some key trans-Tasman routes such as Auckland-Brisbane and Auckland-Sydney or alternatively, new routes which Virgin Blue may wish to serve upon entry; and

- they provide that the Applicants can actually increase capacity significantly. Virgin submits that it is telling that while Qantas / Air NZ contend that they wish to reduce inefficient capacity, the one scenario where they contemplate an increase in capacity is in response to new entry.

Virgin Blue also submitted that Air NZ should be required to divest itself of Freedom Air.

In relation to public benefit undertakings, Virgin submitted that the proposed undertakings bind the Applicants to a strategy which may lock out new entrants on new routes. Virgin Blue further submitted that if there is not a public benefit inherent in the Strategic Alliance Proposal, the parties should not seek to create one in effect by establishing a binding legal commitment.

Virgin Blue also provided a copy of a report conducted by Frontier Economics. The report was commissioned by Virgin Blue to review the modelling undertaken by the NECG. Frontier Economics contended that the NECG had understated the detriment likely to flow from the proposed alliance, as the price increases and capacity decreases had been substantially understated, and the proposed alliance is likely to have a similar effect on freight services (that is, to increase prices and reduce capacity) as it has on passenger services.

Further, Frontier Economics contended that the NECG had overstated the benefits.

To support this, Frontier Economics suggested that:

- there is no basis for the tourism benefits identified by the Applicants as likely to flow from the proposed alliance;
- the costs savings are unsubstantiated and appear to be attributable to the Applicants failing to engage in inefficient and potentially unlawful conduct;
- the Applicants have overstated the scheduling efficiencies; and
- there is no reason why the proposed alliance should not result in any new direct services that otherwise would not have occurred.

Mr Peter Wakeman

Mr Wakeman submitted that the application is not in the interests of the public and that the benefits accruing to frequent flyers are falling as a result of increased points required for date changes and last minute bookings, increased points required to fly short sectors, increased waiting time and a reduction in the quality of service.

Western Australian Government

The Hon Alannah MacTiernan MP (Minister for Planning and Infrastructure (WA)) made a submission to the Commission in relation to this matter on behalf of the Western Australian Government ("WA Govt").

The WA Govt submitted that it is necessary to have financially robust airlines in order to function in a competitive and volatile operating environment and that the Proposed Arrangements, if authorised, would equip both airlines to better withstand the uncertain and competitive international environment.

The WA Govt submitted that it is important that future access to the Australian and domestic New Zealand markets is safeguarded and in this respect recommended that an appropriate number of gate slots should be reserved at Sydney, Melbourne and Brisbane airports. The WA Govt submitted that, should the Proposals be approved, Virgin Blue should be able to operate and develop competition on reasonable terms and that future access should be provided on a basis that would allow new entrants to compete on fair terms with the Alliance and with Virgin Blue. In addition, the WA Govt submitted that consideration should be given to providing rights to airlines such as Singapore Airlines to carry traffic from Australia and New Zealand to and from the United States.

The WA Govt submitted that the Perth-New Zealand service should remain and grow as a non-stop international service and that the Commonwealth Government should ensure that Western Australia is not disadvantaged in terms of service standards and the cost of services.

The WA Govt submitted that it supports the Proposed Arrangements on the condition that the above conditions are met.

Westralia Airports Corporation Pty Ltd

Westralia Airports Corporation Pty Ltd ("WAC") submitted that it would like to ensure that either Qantas or Air NZ operates non-stop services between Perth and New Zealand. WAC acknowledged the Applicants' submission that under the Proposed Arrangements, the Perth-Auckland route would increase by one return flight per week, however, is concerned that this service will be withdrawn as the Alliance becomes fully operational. WAC noted that Qantas had previously advised that the airline had adopting a policy of directing all Perth-New Zealand traffic through Melbourne and Sydney.

WAC submitted that any reduction in non-stop Perth-Auckland services would have an adverse affect on tourism as tourists prefer to travel on non-stop flights.

Submission on behalf of six separate interested parties

A submission was also made on behalf of the following parties:

- Gullivers Pacific Group;
- Infratil Limited;

- Major Accommodation Providers;
- Ms Kerry Prendergast (Mayor of Wellington);
- Talley Fisheries; and
- Wellington International Airport Limited.

This submission is hereafter referred to as the "Combined Submission". This submission was made to the NZCC and the relevant aspects of the Combined Submission to the Commission are discussed below.

The Combined Submission submitted that the Proposed Arrangements should not be authorised because:

- benefits claimed in respect of increased tourism and increased engineering and maintenance have been substantially overstated;
- NECG has estimated claimed cost savings on the basis that the accrue from the difference between the "wasteful" actions the Applicants will engage in if the Proposed Arrangements is not approved and the actions they will take if the Proposals proceed. The Combined Submission stated that a more realistic counterfactual would reduce these cost savings substantially;
- there may be gains to the Applicants from scheduling arrangements, but there is also likely to be at least an equivalent loss due to the loss of other code sharing opportunities under the Star Alliance (for Air NZ) or **one**world (for Qantas);
- if new direct services can be provided (viably), normal competitive behaviour should result in the most efficient airline providing that service;
- it is unclear how NECG derives additional freight capacity;
- many of the assumptions used by NECG are questionable;
- a "war of attrition" is not the relevant counterfactual because the Applicants have not considered the effects of structural changes to Air NZ's business model, the improved financial performance of Air NZ and the significance of Air NZ's participation in the Star Alliance; and
- the relevant counterfactual is Air NZ continuing to compete effectively under its refined business model while remaining in a position to effectively evaluate other opportunities as and when they arise.

APPENDIX B

The Applicants' response to submissions lodged by third parties

The counterfactual

The Applicants submitted that several submissions "misunderstand" the nature of the counterfactual as modelled by NECG and stated that rather than an "explosive battle" between Qantas and Air NZ, the counterfactual will see a slow wearing down of resources. The Applicants submitted that expansion into New Zealand and across the Tasman is part of Qantas' long term business rationale and is fundamentally important to Qantas' international strategic position.

In response to submissions relating to Air NZ's recent increase in profitability, the Applicants submitted that this improved performance can be attributed to a number of factors external to Air NZ and one factor within Air NZ's control, namely, the introduction of Air NZ Express Class. The Applicants noted that there is currently a great potential for adverse external shocks that have the potential to impact on Air NZ's performance.

The Applicants also discussed alternative options that have been investigated by Air NZ and noted that these alternatives do not provide the same benefits as the Proposed Arrangements.

Entry/expansion by Virgin Blue or another airline

The Applicants noted Virgin Blue's submission that it intends to expand into the trans-Tasman and domestic New Zealand markets but suggested that Virgin Blue's concerns regarding the extent to which it will be able to expand in those markets should be "afforded no weight". The Applicants also responded to a number of specific claims made by Virgin Blue and submitted that any residual concerns that the Commission may have in relation to VBA entry will be removed by the application of the Applicants' Proposed Undertakings.

Freight capacity

In relation to submissions which suggest that freight prices are likely to increase and freight capacity and choice are likely to decrease under the Proposed Arrangements, the Applicants submitted that for specialised freight operators, entry and expansion barriers in freight markets are low. The Applicants also submitted that the Proposed Arrangements are likely to result in an increase in freight capacity, primarily driven by a greater number of wide-bodied aircraft that will be operated under the Proposed Arrangements.

Travel distribution

In response to claims made in other submissions that the Proposed Arrangements would result in a reduction in the level of remuneration to travel agents for the sale of Qantas and Air NZ products and services, the Applicants noted that clause 1.2(g) of the Strategic Alliance Agreement states that coordination and/or cooperation on the remuneration of travel agents shall not require alignment of product or service offering. The Applicants submitted that Qantas does not plan to change its level of remuneration.

In any event, the Applicants submitted that a reduction in travel agent remuneration will not materially affect the travel distribution services market and noted that, if a change did occur, travel agents may choose to charge customers a fee for service.

The Applicants also submitted that any coordination between the Applicants in respect of travel agent commission would not raise concerns in terms of the ability of other airlines to compete.

The Applicants submitted that concerns in relation to the impact of Qantas Holidays on the wholesale distribution market are "displaced". The Applicants submitted that the Proposed Arrangements will not materially affect existing holiday package providers.

Tourism benefits

The Applicants noted that tourism benefits are discussed in detail in the TFI Report and the Qantas Holidays Business Plan submitted to the Commission.

Proposed undertakings and conditions

In relation to submissions lodged by third parties in relation to the Applicants' Proposed Undertakings, the Applicants submitted that it is not appropriate to restrict products or pricing.

Price and capacity impacts

The Applicants noted that the NECG response to submissions (outlined below) addresses price and capacity impacts of the Proposed Arrangements.

Impact on Origin Pacific

In relation to Origin Pacific's concerns regarding the Proposed Arrangements, the Applicants submitted that they disagree with its claims that the Proposed Arrangements will result in the Applicants having a degree of market power that will allow them to engage in predatory practices.

In response to Origin Pacific's concerns that the Proposed Arrangements will have an adverse impact on its ability to access feed and code share opportunities from Qantas, the Applicants submitted that it would be inappropriate for the Commission to deny authorisation of the Proposed Arrangements on this basis, given that Origin Pacific admits that it does not want these opportunities "forever". The Applicants also noted that other carriers will provide an opportunity for feed and code share arrangements with Origin Pacific in the future.

The Applicants also noted that the Proposed Arrangements *"may well stimulate sentiment in Origin Pacific's favour"*.

The Proposed Arrangements' impact on employment in Australia

The Applicants submitted that the undertakings proposed by the ACTU and the AMWU in relation to employment in Australia are not appropriate. The Applicants submitted that there will be no decrease in capacity under the Proposed Arrangements compared with the future without the Proposed Arrangements and, as such there will be no job losses as a direct result of the Proposed Arrangements.

Relevance of Australian air traffic rights

In relation to the numerous submissions to the Commission that the Proposed Arrangements should be contingent on further liberalisation of the aviation industry and an extension of traffic rights to foreign flag carriers, the Applicants submitted that the Commission should make its determination on the basis of the current regulatory environment.

Frequent flyer points

The Applicants submitted that the Proposed Arrangements will not adversely impact existing Air NZ and Qantas frequent flyer members.

NECG Response

NECG made a submission to the Commission for the Applicants in response to submissions received by the Commission from third parties relating to the NECG Report submitted as part of the Applicants' initial supporting submission.

NECG commented on issues raised by third parties relating to:

- market definition;
- barriers to entry and expansion;
- the "unrealistic" counterfactual;
- the viability of competition between FSAs and VBA(s);
- the appropriateness of the inclusion of cost efficiencies as a public benefit in the context of the Commission's consideration of the Applications;
- the Cournot model used by NECG as the basis for its econometric modelling;
- the benefits from improved scheduling and improved flights;
- the claims that the tourism benefits claimed by the Applicants are implausibly large; and
- engineering and maintenance benefits.

The NECG submission specifically addressed submissions in relation to the econometric modelling carried out by NECG lodged by Frontier Economics (on behalf of Virgin Blue) and Professor Hazledine (University of Auckland).

Tourism Futures International: updated report

TFI reviewed a number of submissions lodged by third parties in relation to the impact of the Proposed Arrangements on tourism. In particular, TFI commented on the following issues:

- the impact of the Proposed Arrangements on dual destination travel and the associated impact on Australian inbound tourism;
- the "completeness" of forecasting arrivals;
- the impact on the United States' inbound tourism market;
- the implications for inbound tourist dispersal under the Proposed Arrangements; and
- the implications for the ATC of the proposed joint promotion of Australian and New Zealand tourism.

APPENDIX C

Commission consideration of NECG modelling of anti-competitive detriment

NECG analysis of anti-competitive detriment

The Applicants submitted that the main source of potential anti-competitive detriment is the coordination of prices and schedules on the trans-Tasman routes. The Applicants claimed that the Proposed Arrangements will produce only slightly higher prices and lower capacity than the counterfactual over the medium term.

In support of these claims, the Applicants cited a report commissioned from NECG ("the NECG Report") which sets out the results of modelling and analysis undertaken by NECG. NECG's analysis uses a model of air service markets ("the NECG Model") based on oligopoly under Cournot competition to simulate market outcomes under coordination with the Proposed Arrangements and continued competition under the counterfactual. This Model, which quantifies the price and output effects on passenger air services across routes (city pairs) covered by the alliance agreement, is discussed further below.

The Applicants also drew upon the findings of the NECG Report to argue that the alliance will have negligible negative impacts on productive efficiency, including x-inefficiency and rent-seeking behaviour.

The NECG Report acknowledged other potential detriments from the Alliance, however it claimed that none of these are material and they are therefore not quantified. These included detriments relating to provincial New Zealand routes and the possibility of Air NZ transferring from the Star Alliance to the **one**world alliance. The first of these is not likely to be directly relevant to the Commission's deliberations as the effects are specific to New Zealand.

NECG also canvassed the likelihood of other detriments arising from the Alliance. In particular, NECG considered detriments relating to productive efficiency, service quality, innovation incentives (including x-inefficiency) and rent-seeking behaviour.

<u>The NECG Model</u>

NECG based its analysis on an assumption of Cournot competition between airlines. NECG noted that the Model has certain limitations, but it is argued that alternative models would require a greater range of assumptions, take significantly longer to develop and would be more difficult to interpret.

The Cournot modelling is undertaken at the level of individual city pairs and is modelled separately for each of the five years. It takes as an input the airline schedules that are expected by the Applicants to apply under the Proposed Arrangements, and the schedules expected to apply under the counterfactual put forward by NECG and the Applicants. For the counterfactual, however, Qantas and Air NZ submitted their expected schedules directly to NECG on a confidential basis. That is, each airline was unaware of the schedules submitted to NECG by the other for the future without the Proposed Arrangements. Market share is then assumed to be identical to the (assumed) capacity shares.

A further important assumption made by NECG is that a value based airline ("VBA") is assumed to have costs that are 20 per cent below that of a full service airline ("FSA"). For domestic New Zealand routes, NECG also assumes that Air NZ's costs are 7.5 per cent lower than an FSA, as it is moving towards what NECG characterises as "VBA+" business model.

The Model calculated as outputs the expected price and quantity (number of passengers) outcomes under the future with the Proposed Arrangements and without the Proposed Arrangements respectively. These were then used to undertake a welfare analysis, in which deadweight social losses under each scenario were quantified, with the difference being estimated as a detriment. A key driver of the NECG Model is the passenger market shares of airlines in the market; these correspond to capacity shares which are based upon the factual and counterfactual schedules dictated by the Applicants. In undertaking the welfare analysis, the Model does not expressly estimate transfer payments between consumers and producers, as NECG argued that a total surplus standard – rather than a consumer surplus standard – is the appropriate measure.

The welfare analysis made adjustments to account for net cross-border wealth transfers between Australia and New Zealand. These arise mainly due to the differing nationalities of consumers, the respective market shares of Qantas and Air NZ, and the profit-sharing mechanism embedded in the Strategic Alliance Agreement.

As noted earlier, NECG acknowledged that there are limitations to the modelling. One of these, identified by NECG, is the fact that the modelling produces a single average retail price (for each city pair modelled). NECG claimed, however, that as a consequence of this and certain other assumptions of the Model, "the market outcomes that are predicted from VBA entry are biased in the direction of higher prices and lower output than would actually transpire."[109]

A technical description of the model is set out in pages 105 to 109 of the NECG Report. Further details on the assumptions and implementation of the Model are set out in pages 109 to 118 of the Report.

Following comments from the Commission and the NZCC on the report submitted on 8 December 2002, NECG identified a number of changes required to its Model. This was also necessitated by the withdrawal of United from the Auckland-Los Angeles route, the withdrawal of Air NZ from the Sydney-Los Angeles route, the addition of capacity on the Auckland-Los Angeles route by both Qantas and Air NZ and a change in the composition of flights operated by Qantas on the Sydney-Auckland route. Consequently, NECG re-submitted its modelling to the Commission on 5 March. Compared to the initial report, the revised modelling had higher estimates of detriments. In what follows, where references are made to the outcomes of the NECG modelling they apply to this revised modelling.

[109] NECG Report, p.105.

The outcomes of NECG's modelling varied significantly across city pairs and years. By Year 3, prices on most affected routes are lower under the counterfactual than the future with the Proposed Arrangements.

Correspondingly, output is in many cases lower under the future with the Proposed Arrangements as compared to without. In NECG's modelling, output is affected not only by the calculated changes in price, but also by the increased (decreased) demand that NECG argued arises as a consequence of greater (lesser) total capacity supplied in the market. This is due to the effect of capacity on quality of service, primarily through frequency level, and is incorporated through the inclusion of a term capturing the capacity elasticity of demand. Lastly, natural market growth is incorporated in the modelling, but as it is applied to both the situation with and without the Proposed Arrangements, it has little impact on the modelled welfare outcomes.

The modelled welfare outcome (for Australia) of the price and output changes is that total deadweight losses are higher with the Proposed Arrangements than without them. This incremental deadweight loss totals around $120 million (in present value terms) over five years. Against that, NECG's Model suggested that the Proposed Arrangements would lead to net wealth transfers *to* Australia and over the same time horizon, these are argued to generate around $85m of benefits. The detriment to Australia is therefore expected to be approximately $35 million over five years (without taking into account the benefits identified elsewhere in the NECG Report).

<u>Other anti-competitive detriment</u>

With respect to detriment relating to global alliances, the NECG Report does not attribute a value to any possible transfer, since it considers that any commercial decision that Air NZ switch alliance partners would only be made in the event that it benefits both Qantas and Air NZ. NECG suggested that there is a potential benefit but that the distribution and magnitude of any such benefit is too uncertain to include.

NECG also acknowledged that there would be a loss of frequent flyer points should Air NZ exit the Star Alliance. It is claimed that the cost of such a loss would effectively be borne by the Applicants indemnifying holders of frequent flyer points by transferring the points to the **one**world alliance.

In relation to productive efficiency, it is noted above that the Applicants relied upon the arguments of NECG in making the claim that the effects of the Proposed Arrangements on productive efficiency would be negligible. On this issue, NECG suggested that the most obvious additional costs are integration costs, and that these would be insignificant. The reasons put forward are that the costs are one-off and that, in agreeing to enter the Proposed Arrangements, the Applicants would have taken such costs into account. The fact that the Applicants have reached an agreement indicates that they believe that they would be better off despite any integration costs.

The remaining effects on productive efficiency are argued to relate to efficiency of fleet allocation and maintenance, captured elsewhere in NECG's analysis (and have been discussed in the Commission's Determination).

NECG argued that, regarding quality of service, the relationship between price and quality needs to be borne in mind. Overall, it is claimed that the increased likelihood of entry and expansion by a VBA will broaden the range of choices available to consumers and therefore provided a benefit rather than a detriment.

NECG claimed that innovation will be enhanced under the Proposed Arrangements. NECG put forward a number of arguments to suggest that firms engaging in fierce price competition (as under the Applicants' counterfactual) have fewer incentives to innovate. These arguments include:

- a focus by management on price rather than innovation;
- the drain on resources imposed by a price war;
- lower expected returns from investment in innovation;
- the potential exit of one party to the price war under consideration; and
- capital resource constraints arising under a price war.

NECG suggested that demand side innovation arises through the entry of VBAs and, for the reasons described above, this will be greater and faster under the Proposed Arrangements than in the counterfactual scenario.

NECG also considered the possibility of reduced supply-side innovation or "x-inefficiency". NECG argued that such inefficiency is unlikely to arise and, even if it does, it would be likely to be small.

In relation to rent-seeking, NECG argued that there is nothing to suggest that the Proposed Arrangements will increase rent-seeking behaviour relative to the counterfactual. Furthermore, NECG suggested that if it is argued that x-inefficiency will erode cost efficiencies, the extent of rent-seeking is also correspondingly lower. Overall, NECG posited that the level of rent-seeking will be the same under both the Proposed Arrangements and the counterfactual.

PricewaterhouseCoopers

PwC was commissioned by the Applicants to provide an independent review of the economic analysis prepared by NECG. The review covered the methodology and inputs adopted by NECG and, as far as possible, tests the accuracy of the Model.

PwC agreed with NECG that the Cournot competition model best reflects the nature of the relevant markets, and concluded that the price and output outcomes of the Model appear logical.

More generally, PwC concluded that nothing has come to its attention to suggest that the models are not reliable and appropriate, the inputs are not reasonable, or that the calculations in the NECG Model are not reliable.

Interested parties' views on NECG's anti-competitive detriment analysis

Virgin Blue submitted that in weighing public benefits and detriments under subsections 88(1) and 88(9) it is not necessary for the Commission to conduct a quantitative assessment to each item.

Nonetheless, Virgin Blue engaged Frontier Economics to review the NECG modelling of the benefits and detriments of the Proposed Arrangements. Among other points, Frontier Economics argued that detriments are understated. In particular, Frontier Economics suggested that the price increases and capacity decreases identified by the Applicants have been substantially understated, and that the deadweight loss associated with the Proposed Arrangements has been understated as a result.

Frontier Economics made a number of specific comments regarding the application of the Cournot model of competition. It noted that NECG did not use the Cournot model to predict capacity decisions. Rather it:

> *"...uses Cournot only to determine aggregate prices and quantities for routes where market shares are given. This is a particularly inappropriate application of the Cournot model".*[110]

Frontier Economics also noted that markets for air services are characterised by product differentiation across routes and across types of carrier.

Frontier Economics also made a number of comments on the treatment of marginal costs in NECG's Model:

> *"The NECG model treats marginal costs rather oddly. Although they are allowed to vary across firms, these variations have no effect on the outputs of the various firms".*[111]

In particular, it is argued that the differences in marginal costs have no effect on the relative outputs of the VBA and the merged entity. This is tied to exogenously driven market share, notwithstanding the differentiated product, and possible lower pricing, of a VBA.

Furthermore, despite the substantial excess capacity NECG claimed will prevail under the counterfactual, the excess capacity is not allowed to influence marginal costs in the Cournot modelling. That is, while it might be expected that marginal costs are significantly lower under the counterfactual, the Model does not produce such results. Furthermore, the excess capacity tends to increase prices under the counterfactual, as it shifts the demand curve out through the inclusion of the capacity elasticity of demand parameter.

As a consequence, it is suggested by Frontier Economics that the NECG Model produces results that are quite counter-intuitive as excess capacity under the counterfactual does not depress prices; but rather increases them.

---

[110] Frontier Economics, p.24.
[111] Frontier Economics, p.25.

In relation to NECG's estimation of deadweight loss, Frontier Economics noted that it is not clear how deadweight loss calculations cope with shifts in demand curves, shifts in marginal costs or combinations of a decrease in price and an increase in output that occur for some routes. In particular, Frontier Economics concluded that the NECG modelling significantly underestimated deadweight losses in the factual relative to the counterfactual.

In addition to the arguments put forward by Frontier Economics in relation to the price and capacity modelling, Virgin Blue also submitted that the NECG modelling included no allowance for losses in productive and dynamic efficiency.

Professor Hazledine provided a critique of the NECG Model and its findings in relation to price, quantity and welfare outcomes. He also undertook his own analysis of the Proposed Arrangements based on many of the assumptions and inputs NECG set out in its Report.

Professor Hazledine's modelling followed the basic procedure adopted by NECG, but made two modifications which he considers necessary to make the Model more realistic. These modifications related to the nature of demand and supply for air travel services, and the current state of competition between Qantas and Air NZ.

With respect to the nature of demand and supply for air travel services, Professor Hazledine suggested that the NECG Model failed to take into account the differentiation of products offered by airlines such as Qantas and Air NZ, and those offered by VBAs. For example, Professor Hazledine noted the lack of frequent flyer programs, airport lounges and in-flight service in the product offered by VBAs.

In particular, Professor Hazledine argued that allowing for differentiated products avoids a technical difficulty in the modelling conducted by NECG. He stated that:

> *"Because the VBA has a lower cost than the incumbents, under homogenous product assumptions its market share would be predicted as larger than Air NZ and Qantas together (after the cartel), which is something NECG do not want to happen. So they are forced to impose a 'fudge', using costs to predict the post-cartel price (their equation (9), p109), but then suppressing their earlier equation (5) [p107], which would assign market shares based on the basis of their relative costs; instead imposing market shares as matching exogenously given airline capacities."*[112]

Professor Hazledine's second point of difference with NECG's modelling was in relation to the nature of competition between Qantas and Air NZ. He suggested that while the Cournot model may be quite a realistic summary of oligopoly under fairly normal competitive conditions, this is not necessarily the case currently.

Professor Hazledine also adopted a slightly different approach to NECG in modelling the effect of VBA entry. While he adopted the NECG forecast of the timing and extent of new entry, he suggested that pricing to achieve load factors of 75 per cent

---

[112] Hazledine, p.11.

enables competition to be simulated while still treating new entry as exogenous to the modelling.

Based on these adjustments, Professor Hazledine concluded that the costs of allowing the Proposed Arrangements to proceed would substantially outweigh the benefits, particularly for New Zealand. While he noted that the net impact on Australia varies in different markets, he points out that all, or almost all, of the benefits accrue to Qantas.

The six parties to the Combined Submission argued that some of NECG's input assumptions are questionable. They further suggested that the assumption of a linear demand curve would underestimate deadweight losses; and that the calculation and allocation of wealth transfers between consumers and producers among New Zealand, Australia and other countries may contain errors and are not clear.

GPG submitted that the Applicants and NECG are significantly understating likely anti-competitive detriment that flows from the Proposed Arrangements.

Melbourne Airport noted that NECG's analysis shows that the bulk of the benefits flow to the shareholders of Qantas and Air NZ.

SACL noted that the most significant benefits from the Proposed Arrangements accrue to the Qantas and Air NZ and are not expected to be passed on to travellers through lower airfares.

Submissions on the NECG Modelling of anti-competitive detriment provided since the Commission's Draft Determination

<u>The Applicants</u>

The Applicants noted that the Commission expressed reservations in relation to NECG's quantification of anti-competitive detriment in its Draft Determination.

The Applicants noted that one of these concerns related to the level of prices estimated under the counterfactual and submitted that, for the same reasons outlined in Part 11 of this Determination, the lack of consideration given to the NECG Modelling is unjustified.

In relation to the Commission's concern that the modelling failed to take into account the effect of capacity utilisation on airlines' decision making processes, the Applicants submitted that the Commission has not examined the impact on the NECG results of constraining load factors to the levels it believed reasonable in order to determine whether the NECG modelling over- or under-estimates the anti-competitive detriment of the Proposed Arrangements.

The Applicants submitted that, in its Draft Determination, the Commission did not cite any evidence to support its assertion that the question of distribution is relevant to the Commission's assessment of the Proposed Arrangements. The Applicants also submitted that, in any event, they do not consider that any income distribution effects, even if it were appropriate to take these into account, could or would offset the efficiency gains from the Proposed Arrangements.

The Applicants also submitted that the Commission has not provided any evidence as to the extent and pattern of the alleged distribution impacts of the weights the Commission has applied in assessing these impacts' materiality.

The Commission's views on NECG anti-competitive detriment analysis

The following discussion first examines the NECG's modelling of anti-competitive detriments under the counterfactual submitted by the Applicants. It then considers the impact of adopting the alternative counterfactual set out in Part 8; namely, the status quo subject to natural growth.

Finally, other potential anti-competitive detriments raised by NECG are considered.

<u>Price, quantity and welfare outcomes under the Applicants' counterfactual</u>

A critical feature of NECG's approach to modelling anti-competitive detriments is that it takes capacity as an input and translates capacity shares directly into estimates of market share for each airline. Using this information, the Model calculated price and quantity (passenger) outcomes and from that, welfare outcomes. These welfare outcomes are essentially estimates of allocative efficiency, the net welfare foregone as a result of resources not being put to their best use. That is, consumers willing to pay the additional costs associated with providing air travel for them are not given the opportunity as prices do not reflect these costs.

Importantly, the Cournot-based modelling - described on pages 105 to 118 of the NECG Report - is not the main tool used in estimating the purported benefits of the Proposed Arrangements. For example, the cost saving benefits are calculated on the basis of the schedules - under both the Proposed Arrangements and the counterfactual - provided by the airlines, in conjunction with *actual* unit cost information, again provided directly by the airlines. While estimates of passenger numbers (an output of the Cournot-based model) affect *total* cost estimates, they do not affect the estimates of cost *savings*, as the savings attributable to the difference in passengers is netted out in adjustments made by NECG. Consequently the Cournot modelling has no effect on the cost saving estimates provided to the Commission.

The other major class of benefit identified by the Applicants and NECG is in relation to tourism. While these benefits are mitigated by the Cournot-based model to the extent that there are lower passenger numbers (and hence tourists) under the Proposed Arrangements as compared to the counterfactual, the benefits themselves are argued to stem from the stimulation to tourism through increased promotion effectiveness and effort.

As a consequence of this somewhat unbundled approach to modelling, it is possible to consider the outcomes of the Cournot-based modelling of the detriments independently from the modelling of benefits, while noting that any conclusions on the modelling of detriments will have flow-on effects to the estimates of tourism benefits in particular.

As noted above, the Commission has received two submissions which address the NECG modelling of detriments in some depth: one from Frontier Economics, commissioned by Virgin Blue; and one from Professor Hazledine of the University of Auckland.

Each of these submissions is critical of the NECG approach and both identify the fact that market share is determined on the basis of capacity as a particular problem with the Model, given its assumption of a homogenous product. Furthermore, they each critique NECG's treatment of marginal costs, noting that these are not permitted to affect the relative outputs of the market players, in particular between the VBA and the merged entity.

Against that, however, NECG suggested that:

> *"One of the advantages of this approach is that it avoids assuming that firms have symmetric costs. Airlines have different characteristics that are translated into different market shares. These different market shares are reflected in different marginal costs."*[113]

A key point here seems to be that since capacity is taken as an input to the NECG Model, the Model severs the connection between an airline's *capacity* decision from the anticipated passenger *quantity* (and price) outcomes. Submissions suggested that when combined with the assumption that relative costs do not influence market share, the Model generates counter-intuitive outcomes. As noted earlier, Frontier Economics' analysis leads it to conclude that the increased capacity in the counterfactual does not depress prices but in fact raises them, since it shifts the demand curve outward.

The Commission's analysis of the NECG Model suggests that its estimates of industry-wide marginal costs[114] on most routes appear to be higher under the counterfactual than under the Proposed Arrangements. This result does not appear to be a consequence of changes in the marginal costs of individual firms (in response to capacity changes), but rather is due to the fact that under the Proposed Arrangements there is one fewer firm in the market. Since prices increase as marginal costs increase, this will increase prices in the counterfactual relative to the situation under the Proposed Arrangements and correspondingly lower the estimated detriments.

While NECG argued in correspondence to the Commission that only the *relative* marginal costs are relevant, these relative differences are a function only of capacity shares; which in turn rely on the assumed schedules. Thus, the extent to which the capacity under the counterfactual is surplus to requirements is not reflected in marginal cost. As Frontier Economics noted, this is an odd result given that the opportunity cost of filling an extra seat is very low where there is significant excess capacity.

If indeed the prices under the counterfactual are estimated to be higher than they should be, then passenger volumes will be correspondingly lower. The greater any understatement of passengers is under the counterfactual relative to that under the

---

[113] NECG, p.107.
[114] The sum of the marginal costs of individual firms on a particular route.

Proposed Arrangements, the greater is the extent to which deadweight losses will be underestimated.

Having said that, it should be noted that the primary constraint on the calculations of competitive detriment in the NECG Model are the different assumptions under the Proposed Arrangements and the counterfactual regarding the behaviour of the Applicants and other actual and potential competitors on the routes in question. Since the Applicants assume that all competitors other than the VBA make the same capacity decisions regardless of whether the Proposed Arrangements proceed or otherwise, the NECG assumption of a greater degree of VBA entry under the Proposed Arrangements is critical to the calculation of competitive detriments.

The Commission's views on the likelihood of VBA entry under each scenario is discussed further in Part 11 of this Determination. In light of the conclusions set out there - most pertinently that the extent of entry by a value-based airline is not likely to increase as a consequence of the Proposed Arrangements – and the discussion above, the Commission considers that the competitive detriments quantified in the NECG Model could be understated.

It should be further noted that while the assumptions regarding VBA entry are critical, the behaviour of other airlines on affected routes can also make differences to the calculation of detriments in the NECG Model. For example, if even the smallest fifth freedom carrier is assumed to withdraw on the Auckland-Sydney route were the Proposed Arrangements to proceed, the estimated net detriment to Australia on that route (including transfers), using the NECG Model, increases by around 14 per cent.

The analysis of Professor Hazledine tends to support the view that there exist difficulties in the application of NECG's Model which undermine its conclusions. Professor Hazledine conducted his own estimation of the detriments that would flow from the Proposed Arrangements, modifying the NECG analysis in the manner described earlier.

Professor Hazledine's key findings were that in relaxing certain key assumptions made by NECG including a change to incorporate a VBA with a differentiated and lower cost product, the net result of allowing the alliance would be to generate deadweight losses substantially in excess of the amount estimated by NECG. Professor Hazledine's estimates of net detriments - on the domestic New Zealand and trans-Tasman routes alone - range between NZ$200-$400 million per annum.

In response to Hazledine's submission NECG argued that:

> *"....Hazledine assumes that the future with the Alliance is characterised by Qantas/Air NZ dominant firm price leadership, while the future without the alliance is perfectly competitive (or very nearly so in the case of domestic New Zealand)."*[115]

NECG further argued that this is highly inappropriate, and suggested that the load factor outcomes generated under Hazledine's approach demonstrate that the approach

[115] NECG Response to submissions, p.46.

is flawed. In response to NECG, however, Professor Hazledine pointed out that highlighting these implausible results was the point of his submission.

Analysis of load factors, that is, the percentage of seats flown which are actually used, is a standard way of examining the relationship between capacity and passenger volumes in aviation markets. Analysis undertaken for the Commission by independent consultants shows that historical load factors for Qantas and Air NZ have been in the 60 to 80 per cent range.[116] Load factors on international routes tend to be sustained within a narrower band, from around 65 to 75 per cent in most cases.

NECG's criticism of Professor Hazledine's load factor outcomes can be put in context by examining the load factor outcomes that NECG's own modelling entails. The Commission has estimated load factors on each route based on the passenger volumes estimated by NECG, and the schedules underpinning these, under both the situation with and without the Proposed Arrangements.

On around half of the modelled routes (with and without the Proposed Arrangements), the industry-wide load factors generated by the NECG Model fall outside – in some cases a long way outside – the 60 to 80 per cent range. On one route the load factor generated is in excess of 100 per cent. Many of the remaining estimates are only marginally within a realistic range. Furthermore, these are sustained from Years 3 to 5 of the modelling period.[117]

The Commission therefore has concerns that, in failing to sufficiently take into account the effect of capacity utilisation on airlines' decision making, including pricing, the NECG modelling overlooks a critical element of the competitive process and potentially the manner and degree to which airlines compete.

In their response to the Commission's Draft Determination, the Applicants criticised the Commission for not examining the impact on the NECG results of constraining load factors to the levels the Commission considers reasonable. The Commission notes, however, that in a meeting on 3 February 2003, NECG and the Applicants undertook - in response to questions raised by the Commission - to provide such an analysis themselves.

On 28 July 2003 the Commission received spreadsheet models prepared by NECG which presented results of constraining load factors to between 65 per cent and 85 per cent. According to this modelling, the net effect of constrained load factors on NECG's estimates of net anti-competitive detriment (including both deadweight loss and net international welfare transfers) is minimal. However, odd results – unrealistically low, even negative, prices on some routes – still emerge. NECG attributes these results to the fact that "the model does not capture the Applicants' intention and ability to stimulate additional demand on these routes".

These outcomes and NECG's own comments tend to reinforce the Commission's general concerns about the NECG modelling. That is, the simplifying assumptions

[116] These estimates cover the period 1995-2002.
[117] Identical load factor results obtain for individual airlines as for the market as a whole, given NECG's assumption that market share matches capacity share.

that are required to allow the models to work do not seem to fully reflect the competitive behaviour of firms in practice.

While Professor Hazledine's analysis may make strong assumptions regarding the nature of competition, it does clearly suggest that estimated net welfare outcomes are likely to be highly sensitive to assumptions regarding the intensity of competition prevailing under, or absent, the Proposed Arrangements.

In earlier responses to the Commission, NECG noted that using oligopoly models which exhibit less competition than the Cournot model would imply that its modelling of detriments is conservative. However, the converse also applies. If, as suggested by Professor Hazledine, current competition is more intense than that modelled by NECG, the detriments will be underestimated. The magnitude of such underestimation is argued by Professor Hazledine to be high.

NECG's arguments regarding the conservatism of the Cournot model may apply if, indeed, Cournot is an appropriate model in the both the world with the Proposed Arrangements *and* the world absent the Proposed Arrangements. Hazledine's approach, however, allows for different assumptions about the way airlines compete under the two different cases.

Because of the apparent sensitivity of modelled welfare outcomes with respect to this issue, NECG's implicit assumption that the way airlines react to the behaviour of competitors is the same with or without the Proposed Arrangements is of significant concern to the Commission.

In this regard the Commission has considerable reservations about NECG's quantification of anti-competitive detriments. Furthermore, if the modelling approach adopted underestimates the impact of the Proposed Arrangements on total passenger volumes, then – by virtue of the links in NECG's modelling to tourism benefits – the proposed benefits will also be overstated. The modelling of benefits is discussed in the Commission's Determination.

Detriments under the Commission's counterfactual

As argued earlier in this Determination, the Commission remains unconvinced that the counterfactual put forward by the Applicants is indeed the most likely alternative in the event that the Proposed Arrangements do not proceed. Rather, the Commission is of the view that the status quo, subject to natural growth, is a more likely outcome.

It is therefore pertinent to consider the implications of the adoption of such a scenario on the likely benefits and detriments that could be expected to flow from the Proposed Arrangements.

One immediately apparent consequence of adopting the Commission's counterfactual is that the cost saving benefits are substantially lessened, as the degree of increased capacity under the counterfactual falls.

In itself, however, this does not necessarily mean that the net benefits (including detriments) from the proposed alliance should be discounted. Indeed, it might be expected that if the capacity differences between the factual and counterfactual are smaller, the effect on prices and outputs would also be smaller and thus the estimated deadweight loss detriments reduced. Since NECG argues that these detriments are so much lower than total (gross) benefits, the overall estimates of net benefit could still be positive, albeit somewhat reduced.

However, as discussed above, the Commission has serious concerns about the estimation of anti-competitive detriments, and a number of these concerns arise independent of the counterfactual deemed most plausible. It should also be noted that a significant determinant of the price and quantity outcomes of the NECG Model is the number of airlines flying on each city-pair route. Under NECG's approach, this variable is not affected by the frequency of flights these airlines operate, only by the number of competitors that are assumed to operate. The latter is primarily affected by the assumption of increased likelihood of VBA entry under the Proposed Arrangements.

NECG's claim that the Proposed Arrangements will generate substantial net benefits to Australia is also called into question by the findings of the Productivity Commission's ("PC") 1998 inquiry into international air services. In the course of that inquiry, the PC examined the actual outcomes of increased competition brought about by Ansett International's entry on a number of international routes. Critically, the PC found that the effect of increased competition was to *increase* total net welfare (even after taking into account changes in costs). While airline profitability was lower under the conditions of increased competition, this was more than offset by gains to consumers.

Furthermore, there are a number of additional considerations which are relevant to the Commission's evaluation of the Proposed Arrangements. The first of these is the risk that the projected cost savings are not realised. This is discussed in more detail in Part 13 of this Determination.

Secondly, and perhaps most significantly, NECG's analysis does not address the issue of the distribution of the estimated benefits and detriments of the Proposed Arrangements between various parties, other than making some adjustments for international wealth transfers.

The question of distribution, however, may have relevance to the Commission's assessment of the Proposal. While the Commission is of the view that benefits to a particular group or segment of the community may be regarded as benefits to the public, consideration needs to be given as to whether the community has an interest in that group being benefited and whether that benefit is at the expense of others, for example, consumers through higher prices. Where benefits are not passed on to consumers they are likely to be accorded a lower weight by the Commission. Furthermore, where benefits appear to accrue to a particular group, it is important to consider the durability of those benefits. To the extent that the Proposed Arrangements increase the scope for x-inefficiency, the durability of the benefits that are argued to accrue to Qantas will be mitigated. Notwithstanding the possibility that such benefits may dissipate over time, the following section provides a more detailed discussion of the welfare distribution outcomes of NECG's modelling.

Welfare distribution

NECG's revised modelling estimates total detriments (over both Australia and New Zealand) as totalling around $174 million over five years. For Australia alone the figure is around $35 million, comprising around $119 million of deadweight loss offset by some $84 million of net wealth transfer gain.[118] In undertaking this welfare analysis, NECG stated that:

> *"Where transfers are made between producers and consumers in New Zealand or producers and consumers within Australia they are ignored in the analysis.*
>
> *We believe that this approach is consistent with the intention of, and logic underpinning, the authorisation mechanism."*[119]

Consequently, it is not clear from NECG's modelling as to who the claimed benefits and detriments of the Proposed Arrangements accrue to. Furthermore the magnitude of implicit wealth transfers between consumers and producers is not transparent.

Having said that, since cost saving benefits are essentially estimated "outside" the Cournot model (on the basis of unit cost and scheduling information provided by the airlines) these are effectively already allocated as accruing to the Applicants.

It should be noted, however, that the allocation of these cost saving benefits to Qantas (Australia) and Air NZ (New Zealand) is not a matter of directly measuring the cost savings generated for each of the airlines. Since the Applicants' Strategic Alliance Agreement provides for a sharing of profits between the two airlines according to their relative capacities, changes in the costs of providing particular services do not simply equate to benefits to the party whose costs are changing. The NECG modelling does, however, incorporate the profit-sharing mechanism in its allocation of cost saving benefits in allocating these benefits between countries.

The fact that the cost saving benefits are estimated separately from the modelling of anti-competitive detriment (deadweight loss) and net wealth transfers, however, means that these elements can be examined independently.

To this end, the Commission has undertaken its own analysis of the allocation of these particular anti-competitive detriments[120] to examine the distributional effects implicit within the NECG analysis.

As might be expected, this analysis shows that in aggregate, while deadweight losses reduce both consumers' and producers' surplus, producers – in particular, Qantas and Air NZ – benefit through extremely large wealth transfers from Australian, New Zealand and foreign consumers. The net effect on the Applicants is strongly positive, but for consumers is unambiguously negative. In gross terms, the transfer payments

---

[118] Note, however, the earlier remarks regarding the Commission's concerns over the possible underestimation of deadweight loss detriments.
[119] NECG, p. 117.
[120] References to "competitive detriments" will generally refer in this part to deadweight losses. The discussion will, however, also discuss distributional issues embedded within NECG's "net transfer" estimates as these are included by NECG in its quantified "Detriments".

from consumers to producers (around $167 million in Year 3) are far in excess of the deadweight loss estimates (around $83 million in Year 3) provided by NECG.

These wealth transfers between consumers and producers should not be confused with the "net transfers" identified in the NECG report. The NECG estimates take account only of the extent to which price increases result in wealth transfers from consumers of one nationality to producers of another.[121] The net effects of these types of wealth transfer are then captured in NECG's "Net transfers" column.

After allocating the transfer payments between countries, NECG estimated that the net effect on Australia is positive, since the total transfer payments to Qantas outweigh the total transfer payments from Australian consumers.

Interestingly, NECG's estimation of net international wealth transfers results in net gains to *both* Australia and New Zealand, suggesting that both countries gain at the expense of foreign consumers (who are also substantially worse off under the Proposed Arrangements).

As with the allocation of cost saving benefits, the allocation of deadweight losses and net wealth transfers is complicated by the nature of the agreement between Qantas and Air NZ. However, the NECG Model makes adjustments to reflect this.

Notwithstanding these complications, the general analysis, when applied to Australia alone, still holds. Australian consumers are significantly worse off, while Qantas reaps available benefits of higher prices.

A further point to note is that the issues previously discussed in relation to NECG's price and quantity modelling also have implications with respect to distribution. As already noted, the Commission has concerns that deadweight losses may be underestimated if the price and quantity differences between the factual and counterfactual are understated. Additionally, however, the magnitude of the wealth transfers from consumers to producers is dependent upon the price and quantity estimates – if the differences between the two scenarios are underestimated the size of the transfer payments from consumers to producers will be underestimated also.

The above welfare analysis becomes relevant when the extent of foreign shareholdings in the Applicants is considered. Notably, the NECG Report makes no mention of the implications of foreign shareholdings in the various airlines on the allocation of benefits to Australia and New Zealand respectively. While it might be suggested that Qantas (and therefore Australia) would gain from such considerations through the 22.5 per cent shareholding in Air NZ that would prevail under the

[121] For Australia, this means that if Australian consumers pay higher prices to, for example, Air NZ, an amount is included as a detriment to Australia. Conversely, if New Zealand or other foreign consumers pay higher prices to Qantas, an amount is included as a benefit to Australia. The net impact of these two effects constitutes the net transfers. Note that these calculations are affected by the profit-sharing mechanism contained in the Applicants' agreement.

Proposed Arrangements, this is likely to be outweighed by the fact that foreign shareholdings in Qantas are currently above 45 per cent.[122]

The NECG approach of reporting only net international transfers has the effect of obscuring the magnitude of the gross welfare transfers that are implicit in its modelling. However, under the Proposed Arrangements, the implied gross transfers between consumers and producers – which are, by definition, equal – are large. Were the NECG analysis more complete – that is, accounting for transfers to the foreign shareholders of Qantas and Air NZ – these large transfers would be more apparent.

As already observed, the vast majority of benefits under the Proposed Arrangements accrue to the Applicants. Most relevantly for the Commission, the majority of Australian benefits accrue to Qantas. Given the extent of its foreign shareholdings, though, it appears that the extent to which these are considered a public benefit to Australia could be significantly discounted.

Other anti-competitive detriment

The arguments put forward by the Applicants and NECG in relation to other sources of potential anti-competitive detriment are discussed in the Commission's Determination. The issues of productive efficiency, innovation and x-inefficiency are examined further in the Commission's evaluation of the cost saving benefits claimed by the Applicants.

In relation to NECG's claim that the Proposed Alliance will increase demand side innovation, the discussion in the Determination is relevant. The increased innovation is attributed directly to the higher probability of VBA entry under the Proposed Arrangements. In light of the Commission's view that VBA entry is not likely to increase should the alliance proceed, such innovation should not be considered as a benefit.

Conclusions

The Commission has concerns with a number of aspects of the approach that NECG has used to estimate the public detriment associated with the Proposed Arrangements.

First, in failing to take sufficiently into account the effect of capacity utilisation on airlines' decision making, the NECG modelling overlooks a critical element of the competitive process and potentially the manner and degree to which airlines compete. The Commission notes the apparent sensitivity of modelled welfare outcomes with respect to this issue.

Second, the quantified detriments are primarily constrained by the Applicants' assumption that VBA entry is more likely under the Proposed Arrangements than without. Since the Commission does not agree with the Applicants' arguments for making this assumption, the quantified detriments are likely to be understated.

---

[122] The Commission notes that as at 1 July 2003 foreign (that is, non-Australian) persons accounted for 50.48 per cent of Qantas shares.

Third, the Commission remains unconvinced that the counterfactual put forward by the Applicants is indeed the most likely alternative in the event that the Proposed Arrangements does not proceed. Rather, the Commission is of the view that the status quo, subject to natural growth, is a more likely outcome. As it might be expected that the capacity differences between the scenario of the future with the Proposed Arrangements presented by the Applicants and the Commission's view are smaller than the difference between the Applicants' future scenarios with and without the Proposed Arrangements, the effect on prices and outputs could also be smaller and thus the estimated deadweight loss detriments could also be smaller.

Finally, NECG's analysis did not fully address the issue of the distribution of the estimated benefits and detriments of the alliance between various parties, other than making some adjustments for international wealth transfers. The Commission analysed the burden of anti-competitive detriments and possible detriments to examine the distributional effects implicit within the NECG Model. This analysis shows that in aggregate, while deadweight losses reduce both consumers and producers surplus, Qantas and Air NZ benefit through significant welfare transfers from Australian, New Zealand and foreign consumers. The net effect on the Applicants is strongly positive, but for consumers is unambiguously negative. In gross terms, the transfer payments from consumers to producers are far in excess of the deadweight loss estimates provided by NECG. Furthermore, the NECG modelling fails to quantify the extent to which the benefits to Qantas accrue to foreign shareholders, rather than to Australia.

APPENDIX D

Outline of submissions provided since the Commission's Draft Determination

The Applicants

The Applicants provided the Commission with a further submission written submission subsequent to its Draft Determination.

The Applicants made submissions to the Commission in relation to:

- The Commission's conclusions on the background to the Applications and the current crisis in the international airline industry;
- Qantas's performance and long-term developments in the aviation industry;
- Air NZ's performance and financial prospects, particularly on long haul international routes;
- The success of Virgin Blue in the Australian domestic market;
- The reasonableness of the counterfactual adopted by the Commission;
- The market definition(s) adopted by the Commission;
- The Commission's assessment of the anti-competitive effects of the Proposed Arrangements;
- The information contained in the NECG Report in relation to anti-competitive detriment;
- Barriers to entry; and
- The Commission's assessment of the public benefit likely to flow from the Proposed Arrangements.

Each of the Applicants submissions above are discussed in further detail in the body of this Determination.

The Applicants also provided the Commission with a series of revised undertakings aimed at addressing the Commission's concern that the initial undertakings were limited in their effectiveness.

The Applicants also submitted that the Commission should accept the behavioural undertakings proposed as a means of minimising anti-competitive detriment and safeguarding public benefits and noted that the Commission and other competition authorities have done so in the past.

The undertakings proposed by the Applicants are discussed further in Part 14.

Bryan Beudeker

Mr Beudeker submitted that the Commission should consider authorising the Proposed Arrangements as they provide an opportunity for environmental improvement by way of reductions in greenhouse gas emissions and noise pollution and improvements in local air quality.

Gullivers Pacific Group

GPG submitted that it supports the Commission's Draft Determination and the proposal to decline authorisation on the grounds that the Proposed Arrangements are highly anti-competitive in terms of passenger and freight services and would be likely to lead to increases in fares/freight rates and decreases in capacity and quality of services.

GPG also submitted that:

- it has reservations about the extent of public benefit arising from cost efficiency savings;
- it has doubts about the viability of new direct services proposed under the Proposed Arrangements as these services have been tried and destabilised;
- the public benefits on the trans-Tasman route are difficult to quantify;
- the Proposed Arrangements may not lead to a significant level of increased tourism and that the public benefits claimed by the Applicants in relation to tourism are significantly overstated;
- it is difficult to see that public benefits will arise in relation to freight services; and
- the Proposed Arrangements will only result in a benefit of marginally increased global competitiveness for Qantas, however, these are not easily transferable into a national interest benefit claimed by the Applicants.

GPG also submitted that the global aviation industry depends on GDP performance as do other sectors and that an anti-competitive merger should not substitute for good governance and effective management.

GPG submitted to the Commission that an analysis of IATA/OECD statistics show that there is a direct correlation between GDP growth and passenger number growth. GPG submitted that, as New Zealand continues to grow its GDP at even a low rate for the forthcoming years, the multiplier effect (of approximately 2.5) will ensure that Air NZ will face an increasingly large international air services market to service.

GPG submitted that domestic sales growth is similarly structured so that it is influenced by business cycles. GPG submitted that efficient business manage these risks and sustain their businesses in the national and consumer interest and that inefficient businesses do not.

GPG submitted that maintenance of competition in an imperative to innovation and that this is at the heart of the requirement to give Australian and New Zealand consumers increasing real value improvements in the airline services market.

GPG submitted that both passenger and freight markets are subject to GDP growth or decline and that the pressures that the airline industry are currently facings are no more or less than other businesses are facing at this time, without expecting to have a monopolistic environment in which to operate.

GPG submitted that the ever-changing market environment makes the airline business inherently risky. GPG submitted that this high level of risk is not a short term phenomenon.

GPG submitted that the Applicants' attempt to characterise the current situation in the aviation industry as a special situation is "provocative and unrealistic".

GPG submitted that, provided that market power is constrained by competition law, markets in the future will be likely to involve more airlines because business organisational constraints limit the ability of a single firm to provide diverse services that are increasingly being demanded by consumers.

GPG also made submissions to the Commission in relation to its view of markets, the counterfactual, public benefit and detriment and undertakings. These submissions are discussed in detail in the body of the Commission's Determination.

South Australian Government

The Premier of South Australia, the Hon Mike Rann MP, made a submission on behalf of the South Australian Government ("SA Govt").

The SA Govt submitted that it supports the granting of authorisation by the Commission in respect of the above arrangements.

The SA Govt submitted that the competitive disadvantage faced by South Australian tourism operators and businesses trading with New Zealand resulting from the present "costly, inefficient and inconvenient" air access to the market justifies the SA Govt's continued support for the approval of the Proposed Arrangements.

The SA Govt submitted that Qantas or Air NZ, with their existing networks, global reach and acquisition of suitably sized aircraft are best placed to provide on-carriage to and from the United States over Auckland.

The SA Govt also submitted that its market research suggests that either carrier could operate viable services in their own right but that it is clear that neither will implement services in the absence of the Proposed Arrangements.

Virgin Blue

Virgin Blue noted that, in its view, the key cause of the anti-competitive detriment identified by the Commission is the inability of a new entrant to place significant competitive constraint on the Applicants under the Proposed Arrangements given the significant barriers to entry faced by potential new entrants and the significant market share of the participants under the Proposed Alliance.

Virgin Blue noted that it has been identified as the only likely new entrant to the trans-Tasman market. Virgin submitted that it generally agrees with this assessment.

Virgin Blue submitted that it believes that, with suitable undertakings in place, it can impose a significant competitive constraint on the Applicants under the proposed Arrangements which will reduce the anti-competitive effect of the Proposed Arrangements as identified by the Commission in its Draft Determination.

Virgin Blue outlined these undertakings to the Commission as:

- the divestiture by Air NZ of Freedom Air;
- restrictions on Air NZ and Qantas from establishing another low fare airline;
- restraining Qantas from flying Australian Airlines in addition to Impulse and Jet Connect aircraft on the trans-Tasman, New Zealand and Pacific routes for a period of three years;
- new entrants must be provided with access to terminal facilities and slots at a level equivalent to that enjoyed by the Applicants, particularly during peak times;
- Virgin Blue must be able to enter into satisfactory commercial arrangements for maintenance services, spare parts and ground handling services at al major airports and route reprotection; and
- the Applicants should provide an undertaking to the Commission to limit their capacity response to new entry and this undertaking should prohibit them from increasing capacity for a period of two years on any route following new entry.

Virgin Blue submitted that, with the above undertakings in place, it can ultimately obtain a market share similar to that it achieved in the Australian domestic market.