Tourism
Industry
Association
New Zealand

Tourism Industry Association New Zealand

New Zealand's airline industry: "Policy and Preferences"

Comments to the
New Zealand Commerce Commission on
the Proposed Air New Zealand/Qantas
Alliance

February 2003

About Our Association and Industry

The Tourism Industry Association New Zealand (TIANZ) represents the interests of over 3,500 businesses in the tourism industry.

Tourism is a $15 billion industry and generates 13% of New Zealand's exports (foreign exchange earnings). International visitors account for approximately 40% of Tourism's visitor volume and value. The tourism industry employs 1 in 10 New Zealanders in a diverse range of businesses – the majority of which are small and medium sized enterprises. Not only is tourism important because of its size. It is also:

- Highly employment intensive;
- Regionally dispersed;
- Has the flexibility to change its target markets quickly as conditions change;
- Can offer a good return on investment.

The tourism industry in New Zealand consists of more than 10,000 small and medium sized businesses. Of these businesses, most employ less than five people.

New Zealand welcomes over two million overseas visitors to its shores every year. The domestic tourism industry is also important in helping to sustain a vibrant tourism industry. TIANZ estimates that over 75 million visitor nights are spent by New Zealanders every year.

TIANZ welcomes the opportunity to comment on the proposed alliance between Air New Zealand Qantas as has been submitted for consideration to the New Zealand Commerce Commission, and the Australian Competition and Consumer Commission.

Both Air New Zealand and Qantas are members of TIANZ.

This submission consists of the following:

- A statement on TIANZ's policy regarding a competitive and efficient air services network into and around New Zealand that supports Tourism

- A review of the recent history of service in the airline industry in New Zealand and the key issues being faced by that industry

- A statement on the key public good issues that TIANZ believes should be taken into account by the Commission as it assesses the Alliance proposal

- An assessment of the proposals compared to the status quo and how they might impact on pricing, service standards, innovation, returns, and the overall public good.

The tourism industry and the airline industry

The airline industry, both domestic and international is critical to the success of the New Zealand tourism industry as almost all international visitors fly to New Zealand. The domestic airline main trunk routes, and provincial routes enable both international and domestic tourists to access all parts of the country, and this has enabled tourism to provide economic development benefits to all regions of New Zealand. The airline industry is also a vital component within the nation's non-passenger transport system and provides services to exporters and importers without which our economy would fail to perform either competitively or efficiently.

To be successful, tourism requires the following:

- Main trunk network services using aircraft and service levels that are comparable to those in the countries of our key sources of visitors (Japan, USA, UK, Europe and Australia)
- International services to key countries of origin that source valuable visitor streams
- A diverse regional network using appropriate modern aircraft
- City-to-city service standards that support business and non-business customer activities within a business day (0630 hours-2100 hours)
- Service pricing at a level that enables an efficient provider to make a return on capital employed at a cost of capital (CoC) that is internationally competitive, ie. a premium over the risk-free rate (government bonds) that reflects the risk of patronage (e.g a likely range for the cost of capital would be between 8%-13%)
- Supporting infrastructure that enables pre/post flight efficiency, minimal waiting and transit time, ample facilities for surface transport, appropriate rest facilities for service users, catering etc. The standards for these services should reflect those of our key sources of visitors (Japan, USA, UK, Europe and Australia)

TIANZ's Policy for New Zealand's Air Services Network.

TIANZ believes that the tourism industry and New Zealand as a whole should be serviced by a domestic and inbound airline industry that is characterised by the following key factors:

Competitiveness	TIANZ supports a competitive (efficient) model. A single supplier model that is heavily regulated in terms of price and behaviour is not supported. TIANZ believes that the consent of the Commerce Commission for any (proposed) commercial transaction is sufficient evidence of it meeting the issue of competitiveness.

Efficiency	TIANZ supports the quest for business excellence and efficiency in all forms of Tourism Supply. Models of best practice that work elsewhere are opportunities for positive inclusion in the NZ environment. The NZ air services network is small by international standards and customers are unlikely to enjoy competitive and profitable service quality without ruthless efficiency being practised by airlines
Profitability	The intensive capital requirements of airlines together with strict safety and quality regimes demands that prices be set so as to achieve short to medium term profitability (within a competitive framework). The recent historical practice of delivering excessive value to either customers or distribution channels at the expense of shareholders/suppliers/staff and the consequential failure to maintain economic value is not supported by TIANZ. A fair balance must be struck!
Frequency	Customer support of airline services is a key factor in determining frequency, but TIANZ believes that tourism is best served by matching assets to demand and by stimulating demand through value propositions rather than by overcapitalisation of routes and consequential price-led behaviour.
Coverage (Routes)	TIANZ observes that Tourism is currently experiencing around 6% volume and 9% value growth per annum. This is seen as sufficient to interest suppliers and is evidence that NZ is a destination that is in demand by overseas visitors. However, TIANZ is aware that airlines, particularly Air New Zealand, contribute to the promotion of New Zealand as a destination. TIANZ expects close integration between Air Service Providers and Tourism New Zealand so as to project a consistent and attractive view of New Zealand to the priority markets of Japan, United Kingdom, USA/Canada, Australia and Europe and the secondary markets of Asia. TIANZ estimates that the public good benefit to New Zealand from the promotion of its routes by Air New Zealand equates to a present value of over $1.4 billion – or an annual sum of approximately $100 Million. Domestic coverage is dependent on demand. TIANZ policy on this facet of coverage is that airlines in a commercial and profitable environment will offer such coverage as is supported by demand. The issue of seasonality is large and TIANZ encourages regions and airlines to co-operate on stimulation of demand as a means of reducing the debilitating effect of seasonality (a factor of over 2 ½ to 1 between peak and off-peak).

TIANZ's submission and the analysis contained within it support the attainment of this policy.

Recent airline history in New Zealand

Recent airline history in New Zealand has been characterised by a number of new entrants to the New Zealand market providing some notable and direct benefits to the consumer plus indirect benefits to the wider public.

The entrance of Ansett New Zealand into the domestic market in 1987 provided the catalyst for:

- Short-term consumer choice as far as tariffs were concerned

- Extensive upgrades to airport infrastructure including the construction of new terminals

- Improvements in ancillary infrastructure such as transport services, terminal services and roading

- The introduction of on-line service information systems

- Improved onboard service, including a full meal service and the option of travelling business class

- Better route/time convenience, especially to regional parts of the country.

In addition to Ansett New Zealand, the 1990s saw the arrival of Kiwi Air, Freedom Air (as a subsidiary of Air New Zealand) and Origin Pacific. Kiwi Air and Freedom Air brought low-price - service differentiated fares to the Trans-Tasman routes. Origin Pacific and the domestic operations of Freedom Air introduced low-price – service differentiated services within the domestic market. However, all of these airlines with the exception of Origin Pacific are no longer operating domestically. Freedom Air is a subsidiary of Air New Zealand and is considered to be part of its price-service product differentiation.

The consumer gains from airline competition between the years 1987 and 2002 have also come at a significant cost to the industry. TIANZ estimates that the combined Ansett New Zealand/Qantas New Zealand losses were in the vicinity of $500 million over this period. Competition and off-shore expansion also affected Air New Zealand and in 2001 the airline was virtually insolvent and lost shareholder value of approximately $1.5 billion.

TIANZ understands from the Air New Zealand Alliance proposal that the Qantas New Zealand domestic operations continue to lose money.

Both Qantas and Air New Zealand claim that the Trans Tasman route is unprofitable and have revisited capacities and prices.

This past history illustrates that:

- A relatively unregulated market readily attracts new entrants however the life of these new entrants has tended to be short

- New entrants provide impetus for service upgrades and new infrastructural services, such as airport terminals. So far, these improvements have endured beyond the life of the new entrant.

- In the short-term, customer appealing competitive behaviour develops but the distribution of market share between incumbent and new entrant fails to develop to the stage where there is sustainable competition.

- Even survivors have struggled to earn returns that enable them to safely reinvest in new capital and earn a rate of return that satisfies shareholders. This leaves the future of full-network provider airlines such as Air New Zealand vulnerable to further price wars with (so-called) Value-Based Airlines selectively entering the New Zealand market (cherry picking routes), or absorption by overseas airlines. These vulnerabilities jeopardise the present value of $1.4 billion in offshore, public good marketing that Air New Zealand currently provides to New Zealand.

Public good issues

There are a number of important public good issues for New Zealand that TIANZ believes relevant to the Air New Zealand/Qantas Alliance proposal.

Branding of New Zealand

New Zealand is a remote, non-hubbed destination. Not only is there a need to promote the tourism products available upon arrival, but there is also the need to promote the nation itself as almost every product available on arrival is available elsewhere else in the world!

Promotion of New Zealand as a destination and the visitor products available on arrival occurs through specific product marketing by private sector tourism operators including Air New Zealand. With the exception of Air New Zealand, private sector marketing is predominantly focussed on products available upon arrival. Tourism New Zealand and Air New Zealand are the two organisations that market the totality of the destination. Tourism New Zealand's public good promotion addresses the failure of the majority of the private sector to promote the totality of the destination.

Air New Zealand's marketing efforts contain intrinsic public good promotion of New Zealand and TIANZ estimates that this has a present value of $1.4 billion (estimated from an average of $100m spend per year at a discount rate of 7%). If Air New Zealand ceased to be a separate entity, Tourism New Zealand's budget would need to rise to over $155 million per annum to purchase similar public good exposure. TIANZ observes that this expenditure would be enjoyed by other inbound carriers that have their own national identities and agendas.

Tourism's new objectives

New Zealand's marketing direction is prioritised on generating 'visitor value' in contrast to prioritising 'visitor volume'. The Provisional March 2000 Tourism Satellite Accounts estimates the indirect effect on the rest of the economy from each direct $1 of visitor spend at approximately $1.38 (being the ratio of Direct Tourism Value Added to Indirect Tourism Demand). This is a significant public good issue as it affects not only private sector performance supplying the visitor industry but also the public infrastructure needed to realise the 'worth' of these targeted visitors. It also affects the future capacities of private infrastructure – such as inbound air services – which clearly need to reflect value, rather than volume, based needs. This represents a material change from historical behaviour and was sparked by the release of New Zealand's Tourism Strategy 2010 document in May 2001.

The New Zealand inbound airline market must be able to sustain several carriers (including Air New Zealand for brand purposes) that operate at service levels that are consistent with the expectations of overseas visitors that New Zealand is actively targeting.

Dependency

Almost all incoming visitors arrive in New Zealand by air.

The reality is that many international full service airlines flying to New Zealand have failed or reduced services in recent times. Necessary questions to ask are: can New Zealand afford not to ensure a diversity of choice of services to Australia, the United Kingdom, Japan, the United States and Europe? What mechanisms will ensure longer-term, branded air access to key markets?

Choice

The consumer (both within New Zealand and overseas) should have the ability to have a choice of services. Distribution systems should also facilitate the ability to make a choice. This is essential to ensure that the behaviour that arises from competition is clearly evident in the New Zealand airline industry (irrespective of whether it is generated by head-to-head competition or not) and that service providers continue to operate within a market that expects appropriate standards of service quality.

Overall, TIANZ strongly suggests that the private good issues surrounding the provision of international and domestic air services products must also accommodate these public good issues.

Scenarios for the future

TIANZ is aware of a number of scenarios for the future that merit consideration. Two of these include the status quo and the proposed Alliance. In addition, TIANZ also envisages additional scenarios that might deliver the behaviour of competition.

In summary form, these scenarios are as follows:

1. **Status Quo**

   Continue head-to-head competition where new domestic and trans-Tasman entrants seek a sustainable (profitable) market share.

2. **The proposed Alliance**

   An Alliance of key incumbent suppliers to provide the majority of domestic and trans-Tasman services.

3. **A regulated air services network (Domestic/Trans-Tasman)**

   The behaviour expected from head-to-head competition is achieved by formal regulation to ensure that new entrants can enter the market and develop to the point of achieving a sustainable market share – after which regulation declines.

4. **Public Good controlled air services network.**

   The behaviour expected from competition to the extent that it supports selected public good goals is achieved through the influence of the Crown as major shareholder of the incumbent service provider (Air New Zealand).

Commentary on these Scenarios

TIANZ has considered the potential impact of these scenarios on pricing/capacity, service standards, innovation, returns, and public good. These observations follow:

1. **Status Quo**

   There is no reason to believe that the future of this scenario will differ from what has happened over the past decade.

   a. **Price/Capacity**

   There will be sustainability issues unless a situation is reached where a new entrant can achieve a sustainable market share. [TIANZ believes that relative market shares of at least 70% (incumbent):30% (new entrant) will be necessary to achieve this]. In the short-term, there would continue to be effective competition on both pricing and capacity. If a sustainable position supporting two full service providers is ever reached in the medium to long-term, pricing and capacity will trend towards standardisation.

   b. **Service standards**

   Service differentiation will be an aspect of competitive behaviour in the short term. Beyond that, service differentiation will become standardised and may even gradually reduce over time.

   c. **Innovation**

   Short term innovation will have both direct (air services) and indirect effects (supporting infrastructure). Customers will enjoy fresh options for pricing and service until a sustainable market share is achieved or a decision to discontinue is made. In the medium to longer term, innovation will be governed by the degree to which there is a need to maintain rather than greatly improve market share levels.

   d. **Returns**

   In the short to medium term, Air New Zealand needs capital and opportunity to survive in the international market. During this period there is likely to be low or negative returns on capital employed. Low to medium returns for the medium term and high in the longer term as standardisation occurs. Low returns would be in the range 0% - 5% and medium returns in the range 6% - 9%.

   e. **Public good**

   Losses from head-to-head competition have resulted in government intervention and public guarantees of approximately $850M. Job losses within the airline industry from entrant failure, capacity reduction, ongoing restructuring and the disruptions caused by this change, reduction in service standards and airlines cost-cutting has left a legacy of value destruction. Customers may enjoy short-term gains at the expense of the government and private shareholders.

2. **Proposed Alliance**

This scenario seeks to avoid the historical issues of value loss arising from head-to-head competition through alignment of the resources of the two incumbents and re-positioning them to improve medium to longer term returns from international, domestic and trans-Tasman services. This scenario gives rise for optimism as it seeks to avoid the problems of the past, but not without raising other issues that necessitate clearance from the NZ Commerce Commission.

a. **Price/capacity**

Overall increases in prices have been predicted but within a service offering that provides benefits for customers meeting particular criteria. There will be a consolidation of capacity within New Zealand between Qantas and Air New Zealand. A reduction in competition is acknowledged.

b. **Service standards**

Standards of service, capacity and routes will be driven by the Alliance and unless there is an economic incentive to do so – such as from a new entrant or a need for product maintenance – there may not be the incentive to offer breadth of choice.

c. **Innovation**

Unless standards are benchmarked and there is an undertaking to maintain relativity to international best practice, there is a real risk of innovation being subordinated to a very low priority.

d. **Returns**

A dramatic improvement in returns from the domestic and trans-Tasman market is expected and a significant improvement is expected from the shared international services. A return on capital very much greater than 8% is expected over the medium to longer term.

e. **Public good**

There are a number of identified public good benefits that are clearly evident. Preservation of the brand 'Air New Zealand', opportunity for extension of the brand through combined marketing to important visitor markets such as Europe and USA is a clear public good benefit arising from the Alliance. Maintenance of and extension to trans-Tasman routes in a resource-effective manner will also generate opportunity that extends beyond the supplier airlines. New Zealand's government will gain financially from its intervention investment in 2001. Job prospects from extended engineering services will rise. There is little doubt that focussed, co-operative marketing will deliver additional tourists to New Zealand (and Australia).

Even so, there are also a number of public good issues that are perceived to have negative consequences – such as:

- Prospective new entrants are already claiming that there will be a reduction in competition on domestic and trans-Tasman routes.
- Scope exists for profit and price escalation not only within the proposed alliance but from ancillary service providers who could rely on cost-plus behaviour.
- There has been the suggestion that cross-subsidisation of the highly competitive international market by the potentially less competitive domestic market (including trans-Tasman) is not in the interests of domestic consumers. This suggestion featured in TIANZ initial commentary on the Alliance Proposal and is acknowledged in the Alliance proposal.

The Commerce Commission will consider the net effect of the above on public good. TIANZ supports pragmatic and sincere market behaviour by its members to ensure that the public good is not reduced in either perception or reality.

3. Regulated Air Services Network

New Zealand has not operated within a formally regulated environment to the degree that USA, UK and Australia have in past times. Telecommunications and Transport have been formally regulated at various times in the above examples and in such circumstances where a dominant supplier has either been subject to sale by its public sector owner (e.g. British Telecom, Telstra, British Rail) or has become the subject of litigation as a result of its market behaviour (e.g. Bell Telephone Company). This scenario considers the implications of such an approach here. TIANZ policy does not support heavy handed regulation because of the inevitable commercial distortions and unintended consequences that can arise.

a. Price/capacity

A trade-off in target market shares between the incumbent and new entrants would be enforced by rules. The objective would be as rapid as possible attainment of sustainable market shares by new entrants. Price distortions would be established by a regulator to provide incentives for new entrants and customers and to encourage the capacity of the incumbent to be supplied on a basis as efficient as those entrants.

b. Service standards

Service standards would be regulated for the incumbent by a regulator if they interfered with target market share objectives. Customers would enjoy a wider range of service differentiated products as there would be no immediate competitive response from the incumbent. Service standards on income-rich products (such as main trunk routes) would rise as part of a drive to improve the market share of new entrants. The incumbent would be constrained to provide a full services network at a justifiable price.

c. Innovation

Short term customer focussed (products, distribution) innovation to accelerate market share is expected from new entrants. Efficiency (operational and infrastructural) innovation from the incumbent is expected to enable it to gain the returns set by the regulator.

d. Returns

Medium term regulated returns for two or more parties to ensure sustainable market shares. The incumbent's returns arising from enforced efficiency in operational and commodity activities and the new entrants' returns arising from innovation and volume products on selected high value routes. Over time, an easing of regulation would have 'levelled the playing field' to such a degree so as to enable all suppliers to offer sustainable services in a more-or-less market driven manner. Suppliers battle with regulators to earn a mid-range return on capital (approx 8%).

e. Public good

The New Zealand government recoups its capital with profits and the tax returns from a successful cluster of providers. Customer benefits arise early in the process, but become less spontaneous as market share objectives are achieved. In the longer term, prices inevitably rise, retaliatory practices that have been ruled out by the incumbent render it somewhat disadvantaged permanently. International positioning of New Zealand is prioritised as for the incumbent and may even be further assisted by direct incentive from Government as cross-subsidisation from the domestic market is regulated. Some could argue that a time-bound regulation of this market to encourage new entrants would improve public good (at the expense of the consumer).

4. Public Good controlled air services network.

This is a pragmatic scenario that recognises that so long as there is a majority shareholding in Air New Zealand by the Crown, it will be held accountable to address market behaviours deemed to be injurious to the expectations of the New Zealand electorate.

Such a scenario could arise if the Commerce Commission identified elements of the proposed Alliance that it deemed unacceptable and were unable to be altered to their satisfaction. The ongoing operation of Air New Zealand could conceivably be controlled through formal statements of shareholder (Crown) intent and a Board appointed to ensure that these were implemented. In essence, the scenario is indistinguishable from a private investor scenario where the major investor achieves desired objectives through the same mechanism. The difference is that the Crown is not 'expected' to run businesses, but there is nothing to say that it cannot or should not.

The identified strategic advantage of this scenario – which will not be developed further – is to pursue and achieve public good goals in respect of exports (tourism and high value freight to New Zealand's key trading nations) and regional and social development (domestic air services).

The checks and balances of this scenario are complex, but in the absence of the Alliance as currently proposed, it is the status quo and could be the next step as Air New Zealand still needs access to a willing capital provider and the consent of government for minority shareholding.

Review of scenarios

Based on our consideration of these scenarios and their implications for pricing, capacity, innovation, service levels, returns and public good, TIANZ draws the following conclusions:

- The current market is too small to be sustainable for multiple full service providers and key players in the industry are struggling to obtain returns that are necessary to sustain a business while maintaining international standards of services. The status quo option would result in intense competition over the short-term as new price based carriers enter the market and attempt to create space for themselves at the expense of existing airlines. This scenario will generate benefits for consumers but these benefits are likely to be short-term. These benefits will also come at considerable cost to all suppliers in the marketplace and in the medium to long-term are likely to lead to airlines failing, returning the market to a poorly performing monopolistic situation. This scenario would reduce the capacity of New Zealand owned airlines to contribute to New Zealand's offshore marketing, might lead to some routes being closed (if they are not 'money-making' routes) and would support volume-based tourism rather than value-based tourism.

  TIANZ believes this option will not support its policy for an air services network in New Zealand.

- The Alliance proposal would provide some attractive benefits to the industry, including a greater consolidation of activities (resulting in less duplication of resources), and the possibility of greater returns to suppliers. This option would also enable the New Zealand government and the New Zealand taxpayer to gain a reasonable return from the considerable public investment made in Air New Zealand in 2001. This scenario would strongly support the TIANZ's public good objectives. At the same time, TIANZ is concerned that this proposal would lessen competition. The behavioural effects of this could lead to declining service standards and as well as 'effectively' diminish the ability of new suppliers to enter the market. In addition, the criticism that the domestic market could be used to cross-subsidise the highly competitive international market has not been adequately addressed.

  TIANZ believes this option will partially support its policy for an air services network in New Zealand. This scenario could fully support TIANZ policy with the identification of effective undertakings that delivers the behaviour of competition to the domestic air services market and extends the branding of New Zealand to new markets.

- A regulated scenario would be a new policy approach in New Zealand. The issue of regulation arises primarily from the fact that it might provide a mechanism for establishing multiple full service providers in the domestic air services market. The primary reason for not favouring this option is the risk of distortion that will occur in the transport network. Behaviours that are primarily orientated to satisfy a regulator do not convince TIANZ that the customer's best interests will be prioritised and the universal principle that the 'customer determines business' would be lost. We do not believe that this scenario would work in the longer term as new entrants would need protection until such time as the domestic market grows to around double its current size – a 15 year exercise at current growth rates.
  TIANZ believes this option will not support its vision for an optimal airline industry in New Zealand

- A public good controlled air services network is effectively the status quo prior to the release of the Alliance Proposal. It naturally becomes the status quo should the Commerce Commission decline the application.

  TIANZ believes that this scenario can support its policy for a competitive air services network provided pragmatic public good and commercially-adroit shareholder expectations are set and a residual arrangement for alliance on international routes can still be forged with Qantas.

Conclusion

TIANZ supports and promotes an air services network that facilitates a successful tourism industry, and the overall economic development of New Zealand.

The existing airline industry conditions have been a catalyst for the Alliance proposal and TIANZ agrees that current market conditions are not supporting an airline industry that is serving the long-term interests of the New Zealand consumers and shareholders, the New Zealand tourism industry, and the country as a whole. Recent airline history has shown that competition in itself does not necessarily support the public good interests of New Zealand and that most of the benefits of competition are short-lived and come at the expense of shareholders, long-term service levels, and the New Zealand taxpayer.

TIANZ's assessment is that the Alliance proposal contains many benefits but raises concerns about the potential for market dominance within the domestic network (including Trans-Tasman), and barriers to entry for new entrants.

TIANZ supports the Alliance's objectives in respect of international market development as it is in the best interests of both Australia and New Zealand to combine their efforts to a number of key, value-prioritised markets.

On the other hand, in the case of the domestic market TIANZ supports a "hybrid" approach where the Alliance proposal is tempered with effective undertakings that prevent the possibility or perception of self-serving behaviour at the expense of consumer.

Tourism Industry Association New Zealand

TIANZ would like the opportunity to speak to this submission at the appropriate time.

Tourism Industry Association New Zealand (TIANZ)
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