

Table 3: Summary of routes operated by new entrants

Route	Airline(s)
SYD-MEL	Impulse
SYD-BNE	Impulse, Virgin Blue
MEL-BNE	Virgin Blue
BNE-ADL	Virgin Blue
SYD-OOL	Virgin Blue
MEL-ADL	Virgin Blue
SYD-ADL	Virgin Blue
MEL-CBR	Impulse
SYD-CBR	Impulse
BNE-TSV	Virgin Blue
MEL-HBA	Impulse

On the competitive routes listed above, Qantas load (measured in RPKs) increased 4.2%, while yields (expressed in cents per RPK) declined 18.5%.

While the impact on the non-competitive routes was more moderate than on the routes directly affected, it was still significant. On these routes, making up 49% of the Qantas domestic network, load increased 10.3% and yield declined 8.2% compared to the same period the year before. The non-competitive routes included flights to Perth (where yield fell 10.5%) and the Northern Territory (where yield fell 7.1%) for which the new airlines did not even offer an indirect alternative.

In addition, and importantly, while both Virgin Blue and Impulse provided only economy class products, their entry had significant impacts on business class yields. Qantas load (RPKs) on these routes declined 0.5% and yield (per RPK) declined 8.8%. The combination of declines in both load and yield meant that in the business cabin, revenue per unit of capacity operated (ASK) declined 17.1% during the period.

2.1.4 Rationalisation in ticket distribution

Finally, it is relevant to note trends in ticket distribution over the last decade. These changes, which reflect the widespread diffusion of the Internet and its ever growing attraction as a

distribution channel, have had the greatest impact on travel agents, traditionally the predominant distribution channel.

Requirement to reduce distribution costs

Key changes in the ticket distribution segment are being driven by airlines' attempts to reduce costs. According to the Air Transport Association, distribution costs are the fourth largest expense for carriers after labour, fuel and aircraft.⁴⁸ In order to achieve reductions in distribution costs, airlines are promoting more cost-effective means of distribution, in particular, their own Internet sites and call centres. Comments made by US airlines suggest that ticket distribution via the Internet, in particular, is significantly less costly than distribution via other channels, such as travel agents or their own reservation agents.⁴⁹

Though FSAs have made increasing use of the Internet, the lower costs associated with relying on the Internet as a primary distribution channel are most clearly reflected in the business models of VBAs. At the same time, and related to their active promotion of the Internet as the basis for product distribution, VBAs are choosing not to pay commissions to either traditional and/or online travel agencies. The net impact is to lower product distribution costs, to some extent at the expense of travel agents.

It is clear that, for VBAs especially, the use of their own Internet sites as a primary distribution channel has been successful.⁵⁰ In Australia, one article reports that around 60% of Virgin Blue's

⁴⁸ TravelScene, *International Aviation News*, April 2002, <http://www.travelscene.com.au/t042-apraviat.html>.

⁴⁹ washingtonpost.com, 2001, 'Airlines Push Web Booking To Cut Costs', Keith L. Alexander, August 22, <http://www.washingtonpost.com/ac2/wp-dyn/A43770-2001Aug21?language=printer>, which reports the views of Northwest Airlines and US Airways. See ABC Online, 2002, 'Internet booting travel agents out of airline business', 25 March, http://www.abc.net.au/news/business/2002/03/item20020323194342_1.htm, which reports the views of Delta.

⁵⁰ CNET News.com, 2001, 'Continental axes Web travel commissions', Greg Sandoval, October 24, 2001, [http://news.com.com/2100-1017-274880.html?legacy=cnet&tag=mn_hd](http://news.com.com/2100-1017-274880.html?legacy=cnet&tag=mn_hd;).; and RyanAir.com

fares are currently booked over the Internet by consumers and agents.⁵¹ Virgin Blue has previously stated:⁵²

With more than two thirds of direct sales and over half of travel agent sales generated through the net, Virgin Blue is second only to the UK's low fare carrier EasyJet, when it comes to Internet bookings.

The ACCC has noted in its draft determination in relation to the IATA Passenger Agency Program ('IATA PAP draft determination') that around half of all domestic air ticket sales are through airlines, either through call centres or via the Internet.⁵³ In the same determination, the ACCC also noted the views of travel agents that recognised the increased role of the Internet as a form of distribution, particularly for domestic air tickets.⁵⁴ In New Zealand, 29% of all domestic bookings have been through the Internet since the start of NZ Express, a significant increase on the 4% prior to NZ Express.⁵⁵

Declining commissions

With changes in technology and cost pressures resulting in airlines becoming less reliant on travel agents, especially for distribution of domestic air tickets, there has been a trend towards

news update (30 January 2001), <http://www.ryanair.com/news/bday1.html> which note the achievements of Southwest and RyanAir, respectively, in distributing tickets via the Internet.

⁵¹ 'Business Online, Trouble in Paradise', Kim Cotton, December 2001– January 2002.

⁵² Virgin Blue Press release, 2002, 'Virgin Blue Signs First Global Travel Distribution Deal: Airline Making Inroads in Key Government and Corporate Markets', 17 January, <http://www.virginblue.com.au/news/jan2002.html>.

⁵³ ACCC, 2002, *Application for Revocation and Substitution of Authorisation A90408: International Air Transport Association (IATA) Passenger Agency Program*, 13 May, Authorisation No: A90791, File No: C2001/600 (IATA PAP draft determination), pp. 28 and 59.

⁵⁴ IATA PAP draft determination, pp. 49 and 50.

⁵⁵ This 4% figure was based on a July 2002 sample.

reductions in commissions for both traditional and online travel agents. This trend has been particularly evident in the United States.⁵⁶ Recently, each of the major US airlines has stopped paying 'base' commissions to US based travel agents for airline tickets.⁵⁷ Delta Airlines, which initiated the cuts, stated that a significant driver was the increasing migration to online bookings.⁵⁸

However, other factors have, to some degree, offset the impact of the removal of base commissions. Delta, for instance, announced that it would continue to pay individually negotiated incentive commissions to select agents.⁵⁹ In addition, following moves by Continental and Northwest to cut commissions to online travel agents, Expedia and Travelocity entered into deals with the airlines to get paid on a performance basis or to buy tickets in bulk (referred to as the 'merchant model').⁶⁰

In New Zealand, Air New Zealand has recently already removed base commissions for travel agents. Currently, Air New Zealand does not pay commissions to agents for internet bookings.⁶¹ In Australia, the ACCC noted in its IATA PAP draft determination that declining commissions was a trend observed by the Australian Federation of Travel Agents (AFTA).⁶² The ACCC also

⁵⁶ <http://news.com.com/2009-1017-253373.html?tag=bplst>; wired.com, 1998, 'Online Travel Flies, with Cabin Pressures' Scott Kirsner, March 13, <http://www.wired.com/news/business/0,1367,10899,00.html>; travelbiz.com.au, 2001, 'Northwest and US Airways join US commission caps', 27 August, <http://www.travelbiz.com.au/articles/7e/0c006b7e.asp>; washingtonpost.com, 2001, *op. cit.*; CNET News.com, 2001, *op. cit.*

⁵⁷ ABC Online, 2002, 'Internet booting travel agents out of airline business', 25 March, http://www.abc.net.au/news/business/2002/03/item20020323194342_1.htm.

⁵⁸ *ibid.*

⁵⁹ CNET News.com, 2002, 'Delta cuts commissions to travel agents', Greg Sandoval, March 14, <http://news.com.com/2100-1017-860323.html>.

⁶⁰ CNET News.com, *op. cit.*

⁶¹ xtramsn, 2002, 'Fare Deal For Business Travellers', Denise McNabb, *The Independent*, 17 April, <http://xtramsn.co.nz/business/0,,5008-1307117,00.html>.

⁶² IATA PAP draft determination, p. 41.

noted the view of The Flight Centre that commissions for domestic sales were particularly low.⁶³ However, Qantas has publicly stated that it does not intend to reduce base commissions, and sees travel agents as its primary distribution channel.⁶⁴

Unsurprisingly, the growth of lower cost distribution channels has precipitated significant rationalisation and consolidation among travel agents, a worldwide trend that has impacted on travel agents in New Zealand and Australia.⁶⁵ In our view, what is important in assessing the Alliance is that any competitive impacts arising from the Alliance on ticket distributors need to be distinguished from these broader trends in travel agency commissions and industry consolidation in the Australia–New Zealand region.

Future role of travel agents

While there has been a significant trend towards airlines reducing their reliance on travel agents as a result of both changes in technology and attempts by airlines to reduce distribution costs, there is a view that the extent to which the Internet can be used as a viable alternative to travel agents has its limits, and hence, there will always be a role for the travel agent. IATA holds this view,⁶⁶ and in Australia, the ACCC has previously expressed a similar view.⁶⁷

⁶³ ibid, p. 50.

⁶⁴ Travelbiz.com.au, 2002, 'Agents increase share of QF business', 29 July <http://www.travelbiz.com.au/articles/69/0c00f769.asp>.

⁶⁵ With respect to rationalisation in the New Zealand travel agency industry, see Travel Online, 'Travel flies to the net', NZ *Herald* article, 29 January 2000, Karen Scherer <http://www.travelonline.co.nz/press/herald-29jan.html>. For an illustration of rationalisation in the Australian industry, see travelbiz.com.au, 2002, 'Not a happy New Year for agents forced out of TCF', 5 April, <http://www.travelbiz.com.au/articles/51/0c00c451.asp>. In addition, see the view expressed by the CEO of the Travel Compensation Fund, as summarised in the ACCC's IATA PAP draft determination, pp. 31–2.

⁶⁶ IATA, 'Annual Report', 1998.

⁶⁷ ACCC, 1997, 'ACCC not to oppose acquisition of travel agent', 2 March, <http://www.accc.gov.au/media/mr1997/travel.htm>.

This may well be the case, particularly for international travel. In Australia, a July 2002 article reports that travel agent sales account for around 70% of Qantas revenues, with agents accounting for 82% of international revenues.⁶⁸ As noted above, Qantas has publicly stated travel agents will continue to be its primary form of ticket distribution. In New Zealand, one article reports that 80% of all international bookings are made through agents or wholesalers.⁶⁹ Hence, while the Internet may increasingly reduce the role of travel agents in the longer term, particularly in the distribution of domestic tickets, travel agents are likely to maintain a significant role in the distribution of international tickets, at least in the short to medium term.

However, it is unlikely that this role will simply involve the distribution of tickets. To be viable, agents will have to provide services that go beyond mere ticket acquisition – services that may involve the integrated planning and purchase of travel, the control of travel costs, or the arrangement and rearrangement of complex itineraries. This would be consistent with the observed trend that travel agencies are being used mainly for the purpose of arranging more complex international travel as compared with domestic travel.

These services are increasingly likely to be paid for by the customer, rather than by the carrier – reflecting the fact that it is the customer that is best placed both to value the service and to monitor the efficiency with which it is performed.⁷⁰ By shifting into these services, agents will continue to play an important role, but one which is likely to be significantly more confined, at least in terms of the aggregate volume of resources consumed, than it was in the past.

⁶⁸ Travelbiz.com.au, 2002, 'Agents increase share of QF business', 29 July <http://www.travelbiz.com.au/articles/69/0c00f769.asp>.

⁶⁹ xtramsn, *op. cit.*

⁷⁰ Obviously, all services are ultimately paid for by customers. However, the issue is where in the chain of transactions responsibility is placed for directly paying for any charges incurred. Economic analysis suggests that this responsibility ought to be placed with the party that can best value the service provided and monitor the efficiency with which it is supplied. For ticket sales, it is not inefficient for this responsibility to lie with airline carriers. For services that are 'customised' to the needs of individual customers, it is more efficient for the customer to have responsibility for contracting for, and hence directly paying for, the service.

This outcome is in no sense unusual. Historically, changes in the technology of distribution have always been accompanied by significant changes in the pattern of distribution channels – the dramatic decrease in intermediation that accompanied the growth of supermarkets as a primary means of distribution of groceries (which in turn reflected the ever more widespread availability of cars, and suburbanisation generally) being an obvious case in point.⁷¹ Equally, across a wide sweep of industries, the growth of the Internet is changing distribution channels, especially for goods which do not require physical delivery.⁷² Inevitably, adjustment costs are imposed on distribution resources that are no longer needed, but the efficiency gains improved distribution permits should be welcomed by policy-makers, as they are the basis for durable improvements in consumer welfare.

2.2 Market definition

In defining the relevant markets, it is important to recognise that, ultimately, our purpose is to evaluate the net benefits of the Alliance. Hence, markets should be defined in a manner that best assists in this process. Taking a purposive approach to market definition is consistent with the traditional approach to defining markets in Australian trade practices law.⁷³

There are several dimensions to a market: the product, customer, functional, geographic and temporal dimensions. We focus on the first four dimensions in our analysis.⁷⁴

The economic basis upon which we delineate the relevant markets is based on the approach of analysing demand and supply side substitution. However, we also consider the commercial reality in which airlines operate, especially the global trends affecting the airline industry discussed in section 2.1. This approach recognises that a strict application of tests for demand and

⁷¹ Jones, K. & Simmons, J. 1990, *The Changing Retail Environment*, Routledge, London, p. 137ff.

⁷² Hall, R. E. 2001, *Digital Dealing*, Norton, New York.

⁷³ ACCC, 1999, *Merger Guidelines*, June, para 5.41.

⁷⁴ While we do not define a separate temporal aspect to the market, our analysis reflects the changing dynamics of the markets over time. For instance, the discussion above concerning the increased coordination amongst airlines is suggestive of market boundaries changing over time.

supply side substitution, such as the SSNIP test, may not always accurately expose the relevant arena of competition between firms.⁷⁵

Overall, our views as to the relevant markets do not significantly impact on our evaluation of the net benefits of the Alliance. The following sections merely summarise our views on the relevant markets in which to assess the competitive effects of the Alliance. A more detailed analysis is contained in Appendix A.

2.2.1 Air passenger services market

We believe that there is a product market for air passenger services, which does not include the provision of other passenger services using other modes of transport. This view is consistent with that of the NZCC in its determination regarding the proposed merger between Air New Zealand and Ansett ('Bodas determination').⁷⁶

Customer markets

Within the air passenger services market, our view is that there are no separate customer markets. Our view is consistent with that expressed by the NZCC in its Bodas determination, where it did not define separate customer markets or submarkets, despite recognising that there may exist

⁷⁵ Smith, Rhonda & Walker, Jill, 'The role of commercial reality versus substitution in Market Definition', *Competition & Consumer Law Journal*, vol.5, no.1, August 1997, pp.1–21. The SSNIP test is a formal approach to analysing demand and supply side substitution, and has been endorsed by both the ACCC and NZCC in their respective merger guidelines as a helpful analytical framework for defining markets in many situations. See ACCC, 1999, *Merger Guidelines*, June, para 5.46; and NZCC, 2001, *The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in Section 47 – A Test of Substantially Lessening Competition*, Practice Note: 4, pp. 22–4. Conceptually, the SSNIP test approach aims to define the market as the smallest area over which a hypothetical monopolist could profitably impose a small but significant and non-transitory increase in price (SSNIP).

⁷⁶ New Zealand Commerce Commission, Decision No. 278, 3 April 1996 ('Bodas determination'), para 146.

distinct customer segments.⁷⁷ However, our view may not be consistent with comments made by the ACCC in its RJSA determination, where it remarked that 'a single air transport market for economy and premium class passengers can no longer be assumed.'⁷⁸

Our view is that there are no separate customer markets for the following reasons:

- *Supply side complementarities.* There are likely to be economies of scope associated with servicing a wide range of customers with different demand profiles, as compared with specialising in serving only one type of customer. Serving a wide range of customers facilitates price discrimination, thereby maximising contributions to fixed costs. As a matter of commercial reality, this greatly strengthens the incentives airlines have to compete across customer segments, and hence makes it artificial to regard these segments as distinct markets.
- *The relative sizes of the markets.* In relatively small markets, such as the markets in which domestic Australian, domestic New Zealand and Tasman services are provided, the size of the overall market may necessitate the targeting of a broad range of customers. Virgin Blue's targeting of business customers in Australia (noted in section 2.1.3), is certainly consistent in this respect.
- *Supply side substitution.* This is most evident within the economy class cabin, where the reallocation of seats that occurs is the essence of yield management. The specialised assets required to provide a specialised business class cabin do not appear to be so significant as to prevent supply side substitution between economy and business class services. Given the ease of supply side substitution, there is no reason to believe that if there were significant margins to be made over marginal cost by providing a specialised business class cabin, an economy class-only airline would not seek to do so.
- *Demand side substitution.* On the demand side, we have performed a Critical Loss Analysis (CLA) to demonstrate that economy and business class fares are in the same market, and hence, all customers are in the same market. Our full analysis is presented in Attachment

⁷⁷ Bodas determination, paras 121–5.

⁷⁸ RJSA determination, pp. 47–9. This view has been reaffirmed in its IATA PAP draft determination(see, pp. 56–7).

A of Appendix A. In simple terms, the results of our CLA analysis demonstrate that a SSNIP by a hypothetical monopoly supplier on business class fares for Tasman and domestic New Zealand routes would be unprofitable as a result of substitution to economy fare classes on the same aircraft and to rival carriers operating economy class-only flights on the same routes. Our analysis is consistent with the observed impact of Virgin Blue's entry on Qantas business yields noted in section 2.1.3, which highlights the existence of an unbroken chain of substitution.

Functional markets

Consumers are increasingly purchasing airline tickets directly through airline call centres and internet sites. This has been especially the case for the purchase of domestic air services. Given the scope for consumers to purchase through these distribution channels as well as other channels such as wholesale and retail travel agents, our view is that there are no distinct functional layers within the air passenger services market. This is consistent with the approach that has previously been taken by the ACCC.⁷⁹

2.2.2 Air freight services market

Taking a conservative approach to defining markets, we believe that there is a product market for domestic and international airfreight. Our view is based on similar considerations to those noted by the NZCC in its Bodas determination and the ACCC in its RJSA determination.⁸⁰

Our view is that there is a continuum where, at one extreme, there is freight that is highly non-time critical. Delivery by a range of transport modes, including delivery by sea, may be viable. At

⁷⁹ In its SQ/AN/NZ determination, the ACCC noted that consumers could purchase tickets from any segment of the distribution system, including from travel retailers, travel wholesalers, and directly from airlines. See RJSA determination, p. 44. This view was reaffirmed in its RJSA determination, where the ACCC noted that consumers viewed airlines as an alternative source of tickets to travel agents. See RJSA determination, pp. 50–1. A similar view has been expressed in its IATA PAP draft determination, p. 59.

⁸⁰ Bodas determination, para 149; and RJSA determination, p. 50.

the other extreme, there is freight that is time critical. In these instances, only certain types of transport may be viable as modes of delivery, including delivery by air or, where feasible, rail delivery or "door to door delivery" by road. Consistent with this, our view is that air freight services are likely to be included in a market for time critical freight.

While we believe this to be the relevant market in which freight services are provided, we proceed on the basis that air freight services are provided in a distinct market. This approach will obviously be conservative (i.e. overstate competitive effects arising from the JSA) due to the scope for rail and road delivery to provide alternative modes of transport in some instances. However, proceeding on this basis simplifies our analysis significantly.

Confining the market to only include air freight services, competitive effects are likely to be largely revealed in our analysis of air passenger service markets. As the Productivity Commission (1998) has previously noted, around 90% of international air freight is carried in the bellyholds of air passenger aircraft.⁸¹ This is also consistent with the data we have obtained, which indicates that, in the 12 months to December 2001, 85% of Tasman air freight was carried in passenger aircraft bellyholds.⁸²

This approach will likely overestimate detriments. Aside from the point noted above that other modes of transport, such as road freight, may constrain air freight services in some instances, specialist air freight operators are active in a wide range of markets. In addition, as discussed in section 2.4, entry and expansion barriers into air freight markets are low. As a result, there is a high likelihood that expansion by these service providers could defeat an attempted price increase on freight by passenger airlines. Finally, the transportation of freight is likely to be more conducive to indirect routing than the transportation of air passengers. As the ACCC has noted, provided cargo arrives on time and in good condition, the precise means by which the cargo is transported to its destination is irrelevant.⁸³

⁸¹ Productivity Commission, 1998, *International Air Services*, September, p. 24.

⁸² Bureau of Transport and Regional Economics. The proportion of air cargo carried by passenger operators from New Zealand to Australia was approximately 88% for the 2001 calendar year, slightly higher than the corresponding proportion for air cargo carried from Australia to New Zealand, which was 83%.

⁸³ RJSA determination, p. 43.

2.2.3 Geographic markets

For both air passenger and freight services, we believe there is a single market that includes air passenger services provided in New Zealand, Australia and on the Tasman. Alternatively, there are three separate markets for New Zealand domestic services, Australian domestic services and Tasman services. Within the domestic New Zealand market, we believe it is helpful to distinguish between main trunk services, similar to the approach taken by the NZCC in its Bodas determination.

We also believe that there is a market for Pacific Island services.⁸⁴ 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. We analyse these routes on a city pair basis, namely Sydney–LA, Auckland–LA, Nadi–LA, and Papeete–LA.

While the geographic market definitions aim to capture trends in aviation markets, particularly the deregulation in airline markets and increased airline coordination discussed in section 2.1.1 and 2.1.2, in reality, the boundaries of geographic markets may be blurred. For instance, the increased coordination amongst airlines and network-based competition discussed in section 2.1.2 suggests a broadening in the scope of geographic markets over time. It is important to note that our overall evaluation of the competitive detriments arising from the Alliance does not hinge on the precise delineation of geographic markets.

Despite the fact that our analysis does not hinge on our market definitions, when considering the markets in which air passenger services are provided in Australia, New Zealand and on the Tasman, it is important to consider matters from the perspective of commercial reality.

While it could be argued that there are three distinct markets for air passenger services provided in New Zealand, in Australia, and on the Tasman, respectively, it is clear that both Australian and New Zealand carriers have placed considerable stress on the importance of providing service throughout the area, despite the substantial costs (and in the case of Air New Zealand's investment in Ansett, large losses) this involves. Interlining benefits may have been a factor in the

⁸⁴ We note that the majority of travellers to Pacific Islands are likely to be leisure passengers with high cross-elasticity of demand with respect to other holiday destinations, such as Maldives or Cairns. Therefore both the product and geographic dimensions of the market may be broader.

short term, but long term considerations – perhaps best described as a view that the relevant segments of the market are merging – have undoubtedly dominated. We consequently believe that commercial reality is best captured by considering these markets as integrated.

Despite our view that broader markets are useful, so as to be conservative, our analysis of competitive detriments is performed both on a city-pair basis for those routes directly affected by the Alliance and for broader aggregations (see section 4.2).

2.2.4 Other relevant markets

It is relevant to consider the market in which travel agency services are provided. In many instances, air tickets form part of the overall package that consumers purchase from travel agents. However, travel agents play, and will likely continue to play, a quite distinct role from airlines. They are providers of assortments, bringing together a number of disparate elements required by consumers as part of a total travel package, including accommodation, car hire and other ground transportation and tours, as well as airline transport and advice on what products might best suit their needs. As discussed in section 2.1.4, as the role of travel agents in the provision of simple ticket sales declines, the provision of these value-added services will become an increasingly important part of a travel agent's business.

For the purposes of this report, we define the market for travel agency services to be a value-added market in which travel agents supply an assortment of travel-related products, including airline tickets, package these products and provide advice to consumers. Defining this market enables us to consider the extent to which competition in the provision of travel agency services might be directly affected through an increase in market concentration. It also enables to consider the extent to which increased concentration in air passenger service markets might facilitate the exercise of market power against travel agents.

In addition, it may be relevant to consider the markets in which inputs into air service markets are provided, particularly computerised information and reservation services, engineering and maintenance services, and ground handling services are provided. These are markets that both the ACCC and NZCC have previously considered in analysing airline alliances and mergers.

These markets are relevant in considering the potential for foreclosure to air passenger service markets. Air passenger service markets may be foreclosed if airlines are unable to access inputs from upstream and downstream service providers on terms that would allow an efficient rival to effectively compete with the Alliance, with the effect of thereby deterring or hindering airline entry or expansion in the air passenger services market. In evaluating the possibility for foreclosure, it is relevant to consider the extent to which vertical relationships exist between

incumbent providers of air passenger services and service providers in upstream and downstream input markets.

2.2.5 Relevant markets in which to assess public benefits

The public benefit test relates to the overall impact on the public in the country at issue: in the Australian context it is the impact on the Australian public that is at issue and so the benefits accruing in New Zealand are not relevant to the Australian analysis and vice-versa. Hence, for the purpose of considering public benefits, we view each national context as standing alone.

Having said that, the high level of economic integration between Australia and New Zealand facilitated by agreements such as the Closer Economic Relations (CER) agreement, and more generally, the close ties between these countries, should lead to some weight being placed in each country on benefits secured in the other. Nonetheless, we have not placed any such weight on external impacts in the formal analysis.

2.3 Competitive effects in air passenger services markets

In evaluating the competitive effects arising in the markets defined in the previous section, it is relevant to consider the following:

- market concentration;
- entry and expansion barriers, and more importantly, the *likelihood* of airline expansion; and
- vertical relationships between the members of the Alliance and upstream and downstream service providers.

Our analysis focuses mainly on competitive effects as they relate to the domestic New Zealand and Tasman air passenger routes, since the Alliance will alter the structure of competition along these routes more than any others. However, a full competitive assessment of the Alliance would take account of the continuing integration of aviation markets on a global basis. The liberalisation of air travel and the increasingly international nature of demand mean that airlines increasingly view the arena of competition as being far wider than traditional anti-trust markets. Nonetheless, the evaluation of the Alliance set out here is somewhat narrower, and more closely aligned with the market definition and analysis approach adopted in the ACCC and NZCC merger guidelines.

2.3.1 Market concentration

The Alliance will result in increases in market concentration along directly affected routes beyond the market-share safe harbours outlined in the ACCC and NZCC merger guidelines, except the sole Atlantic route considered, LAX–LHR.⁸⁵ Table 4 presents the market shares, three and four firm concentration ratio (CR3 and CR4) arising from the Alliance for directly affected routes. While we believe that Tasman and domestic New Zealand routes are part of a single Australia–New Zealand market, market concentration ratios are presented separating for Tasman and domestic New Zealand routes. Appendix B presents the market shares, CR3 and CR4 arising from the Alliance for directly affected routes at the city-pair level.

⁸⁵ The NZCC and ACCC safe harbour tests recognise the potential for the exercise of both unilateral and coordinated market power. The NZCC outlines two safe harbour tests: (1) where the three-firm concentration ratio (3CR) in the relevant market is below 70%, and the combined entity has less than a 40% share; or (2) where the 3CR is above 70%, and the market share of the combined entity is less than 20%. See NZCC, 2001, *The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in Section 47 – A Test of Substantially Lessening Competition*, Practice Note: 4, p. 28. The ACCC will have concerns if a merger results in a four firm concentration ratio (4CR) of 75% or more and the merged firm will supply at least 15% of the relevant market; or if the merged firm will supply 40% or more of the market. See ACCC, 1999, *Merger Guidelines*, para 5.95.

Table 4: Alliance market share, 3CR and 4CR: June 2002 to June 2003

	ANZ/SJ/QF/FJ	3CR	4CR
Tasman	85%	92%	96%
Domestic	95%	100%	100%
Short-haul Pacific	70%	81%	90%
Asia	64%	97%	100%
Long-haul Pacific	73%	93%	97%
Atlantic	17%	78%	90%

Notes: Market shares based on forecast capacity for the June 2002 to June 2003 period. Air New Zealand data includes Freedom Air, while Qantas data includes Air Pacific. Air New Zealand data includes United for the Auckland–LA route.

Though the relevant thresholds are exceeded, this in itself does not demonstrate that the Alliance will impact on the performance of affected routes. However, it does suggest that a consideration of other factors, such as expansion barriers and vertical relationships, is required, which we discuss in the following sections.

2.3.2 Barriers to entry and expansion

In its RJSA determination, the ACCC reiterated its view that there were regulatory and commercial barriers to entry to both international and domestic markets, including those relating to capital requirements, the availability of capacity and access to airport facilities.⁸⁶ In its Bodas determination, the NZCC formed the view that a new entrant would face entry barriers to the domestic New Zealand market regardless of whether entry was in the form of FSA or VBA,

⁸⁶ RJSA determination, p. 57.

pointing to the lack of observed entry since Ansett NZ in 1987, and that Ansett NZ's entry had been marked by years of sustained losses.⁸⁷

However, the NZCC also believed that entry barriers were not significant for Tasman and other international routes. In considering conditions of entry for Tasman routes, the NZCC noted that regulatory barriers were not an issue, while there did not appear to be significant barriers to entry arising from access to inputs (including terminal facilities) for either a VBA or FSA.⁸⁸ In assessing conditions of entry for international air passenger services markets other than the Tasman, the NZCC considered designation and access to capacity as relevant factors.⁸⁹ The NZCC did not consider designation to be an entry barrier, though it did believe that access to capacity on some routes might be a problem for an entrant. Importantly, however, the NZCC noted that these issues would not arise with respect to Australia and the US routes since bilaterals allowed for unrestricted capacity.⁹⁰

While it is important to consider the factors that give rise to the overall level of entry barriers, in this instance it is more important to evaluate the likelihood of entry defeating any attempted exercise of market power by the Alliance. In other words, an essentially abstract consideration of the height of barriers cannot be determinative if entry is highly likely to occur as a matter of commercial reality.

If entry is to occur, this would most likely be in the form of an existing airline expanding operations within the Australia/New Zealand region rather than *ex novo* entry. Because of this, if anything, it is most relevant to consider *expansion* as opposed to *ex novo* entry barriers.

As stated in section 2.2.3, our view is that there is a single market that includes services provided in New Zealand, Australia and the Tasman. For this reason, the analysis of expansion barriers considers the ability for an airline operating within this Australia/New Zealand market to expand output so as to constrain the pricing conduct of the Alliance.

⁸⁷ Bodas determination, p. 58.

⁸⁸ *ibid*, p. 67.

⁸⁹ *ibid*, p. 69.

⁹⁰ *ibid*, p. 69.

However, if there were deemed to be separate markets for services provided in New Zealand, Australia and on the Tasman, then an analysis of expansion barriers ought to capture ease of adjacent market entry. That is, an analysis of expansion barriers with respect to the New Zealand domestic main trunk market ought to capture the ability for airlines operating on Australian domestic and Tasman routes to expand output so as to constrain the pricing conduct of the Alliance on New Zealand domestic main trunk routes.

The factors most relevant in assessing entry and expansion barriers in this instance are considered in the following sections.

Legal and regulatory restrictions

Legal and regulatory restrictions relating to freedom rights, foreign ownership restrictions, and the requirement to secure an air operating certificate are unlikely to pose an expansion barrier.

With respect to freedom rights, as noted in section 2.1.1, the Open Skies agreement between Australia and New Zealand allows for authorised airlines to fly unrestricted between Australia and New Zealand, and to operate domestically within Australia and New Zealand. While ownership and control restrictions could, in theory, restrict entry or expansion, we do not believe it plausible to claim that the respective governments would, as a matter of fact, restrict entry on the grounds of foreign ownership.

Furthermore, as to Tasman services, a number of carriers have beyond (fifth freedom) rights, which they use to provide services between New Zealand and Australia. These include Asian carriers such as Thai International, Malaysian Airlines and Garuda. In addition, there are other airlines that have fifth freedom rights that are not currently exercised, for instance United Airlines. These fifth freedom carriers represent a substantial competitive factor and there remains scope for further expansion by one or more of these carriers. The level of competitive discipline that fifth freedom carriers impose is substantially greater than their market shares suggest. Fifth freedom carriers have the choice of either leaving their aircraft on the ground in Australia until they are ready to fly out of Australia to coordinate with the schedules in their respective hubs or they can run a tag flight between Australia and New Zealand on free aircraft time. As there is no opportunity cost in terms of the use of the aircraft (it would otherwise sit on the ground in Australia) the fifth freedom carriers only need to recover variable costs to make the flight viable. This allows them to offer very low fares and gain significant market share.

Finally, with respect to services between New Zealand and the US, there is an Open Skies agreement between the two countries.⁹¹

Sunk costs

In its Bodas determination, the NZCC considered sunk costs to provide incumbents with advantages.⁹²

Sunk costs can provide incumbency advantages, particularly when considering ex novo entry. However, any barriers raised are lessened by the fact that, for domestic New Zealand and Tasman routes, a small number of routes account for a substantial portion of overall market revenues: Just four routes – AKL-SYD, AKL-MEL, AKL-BNE and CHC-SYD account for 77% of all passengers flown on all primary Tasman routes. Furthermore, just three routes – AKL-WLG, AKL-CHC, and WLG-CHC – account for 94% of all domestic New Zealand air passenger traffic on primary routes. Ceteris paribus, a requirement to develop a relatively modest, yet ostensibly viable, route structure would also moderate capital needs for any entrant.

However, expansion barriers are likely to be low. Sunk costs associated with entry on the Tasman would be low for a VBA that had already established a presence in the Australian market. There would, in particular, be few investments required to invest in developing a management, administration and marketing infrastructure, as the existing assets used to provide these functions in Australia could largely cater to the needs of the cross-Tasman service (though there would be some investments of this type required in New Zealand). The same would be true for engineering and similar services, consistent with the discussion in section 2.3.4.

Capital costs

It has been argued that there is a cost asymmetry between entrants and incumbents arising from the higher costs of capital borne by entrants arising from the risk of failure. Whether or not this is true depends on whether there are imperfections in capital markets. Regardless of this, it is clear

⁹¹ Though substantial national ownership and effective control requirements apply.

⁹² Bodas determination, p. 44.

that for a successful existing player in the Australia–New Zealand region, with a business strategy that has proven to be profitable, any asymmetries would be limited.

Economies of scale and scope

Network and density economies can provide some advantage to incumbents in the relevant markets.⁹³ Again, for the domestic New Zealand and Tasman markets, these economies may be lessened by the fact that the city-pairs in question are essentially point-to-point as well as by the fact that a small number of routes account for a substantial portion of overall market revenues, as discussed above.

In contrast, in the denser continental markets – such as the US, and to a lesser extent, Europe – complex and interleaving route structures create scope for economies to be achieved by organising traffic around hub and spoke networks. Control of a major hub can then confer an advantage to an incumbent carrier, as an entrant, to compete, would need to replicate a substantial infrastructure providing and carrying feeder traffic. This could require substantial sunk costs.

Even so, control over ‘fortress hubs’ has proved of relatively little use to incumbent airlines in preventing VBAs from making very substantial competitive inroads. Where city-pairs are of sufficient size to sustain direct service, VBAs have managed to bypass hubs, and indeed, have gained some marketing advantage by reducing the time passengers would otherwise have to spend in transit.

That said, an airline’s access to feeder traffic – for example, from minor routes in Australia to and from the Tasman route – could have an effect on its ability to achieve economies of density. In that event, an entering or expanding airline, absent effective interlining arrangements, might need to incur some cost disadvantage (by foregoing economies of density on the routes it served) or would have to enter both the Tasman and the minor routes simultaneously. It is likely that the sunk costs associated with such two-level entry would be high.

⁹³ Network economies are the cost savings accruing from network size, and the spreading of fixed costs associated with this size over significant quantities of output. Economies of density refer to cost savings accruing from running more traffic over any given route. These economies can arise, for example, from the ability to use larger aircraft with lower unit costs as load rises.

The extent to which this is an issue in practice depends on the importance of feeder traffic on the routes affected by the Alliance. As discussed in section 2.3.3, this is likely to differ between an FSA and VBA.

Access to landing slots and terminals

The NZCC did not see the availability of landing slots as a deterrent to entry in its Bodas determination.⁹⁴ At the time of its Bodas determination, the NZCC expressed some concern over the ability to obtain access to slots at Auckland and Wellington airports during peak periods and inclement weather.⁹⁵ The NZCC noted that, during such periods of disruption and delay, smaller airlines tended to suffer, since priority was given to jet aircraft. With respect to Auckland, the NZCC noted that, in future, very small aircraft might be restricted in their use of Auckland Airport.

Currently, there are no congestion problems at Christchurch Airport.⁹⁶ AIAL has also stated that congestion is only an issue at peak times.⁹⁷ However, the combination of bad weather, topography and aircraft capabilities creates problems at Wellington Airport and, in future, such problems may increase due to traffic growth.⁹⁸ The Traffic Capacity Forum, formed in 1996 and which involves Airways New Zealand, airlines and New Zealand's airport companies, deals with such issues, and new software has recently been introduced at Wellington Airport to manage aircraft flows, and is to be introduced at Auckland Airport.⁹⁹

⁹⁴ *ibid*, p. 50.

⁹⁵ *ibid*, p. 49.

⁹⁶ Christchurch International Airport Limited, 2001, *Response to Commerce Commission Critical Issues Paper*, 27 April, p. 34.

⁹⁷ Auckland International Airport Limited, 2001, *Submission to Commerce Commission*, 27 April, p. 33.

⁹⁸ Wellington International Airport Limited, 2001, *Submission To The Commerce Commission In Respect Of The Commission's Price Control Study Of Airfield Activities*, 27 April, Appendix 6(c).

⁹⁹ www.airways.co.nz/documents/2001AR_3.pdf.

In Australia, Sydney Airport does have landing slot congestion at times, largely due to its jet curfew, which is effective between 2300 and 0600. However, advice from the Airport Co-Ordination Authority suggests that an entering or expanding airline onto Tasman routes would be unlikely to have difficulties obtaining landing slots.

With respect to terminals, the view expressed by the NZCC in its Bodas determination was that the ability for a new entrant to obtain domestic terminal access at the major airports in New Zealand would differ depending on whether domestic entry was in the form of FSA or VBA. While it appeared to form the view that access to domestic terminals might well be an issue for FSAs, it noted the views of the airports that VBAs could be accommodated with little difficulty.¹⁰⁰ There have been no changes with respect to the scope for entrants to access terminals since this determination except that Qantas currently occupies space that was previously held by Ansett NZ. In Australia, there do not appear to be any difficulties in obtaining access to international terminal space.

Despite the fact that an airline would unlikely be constrained from entering or expanding onto the Tasman or onto New Zealand main trunk routes due to difficulties in accessing landing slots or terminals, we note that the Alliance parties are willing to submit undertakings to facilitate entry and expansion should the Commission deem that these are necessary.

Brand loyalty

Both Air New Zealand and Qantas are likely to have branding and reputation advantages arising from their country's flag carrier status, and their sound safety records.

However, experience shows that VBAs such as Virgin Blue in Australia and EasyJet in Europe have had little difficulty in establishing very strong brand presence. Additionally, as noted in section 2.1.3, the US experience has tended to be that incumbents have sharply dropped fares in response to VBA entry. This has also been the case with the recent VBA entry into Australia.

This suggests that any such barriers relating to brand and reputation may well be limited, if not for potential FSA entrants, then at least for potential VBA entrants. This would be especially so for an airline operating in Australia expanding onto Tasman or domestic New Zealand routes, which

¹⁰⁰ Bodas determination, p. 48.

would likely face low hurdles in terms of overcoming branding advantages owing to the close economic and cultural ties between Australia and New Zealand.

It may also be case that switching costs associated with frequent flyer programs are not as significant as has been presumed (though they are likely to have some impact on initial entry costs). In Australia, the collapse of Ansett has meant many travellers have not had sufficient time to build a large inventory of air points on other Australasian carriers. These passengers would be especially important to any Tasman entrant. Any switching costs would be low for these customers. Also, the presence of Virgin Blue in Australia and Origin Pacific in New Zealand, as well as United Airlines and its Star Alliance partners (especially Singapore Airlines) as feeders of international traffic in both countries provides opportunities for any entrants to tap into pools of passengers that have less or no loyalty to the Qantas or Air New Zealand brands.

More significantly, data on air passenger traffic indicates that passenger participation in frequent flyer programs is not so widespread that it would represent a high barrier to entry. Only 29% of all Qantas passengers on Tasman flights in the year ending May 2002 even participated in Qantas's frequent flyer program. Only about one-third of these program members (or about 10 per cent of all passengers) had achieved any of the 'status' levels associated with moderate levels of participation.¹⁰¹ For Air New Zealand over the same routes and time period, the results were similar, with only about 21% of all passengers participants in the airline's frequent flyer program and only about one-third of participants having achieved any but the lowest 'status' level in that program.¹⁰²

Again, it is necessary to distinguish the importance of frequency flyer programs for VBAs as compared with FSAs. In particular, VBAs such as Virgin Blue have actively marketed the

¹⁰¹ That is, only about 36% of the passengers that were members of the Qantas frequent flyer program had achieved at least 'Silver' status (which requires about 5 to 30 one-way flights per year). The remaining 64% qualified for 'Bronze' status, which requires only that they be members of the program.

¹⁰² That is, about two-thirds of participants who flew on the airline's Tasman flights during the period had achieved only the 'Jade' status level, a level that requires no flights at all for qualification.

advantages associated with not operating frequent flyer programs and airline lounges. For instance, the Virgin Blue website boasts:¹⁰³

What you won't find in our low fares ...

The cost of airline lounges and frequent flyer programs.

Expensive add-ons such as these are hardly essential during a short commute. Instead, we focus on giving you true service. Like a dynamic, service-minded crew and the most qualified pilots in Australia.

Finally, perhaps the greatest illustration that branding and reputation advantages do not impose a significant barrier to entry is the collapse of Ansett. Despite Ansett having both a strong brand and a frequent flyer program, this was not sufficient to insulate it from the forces of intense price competition that arose, particularly from VBA entry.

The history of entry and exit in the relevant markets

In considering entry barriers and likely entry, both the NZCC and ACCC consider the history of entry and exit to be relevant.¹⁰⁴

In Australia, since the removal of the domestic 'two airlines' agreement favouring Ansett Airlines and the government-owned Australian Airlines in 1990, entry has occurred on several occasions, and though most entrants have been unsuccessful (e.g. Compass, Compass II and Impulse), there is at least one instance of significant success, namely Virgin Blue. In New Zealand, there have been failures (e.g. Ansett NZ, Tasman Pacific Airlines), though Origin Pacific Airways and Qantas continue to operate. On the Tasman, there has been significant fifth freedom activity. Kiwi International also operated on the Tasman from late 1994 before it went into liquidation in 1996.

In summary, the Australia-New Zealand market has seen entry and expansion by VBAs, with Virgin Blue's entry into Australia being especially successful. However, there is also a record of failure by entrants and even by a seemingly entrenched incumbent.

¹⁰³ <http://www.virginblue.com.au/>.

¹⁰⁴ NZCC, 2001, p. 38; and ACCC, 1999, para 5.128.

Barriers to entry and expansion: summary

Overall, competition in airline markets is capable of being extremely 'tough', in the sense of driving prices to very low levels, and hence can impose great strains on firms that are weak either in financial terms or in terms of the quality of their management. When this happens, sizeable losses can be accumulated in relatively short periods of time. The risk this involves may weigh especially on entrants not in a position to adopt an incremental, 'toe in the water', approach to entry.

However, as summarised above, despite these potential impediments, the NZCC has previously found entry barriers onto Tasman and international routes to not be significant. Our analysis above also demonstrates that expansion barriers for an airline already operating in the Australia–New Zealand region are likely to be low.

A more important consideration in assessing the impact of the Alliance is whether entry is *likely*. To be specific, when considering entry and expansion barriers, while it is important to consider the factors that combine to give rise to the overall level of barriers (such as those listed above), it is more important to evaluate whether the likelihood of entry and expansion defeating any attempted exercise of market power by the Alliance. As we demonstrate in section 2.3.5, in this instance, an abstract consideration of the height of barriers is not especially relevant given that entry is highly likely to occur as a matter of commercial reality.

2.3.3 Access to feeder services

The view could be put that Air New Zealand and Qantas benefit from feeder traffic from other domestic routes for Tasman traffic and, in Air New Zealand's case, domestic traffic on its trunk routes. In its Bodas determination, the NZCC considered the ability of a domestic New Zealand entrant to access feeder traffic from provincial or tourist centres, though did not see this as a significant competitive concern:¹⁰⁵

A high proportion of the total population is concentrated in the three main centres – Auckland, Wellington and Christchurch. Traffic from provincial and tourist routes moving onto main trunk services is not a substantial proportion of total main trunk

¹⁰⁵ Bodas determination, p. 52.

traffic. Information available to the Commission suggests it is less than one-sixth. While access to feed is important, the Commission does not see it as critical.

Likewise, the NZCC also considered the ability for a domestic New Zealand entrant to obtain feed from international arrivals, though again did not see any significant concerns in this respect:¹⁰⁶

Feed from international arrivals is another factor. When Qantas sought a shareholding in Air NZ in 1989, Ansett NZ submitted that a loss of feed from Qantas' international flights would threaten its viability. The Commission concluded that it would not. International feed accounted for a relatively small amount of domestic traffic (around 10%) and there were other airlines flying into New Zealand, although their combined volumes were much lower than for Qantas and Air NZ.

Both Air New Zealand and Qantas have gained important advantages through feeder traffic from other domestic routes for Tasman traffic and, in Air New Zealand's case, domestic traffic on its trunk routes. This feeder traffic is significant and might well place a potential FSA entrant, in particular, at some disadvantage. For example, Qantas estimates that about 42% of its Tasman traffic are interline passengers from its own or another airline network (with more than 90% of interline passengers fed from other Qantas flights).

Offsetting this advantage, to some extent, there are opportunities to form alliances with existing services provided by independent carriers to provide feeder traffic for both Tasman and domestic New Zealand traffic. Passenger feeds from Virgin Blue could potentially provide a trans-Tasman carrier with domestic Australian traffic to and from trans-Tasman services.¹⁰⁷ A domestic New Zealand entrant could provide traffic feeds for the New Zealand side of these routes.

Foreign carriers and a trans-Tasman entrant could provide feeder traffic to and from a domestic New Zealand entrant. In addition, and also importantly, Origin Pacific is available to provide feeder traffic to and from provincial routes to a domestic New Zealand trunk route entrant (as well as a trans-Tasman entrant).

¹⁰⁶ *ibid*, p. 53.

¹⁰⁷ The willingness of Virgin Blue to cooperate with an entrant to provide such feeds would almost certainly depend, to a great extent, on that carrier's entry plans in the relevant market segments.