, the parties will be less vulnerable to the shifting fortunes of international alliances and more confident of being able to participate in these alliances on terms that provide them with the greatest advantage. Last but not least, the wider reach of the Alliance will make each carrier less vulnerable to the immediate threats the industry faces, and therefore better able to fund the long term investments that participating in global aviation markets requires.

The Alliance therefore addresses both of the parties' key requirements: to secure and maintain substantially higher levels of operating efficiency; and to ensure a continued and strengthened ability to act as a fully-fledged participant in an ever more global aviation market.

## **The Alliance's costs and benefits**

There is therefore a compelling commercial logic to the Alliance. But no matter how strong these considerations are from the point of view of the parties, the role of the authorisation process is to consider the Alliance's consequences from the point of view of society as a whole. Fundamental to this assessment is a realisation that competition is not an end but a means – the end being that of ensuring that society can obtain the best use of, and hence greatest value from, the limited resources at its disposal. The question then is whether the Alliance contributes to that end.

We start by summarising some key aspects of our approach to this question, before then setting out the main points of our analysis.

### ***The approach we have adopted***

In assessing the impact of the Alliance, we view the key issue as being that of whether the benefits to society as a whole outweigh the costs, without consideration of the distribution within society of those costs and benefits. To put matters colloquially, we are concerned with the size of the pie, rather than with the allocation of its slices among alternative potential claimants.

In assessing the impact on overall efficiency, we have focussed on a comparison of the world as it is likely to develop with the Alliance relative to the world as it is likely to develop without the Alliance. This follows from the fact that the authorisation test does not ask whether the future will be better or worse than the past, but rather, whether the future should authorisation be granted

would be preferable to that which would otherwise occur. We are, therefore, necessarily engaged in the comparison of alternative futures, recognising that a degree of uncertainty must attach to that evaluative process.

This approach of comparing alternative futures, which is at the centre of our quantitative assessment, has the important effect of ensuring that the only net benefits we ascribe to the Alliance are those that otherwise, would not be realised.

This comparison of the world “with” and “without” needs to concern itself with the longer term, that is, with the consequences once there has been sufficient time for adjustment to occur. However, this does not mean that the adjustment process is irrelevant – for in comparing alternative futures, the costs required in each to attain a longer term position can be of considerable importance. Rather, the question is “taking account of what is involved in the adjustment process, and of where that adjustment process will lead, which course of action best advances society’s interests overall”?

In short, our analysis has three main features: it concerns itself with the “size of the pie”, rather than its distribution; to do so, it examines the future with and without the proposed Alliance, and hence only concerns itself with net benefits that society would not otherwise obtain; and it looks to the impacts in the longer term, without ignoring what is involved in the process of adjustment.

### ***The future with and without the Alliance***

The empirical work we have done therefore compares the outcomes likely to eventuate under the Alliance with those that are most likely in the Alliance’s absence. (Throughout the report we also refer to the future with the Alliance as the “factual” and the future without the Alliance as the “counterfactual”).<sup>7</sup>

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<sup>7</sup> We note that the New Zealand Minister of Finance, Michael Cullen, has also recognised that considering the world without the Alliance is relevant to an assessment of the Alliance. Speaking in an interview, Mr Cullen stated:

I ask you the counterfactual question: If we decide to compete head on with Qantas in full competition, why do we assume that Air NZ is going to win that

Our expectations for the world without the Alliance, as summarised above, involve a substantial increase in capacity and hence in unit costs. It is fair to ask whether such an increase is reasonable and whether it could be sustained over the period analysed.

The capacity increase we have modelled is no more than a continuation of the trend as it has played itself out over recent years. For reasons set out above, we believe Qantas's strategy on the Tasman and in New Zealand requires it to be competitive in terms of frequency. This will involve a continuing rise in the capacity it commits to domestic New Zealand and a somewhat smaller, but still continued, increase in capacity on the Tasman. At the same time, we do not believe that Air New Zealand can afford to accommodate this increase in capacity by scaling back its own commitment to the relevant markets, as doing so would jeopardise by far the largest elements in its operations. As a result, aggregate capacity will rise, as it has indeed been doing in recent years.

Faced with this increase, we believe Qantas could sustain the costs it involves and would do so, given that the strategy would be profitable in terms of the Qantas network as a whole. As for Air New Zealand, it would remain cash positive, though its contribution margins would be very heavily dependent on its domestic routes. The situation could in that sense be sustainable for a time.

That said, we acknowledge that such a situation could place severe strains on Air New Zealand. It is possible that, faced with these strains, limitations on the funding available from the New Zealand Government would force a drastic scaling back of Air New Zealand's operations. In Confidential Appendix F, we set out our understanding of what such a scenario would entail, and its implications.<sup>8</sup> The essence of this scenario is the retrenchment of Air New Zealand from a wide range of routes and the disposal of a significant share of its current fleet.

While resource costs would clearly diminish under this scenario, its longer term implications for New Zealand's economy would be adverse in numerous respects.

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competition and how deep do you think the public pocket should be to keep that competition moving along?

<sup>8</sup> That scenario is Confidential as it relies on material that would not be appropriate to disclose to Air New Zealand's competitors.

More specifically, the scaling back, if not substantial elimination, of long haul operations would seriously jeopardise New Zealand's tourism industry. Obviously, some tourist flows would remain; but the fact of the matter is that only Air New Zealand has the option of flying direct routes to New Zealand from many important sources of tourists. Additionally and importantly, Air New Zealand has a direct interest in, and a demonstrated commitment to, promoting tourism over those routes to New Zealand. A marginalised Air New Zealand, flying primarily the Tasman and domestically, could not realistically be expected to be the force for tourist promotion that the current airline is.<sup>9</sup>

Moreover, as the long haul operations were curtailed, so too would be the access to air freight of New Zealand exporters. Particularly for perishables, exporters would either need to incur higher costs (as dedicated freighters would need to be used) or face the penalties involved in relying on transit routings.

Finally and not without significance, such a scenario would impose substantial costs on Air New Zealand's suppliers and employees. While the idea of allowing the market to sort out winners and losers has its obvious and glib attractions, the reality is that large scale retrenchments are highly costly to society. Indeed, the collapse of Ansett highlighted the very wide range of social costs retrenchment in the airline industry can give rise to, although that case obviously involved the complete failure of an airline, rather than (far reaching) scaling back of capacity.

Although our analysis of the confidential counterfactual reflects what we believe to be sound judgements, it is worth noting that we are not convinced of the ultimate viability of the scenario it sets out. Scaling back an airline is a hazardous operation, that can make the airline ever more dependent on a small number of core routes. This, in turn, makes that airline ever less attractive to the high yield segment, forcing down its average revenue. As competition is attracted to those routes on which it now more heavily depends, a 'death spiral' can be engaged, in which costs cannot be removed as quickly as margins are eroded. The scenario set out in the Confidential Attachment is therefore far from being a 'worst case.'

That said, if it were thought highly likely that this scenario would otherwise eventuate, the case for authorisation of the Alliance would be self-evident. The competitive detriment, properly evaluated, would be slight, though on some routes, the parties would continue to compete. At the

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<sup>9</sup> Equally, if Air New Zealand were replaced by a VBA flying essentially on the Tasman, that too would do little for tourism to New Zealand.

same time, the public benefits of the Alliance – in terms of tourism, freight and the avoidance of high adjustment costs – would be tangible.

We have therefore undertaken the modelling of the impacts of the Alliance not in terms of this scenario, but rather relative to a continuation of the pattern that has characterised recent years – that is, sustained competition on a capacity basis both within New Zealand and across the Tasman. This is a substantially more conservative approach, in that it sets a higher hurdle for the assessment of net public benefits. But we do not believe that the risk of far more adverse outcomes can or should be ignored, as they are by no means implausible.

The question may be raised of whether there is not a realistic prospect of a less demanding form of competition eventuating – a form of competition perhaps best described as ‘cosy duopoly.’

As a general matter, aviation does not have characteristics that make for ‘cosy duopoly.’ Fixed costs are high, marginal costs are very low, the product is highly perishable, and sales occur in small units, with prices that are complex and relatively difficult to observe. These are features that make for very strong competition, and indeed, are closely associated with industries that fail to attain profitable equilibria.<sup>10</sup> Seen in the light of these features, it is unsurprising that aviation, in competitive markets, has generally had great difficulty in covering its cost of capital, and that – some two decades after liberalisation – network carriers worldwide have still not found a business model that allows commercial viability in a competitive context.

As a result, to the extent to which there are cosy duopolies in world aviation, they are based on rather narrow and specific circumstances that rarely occur when competing airlines go head to head on core routes. In particular, we are unaware of any such duopolies persisting in markets not controlled by *de jure* or *de facto* regulation. In these markets, it is the regulator that enforces a division of market shares and capacity, and hence effectively controls fare levels and the extent and distribution of profits. Once the regulation is removed, the ‘cosy’ division of profitability goes with it.

The markets here at issue are unregulated, and hence it cannot be regulatory constraints that result in a mutually profitable arrangement emerging and persisting. Rather any such arrangement would need to evolve out of the dynamic of the competitive relation between the parties. Yet, were it the case that a “cosy duopoly” might emerge, surely some signs of it, or moves in that direction,

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<sup>10</sup> In the jargon of economics, these are industries in which markets may lack a core.

would have appeared in the competitive interaction to date; but no such trend has occurred. A scenario that relied on such a move would therefore be both inconsistent with the global pattern (in which 'cosy duopoly' is associated with regulation) and plainly at odds with the experience to date.

Given this, we feel confident that the appropriate alternative against which to evaluate the economic consequences of the Alliance is one of continued capacity-based competition.

Compared to that alternative, the Alliance will bring profound changes. Once the proposal is in place, all decisions with respect to the parties' flights affecting New Zealand – that is, either within, or to or from, New Zealand – will be coordinated. Duplication that would otherwise occur would be avoided, so that costs would be substantially lower than in the world without the Alliance. No less importantly, coordinated decision-making would allow better scheduling of flights, as the current incentive the parties have to shadow each other's scheduled times would be eliminated. Further, combining the parties' load would make a wider range of direct services profitable, and hence would provide an incentive for city-pairs to be served that currently are only available through indirect flights. Overall, looking to the next 3 to 5 years, the effect of the Alliance would be to:

- increase capacity, relative to the current situation, though not as compared to the extensive duplication likely to occur in the Alliance's absence;
- improve scheduling and expand the range of direct services; and
- reduce costs relative to the world without the Alliance.

The modelling that generates these results is presented in section 4.1. The schedules that would prevail in the world with the Alliance were provided by the parties (based on estimates by the parties at a point in time), and the modelling shows that these schedules, and the aggregate capacity they imply, would be materially more profitable to the parties' than those that we believe would prevail in the world absent the Alliance. As a result, and for the additional reasons set out above, we believe that they are credible expectations of outcomes, were the Alliance to go ahead.

### ***The competitive detriment***

To secure these effects, the Alliance will effectively remove competition between the parties. At the same time, however, we believe it will stimulate competition from new sources, and most notably from low cost airlines. In turn, this will have substantial impacts on the intensity of competition overall. A careful consideration of the competitive context and of the manner in

which it will be affected by the Alliance is essential to fully understanding the changes that are likely to occur.

The starting point in this respect is definition of the markets which will be affected by the Alliance. For reasons summarised in section 2.2, and set out in greater detail in Appendix A, both commercial reality and the more formal approach to market definition typically adopted by competition authorities suggest that, as far as passenger aviation services are concerned, the relevant geographic markets are: the Australia-New Zealand aviation market – or alternatively, the market for trans-Tasman aviation, the market for services in Australia, and the market for services in New Zealand. Within the New Zealand domestic market, we believe it is helpful to distinguish between main trunk services and other services provided domestically within New Zealand. There is also a market for aviation services between New Zealand and the Pacific Islands. (We do not have a firm view on the relevant markets in which services along other directly affected international routes are provided, nor do we believe that such a view is required to assess the issues raised in the matter at hand.) There would also be impacts in the market for air freight, as well as in the market for travel agency services.

The principal effects arise in respect of passenger aviation services. Here the impact of the Alliance would be to significantly increase concentration levels. In some cases, absent new entry, a sole provider would be left on a sector. The likelihood of new entry, its timing and probable scale, are therefore of some significance.

There is scope for a lengthy, but likely inconclusive, discussion of the height of entry barriers into aviation markets. For reasons set out in section 2.3.2, we believe that the more relevant concern is the extent of barriers to expansion. More specifically, it is our view that, as compared to *ex novo* entry, there are few barriers to expansion onto Tasman or domestic New Zealand routes. A small number of routes account for the vast bulk of revenues, while “hub effects”, in which an entrant must match the extensive connectivity offered by an incumbent’s hub-and-spoke network, play little role.<sup>11</sup> Especially for an airline that has already established itself in the Australia-New

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<sup>11</sup> Hub effects – associated with “fortress hubs” such as Chicago or Forth Worth – are often viewed as the major source of entry barriers into the North American aviation market. Although Sydney and Auckland are to some extent hubs for Qantas and Air New Zealand respectively, the degree of hubbing at these nodes is nowhere near being on a scale comparable to that which occurs in the larger hub-and-spoke networks in the US. This reflects the importance of a small number of direct routes (such as Sydney-Auckland and Auckland-Wellington) in the Australasian network.



Zealand market, the costs and risks involved in expansion are therefore likely to be low, as substantial competitive presence can be obtained by providing a small number of point-to-point flights. The success of VBA entry internationally, and of Virgin Blue in Australia, confirms the scope for low cost sources of new competition, once established, to rapidly expand.

For reasons summarised in section 2.3.5, if the Alliance proceeds, it is likely to be profitable for Virgin Blue to expand into the markets most directly affected, and notably the Tasman and the domestic trunk route market in New Zealand, or for a new low cost airline to enter. Indeed, as noted in the same section, public statements made by Virgin, especially prior to and immediately subsequent to the Alliance being announced, clearly indicate that it intends to soon enter Tasman and domestic New Zealand main trunk routes.

Additionally and importantly, economic analysis suggests that VBA entry will be more profitable and hence likely if the Alliance occurs than it would otherwise be. Moreover, it will also be profitable on a greater scale than would otherwise be the case. As a result, we attach a high likelihood to full scale VBA entry occurring in the factual; we do not believe it to be likely, at least in domestic New Zealand, should the Alliance not go ahead.

The logic underpinning this differential in the likelihood of entry is simple. In the world without the Alliance, capacity will be substantially greater in both the Tasman and in domestic New Zealand than it would be were the Alliance to proceed. A VBA entering the market would face a situation in which the segments VBAs normally address, especially in their initial stages of expansion, would already be over-served, with low prices and economic losses. It is difficult to see why even a low cost airline would choose to expand onto these routes under those conditions.

This is not to say that we believe that in the counterfactual world, VBA entry would never occur. On the contrary: there is a compelling commercial logic for a carrier such as Virgin Blue to expand the geographical scope of its operations from Australia to New Zealand. In particular, such an expansion does not require fleet reconfiguration, could allow higher capacity utilisation, would permit the brand to be more fully exploited and – last but not least – would reduce vulnerability to entry by additional VBAs in the Australian market. Nonetheless, it is clear that any airline will choose routes on the basis of relative profitability; and in the world without the Alliance, it is apparent that the routes at issue would not be an attractive option for an entrant in the period analysed.

We therefore feel that it is reasonable to expect that on some routes, particularly in domestic New Zealand, VBA entry would eventuate in the world with the Alliance, but not in the world without. The fact that the parties are willing to propose Undertakings and Conditions that could materially facilitate entry adds further weight to this inference, though our modelling has not taken the

impact of any such Undertakings and Conditions into account. Rather, our modelling reflects our expectations with respect to entry as they are determined by the profitability of that entry, though we also examine the sensitivity of the outcomes to alternative assumptions.

### ***The consequences for prices and outputs***

In short, we expect the Alliance to have two, inter-related, effects on market structure: it will eliminate competition between the parties; and it will accelerate VBA expansion on to the affected routes.

To quantify these impacts, and more specifically their implications for prices and outputs, we have developed models that are set out at section 4.1. These models are based on approaches that are very widely used in, and well accepted by, the economic literature. Essentially, they determine outcomes as a result of a process in which rival firms set the quantities they will offer, with markets establishing prices that clear these quantities.<sup>12</sup>

It is important to note that these models, at least in the specifications we have adopted, are conservative, for at least two reasons.

The first and perhaps most important is that they do not capture some important aspects of price setting behaviour in airlines. More specifically, the modelling essentially derives an **average** fare. However, in reality, airline prices, particularly those charged by network carriers, are extensively differentiated – network carriers' fare structures, in other words, display very substantial price discrimination.<sup>13</sup>

Given that marginal costs are low relative to fixed costs, airlines have strong incentives to achieve high load factors, and use price discrimination (generally referred to as 'yield management') to do

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<sup>12</sup> In the jargon of economics, the model we have used is a Cournot model.

<sup>13</sup> As an illustration, we performed a simple search on the Virgin Blue and Qantas Internet sites on 15 November, 2002, for a return flight between Sydney and Melbourne on 1 February, 2003. Virgin Blue offered only two fares, its "Fair Fare" priced at \$89 one way and its "Fully Flexible" fare prices at \$199 one way, giving an overall spread for a return flight of \$220. In contrast, Qantas offered a broader range of fares for an equivalent return flight, with the lowest fare priced at \$186 and an unrestricted fare was priced at \$481, giving an overall spread of \$295.