

- 13.156. Tourism New Zealand identifies the benefits to tourism (to New Zealand) of Air NZ being part of the Star Alliance. These benefits are not likely to be offset should Air NZ switch to the oneworld alliance. It is also noted that dual-destination tourists are lower-yielding than those with mono-destinations. Tourism New Zealand also questions whether Qantas Holidays will attract an additional 50,000 tourists per year to New Zealand.
- 13.157. TTF acknowledged the benefits of an additional 18,000 dual-destination tourists to Australia as claimed by the Applicants, although the TTF remained unconvinced that Qantas Holidays could achieve an increase from the historic rate of 35 per cent to 50 per cent dual destination travellers. TTF submitted that approval of the Proposed Arrangements should therefore be conditional on a greater commitment to cooperative marketing (that is, marketing in conjunction with Australian tourism bodies).
- 13.158. Frontier Economics, in relation to the forecast additional 50,000 tourists to New Zealand, regarded as “highly questionable” the proposition that Qantas Holidays would only engage in the marketing effort in the presence of the Proposed Arrangements. Frontier Economics noted that, under the counterfactual, the increasing capacity provides both Qantas and Air NZ with an incentive to capture market share and grow the market. It is suggested that if the proposed promotion currently does not take place because of a free-rider effect then a government agency, such as Tourism New Zealand, may provide a solution.
- 13.159. Frontier Economics also raised a concern with NECG’s application of the Cournot Model, claiming that the additional capacity in the counterfactual does not seem to have been taken into account through expected downward pressure on airfares. If this is the case NECG will have underestimated the anti-competitive detriment (that is, the number and value of tourists who will not fly) associated with the Proposed Arrangements.

*Submissions on tourism benefits provided since the Commission’s Draft Determination*

The Applicants

- 13.160. The Applicants submitted that, in its evaluation of the public benefit associated with increased tourism as outlined in its Draft Determination, the Commission has overlooked the ability that Qantas Holidays will have to market under the Air NZ brand. The Applicants submitted that the Proposed Arrangements will enable the Applicants to utilise the strengths of both brands and the distribution network of Qantas Holidays to develop and promote new products as well as existing New Zealand products.
- 13.161. The Applicants submitted that, in its Draft Determination, the Commission did not take into account the nature of tourist decision-making and motivation (as set out by the TFI submission to the Commission).
- 13.162. The Applicants submitted that the Commission’s criticism of the “average” expenditure figures used for additional tourists is unfounded. The Applicants submitted that the issue at hand is the impact of a shifting demand curve

which, according to the Applicants, need not result in lower levels of willingness to pay as output increases and therefore there is no basis for assuming that additional tourists from these areas would have a lower propensity to spend.

- 13.163. The Applicants also submitted that the Commission's concern that dual destination tourists will have a significantly lower level of expenditure in Australia is unfounded. The Applicants submitted that evidence suggests that the stay in each country for the dual destination tourist varies by market and that, for longer haul markets such as the United Kingdom, Europe and the United States, the spend in each country by dual destination traveller is similar to the average for each country. The Applicants submitted that this is attributable to the dual destination traveller travelling for a longer period overall than the mono destination traveller. The Applicants submitted that, for shorter haul markets such as Asia, the stay in each country is less than the overall average, but that the proportion from these markets that visits both Australia and New Zealand is also less than the overall average.
- 13.164. The Applicants submitted that the discounting of the benefit of an additional 20,400 tourists through increased promotion effectiveness is misguided as there is no evidence to suggest that the Proposed Arrangements will decrease the level of efficiency of the Applicants' operations in the Tasman.
- 13.165. The Applicants submitted that, while the Commission questioned the magnitude of the tourism effects being generated by the Cournot model, it did not provide an alternate means of valuing the foreign tourism effect generated by the Cournot model in its Draft Determination.
- 13.166. The Applicants submitted that, in relation to the Commission's concern that an inappropriate multiplier was used to convert tourism expenditure into a net benefit, Professor Peter Dixon had confirmed that an appropriate measure to value an increase in tourism is the increase in consumption associated with an expansion in tourism. The Applicants submitted that this measure would yield a higher multiplier for an expansion in tourism exports than was used in the NECG Report. The Applicants submitted that the Commission selectively drew from the Applicants' submission of 27 February 2003 as it did not allow for the fact that benefits from increased exports would be higher than that estimated by NECG.
- 13.167. The Applicants also submitted that the Commission incorrectly asserted that the NECG analysis did not attempt to develop a net social benefit measure of additional tourism.

#### Gullivers Pacific Group

- 13.168. GPG submitted that, given that Qantas Holidays has been unable to counter factors such as SARS and the impact of the Gulf war, the optimistic estimation of future tourism benefits must be questioned.

*The Commission's view on tourism*

- 13.169. The questions of additional tourist numbers and valuation of their benefit to Australia are addressed in turn.
- 13.170. Regarding the impact on tourism that may be expected under the Proposed Arrangements, the Commission's view is that it is useful to consider separately the two significant effects. First, there is a forecast increase in tourist arrivals in Australia primarily as a result of increased promotion effort and effectiveness, including control of rivalrous advertising, and increased promotion of New Zealand by Qantas Holidays. Second, the Applicants forecast a decrease in tourist arrivals stemming from the higher prices and lower capacity offered under the Proposed Arrangements.
- 13.171. The Commission is of the view that a separate discussion of these two effects is appropriate.

Increased tourism promotion effectiveness – increased efficiency

- 13.172. The Applicants claim that one source of increased tourism under the Proposed Arrangements will arise through a five per cent increase in the efficiency with which the Australasian market is promoted. This would represent a net increase of approximately 20,400 foreign tourists to Australia per annum which, in NECG's estimation, would represent a net benefit to Australia of \$70 million for each of the five years forecast.
- 13.173. NECG claimed that the sources of this efficiency in promotion are:
- greater connectivity and frequency under the Proposed Arrangements, which will increase demand for visits by tourists;
  - new products;
  - a redirection of promotion away from rivalry for market share towards market expanding opportunities; and
  - encouragement for Qantas and Air NZ, along with "National Tourism Organisations", to run joint promotions.
- 13.174. Of these sources, NECG modelled only the impact of the third – the redirection of promotion. In a submission to the Commission,<sup>96</sup> NECG set out support for its view that much of the promotional activity of Qantas and Air NZ on the Tasman routes is directly rivalrous. As NECG put it, "*...in percentage terms Qantas promotional spending is neutralised completely by Air NZ promotional spending*".<sup>97</sup> NECG argued that if Qantas and Air NZ were to cease their head to head rivalry over the Tasman (as is proposed

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<sup>96</sup> NECG, included in submission from the Applicants to the ACCC, 27 Feb 2003, pp.39-46.

<sup>97</sup> *ibid.* p.39.

under the Proposed Arrangements) then “...promotion will focus on market expanding opportunities rather than rivalrous promotion”.<sup>98</sup>

- 13.175. In its modelling, NECG assumed that the additional 20,400 visitors to Australia would not include residents of New Zealand. The implication is that not only will the Proposed Arrangements – through Qantas Holidays – attract an additional 50,000 visitors to New Zealand, but also – through a redirection of marketing effort away from the Tasman and towards non-Australasian tourists – will attract a further 20,400 non-Australasian tourists to Australia.
- 13.176. Frontier Economics questioned whether the Applicants would, in the absence of the Proposed Arrangements, lack an incentive to grow the market as well as individual market shares, commenting that “...under the ‘without’ scenario, Qantas and ANZ are assumed to substantially increase capacity, which would give them every incentive to invest in growing the market as well as capturing market share”.<sup>99</sup> Frontier Economics also argued that if the lack of incentive to invest arises from a free rider problem then this may be addressed through national government agencies such as Tourism New Zealand.
- 13.177. The Commission is of the view that competition between Qantas and Air NZ for market share on the Tasman routes probably does give rise to costs that could be avoided should the two firms cease to compete, as would occur under the Proposed Arrangements. However, in a future with the Proposed Arrangements, Qantas and Air NZ would be likely to assume positions of significant market power on much of the trans-Tasman traffic. As discussed elsewhere in this Determination, firms with market power tend to have their incentives to act efficiently blunted because of the absence of competitive pressure.
- 13.178. The Applicants seemed to argue that Qantas has limited resources for promotional activities and that, at present, these resources are committed to a range of activities, including rivalrous competition for market share over the Tasman. If these resources could be released from their current commitment to the Tasman then they could be applied, in cooperation with the ATC, to promoting Australia to non-Australasian tourists. In the Commission’s view, it is probable that the promotion of Australia to non-Australasian tourists would take place in an effort to expand the market for each of the Applicants without the Proposed Arrangements. Consistent with the “future with-and-without test” discussed previously, the Commission accords more weight to benefits which are more likely to occur in the future if authorisation is granted than that accorded to benefits that would be much less likely to occur. For this reason, the Commission has discounted the benefit of an additional 20,400 foreign tourists when considering the public benefit for the purpose of this Determination.

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<sup>98</sup> *ibid.* p.48.

<sup>99</sup> Frontier Economics, Critique of the NECG Report on the Qantas Air New Zealand Alliance – Report Prepared for Gilbert & Tobin, 11 February 2003, p.34.

13.179. The Commission also notes that there is some doubt as to whether these promotions are likely to be as effective as the Applicants have suggested. This is discussed further below.

#### Increased tourism promotion effort and effectiveness – Qantas Holidays

13.180. The Applicants have argued that, under the Proposed Arrangements, Qantas Holidays would be given the incentive to undertake a marketing effort to promote New Zealand to international tourists. This effort will give rise to 50,000 additional visitors to New Zealand per annum, with 18,000 also visiting Australia. To support their claims, the Applicants provided the Commission with a Qantas Holidays business plan outlining the proposal and also a report by TFI that endorsed as “reasonable” the forecast of 50,000 additional tourists.

13.181. The Commission notes the GPG submissions that Qantas Holidays may have overestimated its ability to market New Zealand as a tourist destination. If this is the case, there is some risk in accepting that promotional activity would result in the achievement of 50,000 additional tourists. Additionally, there is a risk that the growth of the Qantas Holidays business in New Zealand may come at the expense of competitors, a point recognised by TFI.

13.182. Professor Hazledine noted that there does not appear to be any significant constraint on tourists to travel in the Australasian region at the moment. Professor Hazledine asks: “*What is the source of the market failure that currently prevents 81,000 [sic] people from realising their latent desire to be tourists in New Zealand or Australia?*”<sup>100</sup> The Commission accepts Professor Hazledine’s argument in this respect and is of the view that this point underlines the argument that the tourism benefits associated with increased promotional activities by Qantas Holidays are likely to have been overstated by the Applicants.

13.183. The Applicants also claimed that Qantas Holidays can use its expertise to increase the rate of dual destination travel. This view is endorsed by TFI. However, the TTF has questioned the assumed jump in the rate of propensity to visit both destinations from 35 per cent to 50 per cent. As an indication of the impact that a rate of 35 per cent, rather than 50 per cent would have on the claimed Year 3 benefits, the Commission, using NECG’s Model, estimated a reduction in the net benefit to Australia of approximately \$18.5 million, or 17 per cent. The value of dual destination tourism is also discussed below.

#### Tourism impacts from new flights and new fares

13.184. In a broad sense, increased prices and reduced capacity associated with the Proposed Arrangements can be expected to have an unambiguously negative effect on tourist arrivals to Australia. It is the measurement of the size of this effect that is of importance.

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<sup>100</sup> Hazledine, T, Submission to NZCC and the Commission on Proposed Alliance between Qantas and Air New Zealand, 14 February 2003, p.8.

13.185. In the discussion presented above, the Commission set out its concerns regarding NECG's Cournot Model. The work of Professor Hazledine suggests that, using similar assumptions to NECG, the number of tourists forgone has been underestimated by NECG.

13.186. The assumptions underlying NECG's modelling are such that there is no expenditure by foreign tourists forgone as a result of price increases and capacity reductions under the Proposed Arrangements. In fact the only impact on Australia occurs on the trans-Tasman routes from New Zealand residents who would no longer visit Australia. There is no expenditure by foreign tourists forgone because, as NECG put it:

*"...the foreigners found not to be travelling must have been in Australia or New Zealand as part of a longer journey. Thus, if these tourists are deterred from travelling on the Tasman it is assumed that they would holiday for a greater time in either Australia or New Zealand".<sup>101</sup>*

13.187. In effect, NECG assumed that the expenditure forgone by a foreign tourist who arrived in, say, Auckland but who will no longer fly to Sydney, is offset by a foreign tourist who has arrived in Australia but, because of the Proposed Arrangements does not fly to Auckland will spend longer and spend an additional amount equal to the tourist who does not fly to Sydney. This assumption does not appear to be consistent with others maintained by the Applicants. For example, elsewhere the Applicants argue that, in terms of time spent in Australia, there is little difference between single destination tourists and dual destination tourists. If foreigners who, because of the Proposed Arrangements, do not fly from New Zealand to Australia are not compensated for by foreigners staying in Australia, then a significant benefit would be forgone under the Proposed Arrangements.

13.188. NECG's modelling also assumed that Australian resident tourists who do not fly because of the Alliance's higher prices and reduced capacity divert their spending back into the Australian economy. As such their spending forgone (that is, the amount that Australian resident tourists would have spent overseas) is counted as a relative benefit of the future with the Proposed Arrangements as compared to without the Proposed Arrangements.

13.189. NECG sought to demonstrate the public benefit associated with increased tourism by applying a "multiplier" to convert tourism expenditure into a quantified public benefit. In advising on how the Monash Computable General Equilibrium ("CGE") model derived "multipliers" to allow conversion of tourism expenditure to public benefit, NECG claimed that substitution away from overseas travel by Australians (that is, imported tourism) to domestic tourism should be adjusted by a factor ranging from 0.41 to 0.65, depending on the year. The Model provided to the Commission by NECG assumed that this adjustment factor was 1.0. Using NECG's Model, and adopting a factor of 0.49 advised by NECG to apply to Year 3 of the

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<sup>101</sup> NECG, included in submission from the Applicants to the Commission, 27 Feb 2003, p.109.

Alliance, the Commission examined the implications for Australia of forgoing tourism income from New Zealand resident tourists (100 per cent of which would be lost to Australia). Holding all NECG's other assumptions constant, the Commission estimated a detriment to Australia of \$66.7 million, which is significantly higher than NECG's estimate of \$35.5 million. Consequently, the tourism net benefit would be no more than \$65.4 million, rather than \$96.4 million, in Year 3 of the Proposed Arrangements.

- 13.190. Finally, the earlier discussion of NECG's Cournot Model indicated that the decrease in the numbers of passengers caused by the Proposed Arrangements' price increases and capacity reduction may have been understated. While it is difficult to quantify this understatement, it is likely to have a significant detrimental effect on Australia. This effect derives from lower levels of Australians travelling overseas and foreign visitors to Australia. However, the lost benefit of foreign tourist visitors forgone is not balanced by the complementary effect of Australians changing their expenditure from international to domestic tourism. Expenditure by foreign tourist visitors and the general issue of valuation of tourism benefits is discussed below.

#### Benefits associated with additional tourists

- 13.191. The primary economic benefits to Australia of additional international tourists derive from their expenditures which represent an increase in gross export income. To evaluate the impact of such an increase in exports, an analysis should incorporate both the direct and indirect effects. This is best undertaken using a CGE model of the Australian economy. Such models are designed to capture total changes in aggregates such as GDP and employment taking into account macroeconomic level changes in such variables as the terms of trade. Identification of the corresponding changes in aggregate economic welfare requires estimating gross social benefits less social costs, that is, an estimate of change in economic surpluses.<sup>102</sup>
- 13.192. NECG evaluated the benefits of additional international tourists to Australia using a two-stage process:
- a general equilibrium analysis of the effects of additional tourists; and
  - valuation of benefits based on expenditure per tourist.
- 13.193. NECG made use of the Monash CGE model to estimate the scale factor between additional tourism expenditure on tourism by foreigners and its translation into an increase in GDP. NECG determined that this factor was 96 per cent. On this basis, NECG treated as equal the valuation of the benefits per international tourist to Australia and the money expenditure per additional tourist generated by the Proposed Arrangements.

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<sup>102</sup> This point is further discussed below in paragraphs 10.149-10.152.



13.194. The NECG approach involved simply multiplying the estimated additional number of tourists generated by the Proposed Arrangements by the average expenditure per tourist. Where the country of origin was known, a country specific spend amount was applied. However, if the country of origin of additional tourists was unknown an average expenditure figure was used to calculate the net benefits. Different per tourist expenditure figures were attributed to TFI and are reproduced below (see Table 13.1 and Table 13.2). These figures do not appear in the TFI Report supplied to the Commission. The figures were revised by the Applicants (some significantly) from those originally set out in the NECG Report (page 160).

**Table 13.1 Average tourist expenditure by region: initial NECG estimate\***

<b>Region</b>	<b>NZ</b>	<b>Australia</b>	<b>Foreigners</b>
Tasman	\$1,828	\$1,748	\$3,197
Other	\$3,476	\$4,052	-

\* All figures are in NZ\$

**Table 13.2 Average tourist expenditure by region: revised NECG estimate\***

<b>Region</b>	<b>NZ</b>	<b>Australia</b>	<b>Foreigners</b>
Tasman	\$1,632	\$1,770	\$3,950
Other	\$3,476	\$3,748	\$3,950

\* All figures are in NZ\$

13.195. Applying expenditure figures to the estimated net tourist numbers, NECG estimated a net benefit to Australia in Year 3 of \$96.4 million. These estimated benefits also include the estimated expenditure by domestic tourists who divert from the international market to the domestic market under the Proposed Arrangements.

13.196. The Commission's Draft Determination commented on the expenditure figures that NECG used in the analysis of the value of additional tourists. NECG claimed that these figures were provided by TFI, using New Zealand and Australian Government sources. These tourist expenditure figures appear to represent average figures. The Commission expressed the view that they may therefore represent overestimates, or at best upper bounds, as it would generally be expected that additional, marginal, tourists may not have as high a propensity to spend as the average tourist. In responding to the Draft Determination, the Applicants have correctly noted that if the promotion associated with the Proposed Arrangements results in increased demand for travel to New Zealand then the propensity to spend of those additional tourists will not necessarily be lower than the current average. The Commission notes however that if the Applicants provide capacity for the expected additional tourists and the promotion is not sufficient to create that additional demand, then tourists with a lower propensity to spend may instead be sought.

13.197. As discussed above, there are several important assumptions regarding NECG's modelling of the benefits of increased tourism. Under the NECG



analysis, dual destination tourists are as valuable to Australia as single-destination tourists. This implies that a dual-destination tourist will have twice the budget of a single-destination tourist per trip. ATC and GPG make the point that tourists may be constrained by holiday budgets and leave entitlements, particularly in Asian markets. DITR, ATEC and Tourism New Zealand noted that a potential impact of dual-destination tourism may be reduced stays in each country. Regarding length of stay, TFI found that there *“is not a significant difference in overall average stay in Australia regardless of New Zealand stopover”*.<sup>103</sup> It is not obvious whether or how this may translate into the value of such tourists. In this respect, ATC noted that its own recent experience was that marketing Australia alone, rather than jointly with New Zealand, was *“far more effective in delivering yield to the Australian tourism industry”*. The Commission concluded in the Draft Determination that, based on the information before it, the value of dual-destination tourists to Australia may have been overestimated by the Applicants.

- 13.198. In response to the Draft Determination, the Applicants drew on information presented in the TFI Report in claiming that time spent in Australia by tourists from long haul markets which represent the largest proportion of dual destination tourists (such as the United Kingdom, Europe and the United States) was not reduced if time was also spent in New Zealand. A question remains however regarding the benefit to Australia of such tourists.

#### Possible impact of loss of the Star Alliance

- 13.199. The Proposed Arrangements are likely to pose a conflict in terms of the allegiances of the Applicants to different global airline partner alliances: Qantas is a member of **oneworld** and Air NZ is a member of the Star Alliance. Given the fluid global situation prevailing in the international airline industry, it is difficult to be certain about what consequences may flow from the Proposed Arrangements. A move by Air NZ, for example, from the Star Alliance to **oneworld**, could be expected to have a dampening effect on North American originating tourists entering the region through New Zealand. The evolving financial status of several major US airlines could also prove a factor.

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<sup>103</sup> Tourism Futures International, “Australasian Tourism Review”, 5 Feb 2003, p.51.

## Tourist expenditures, GDP and net social welfare

13.200. The link between increased international tourist expenditure and an increase in the net social benefit (sometimes referred to as “yield”) generated for the host country can be influenced significantly by a number of different factors. They include the presence of unemployed resources (especially labour), terms of trade effects, taxes and subsidies, and the consumption of imported goods and services by, and externalities associated with, international tourists. A 1997 study by Forsyth and Dwyer found that:

*“The net [emphasis added] benefits of tourism are normally significantly lower than the aggregate expenditure of the tourists because its necessary to give up real resources, goods and services to provide for these tourists.”<sup>104</sup>*

13.201. That is, there is a real resource cost to the economy in the provision of goods and services to international tourists – and this cost may differ from its private cost. While it is obvious that income for the host country is increased as a result of additional international tourist expenditure, the size of the net benefit (that is, inclusive of costs) is the more useful measure when assessing whether a host country is actually made better-off from that expenditure.

13.202. The Commission regards the Monash model as an appropriate model to assess the normal macroeconomic impacts of increased tourism demand as it is well disaggregated in terms of the industries and tourism related sectors included in the model.

13.203. The Monash model, as is the case with any CGE model, is however sensitive to the assumptions chosen. This is demonstrated by NECG in its report in contrasting situations of fixed real wages (unemployed labour) and fixed employment (flexible real wages), and in its response to the Commission dated 27 February 2003. NECG also noted that infrastructure supply, and in particular, assumptions related to the amount of airline capacity required, affect costs and hence macroeconomic outcome results. Spare capacity in the short term would mean that additional income flows into the economy at a relatively low resource cost. NECG noted that the scale factors estimated between (gross) international tourist expenditures and GDP are 96 per cent for a fixed real wage situation and 40 per cent for a fixed employment situation. NECG, in choosing to adopt a factor of 96 per cent (applied as 100 per cent) has chosen a multiplier within an estimated range to apply to the expenditure of foreign tourists. While this may be a reasonable estimate of the relationship of increased gross tourist expenditure to change in GDP, the Commission is concerned with the use of this multiplier as a means of translating gross expenditure by foreigners (whether potential or forgone) into a measure of public net benefit to Australia.

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<sup>104</sup> Dwyer L. and Forsyth P. (1997), “Measuring the benefits and yield from foreign tourism”, *International Journal of Social Economics*, Volume 24, Issue 1/2/3, p.224.

13.204. The Commission's Draft Determination found that the NECG analysis did not attempt to develop a net social benefit measure taking into account the various factors that affect the full social costs of additional tourism. In response, the Applicants, referring to a report by Professor Peter Dixon, argued that the CGE analysis represented a net social benefit measure. The Commission maintains that the use of CGE analysis to assess net social benefit flowing from increased tourism may be incomplete. For example, increased tourism may involve additional costs including externalities, some of which are negative, such as degradation of highly valued environmental amenities.

#### Sensitivity of results

13.205. The Commission used NECG's Model for Year 3 to test the effect of changing just three of the variables discussed above:

- Qantas Holidays is able to achieve only the historic rate of dual destination travel of tourists travelling to New Zealand (that is, 35 per cent rather than 50 per cent);
- the additional promotional effort (that is, other than Qantas Holidays) to non-Australasian tourists is not an essential part of the Proposed Arrangements; and
- the public benefit of Australian tourists diverted away from international travel and into domestic tourism is equal to half their forgone expenditure.

13.206. The impact of these three changed assumptions is that it reduces the net impact of tourism under the Proposed Arrangements from representing a benefit to Australia of \$96.4 million to a *detriment* of \$23.2 million. This underlines the importance of the assumptions adopted by the Applicants. It also serves to illustrate that the Proposed Arrangements contain negative influences on tourism to Australia.

13.207. In addition, to gauge the impact of some of the matters raised by the Applicants in response to the Commission's Draft Determination, the Commission used NECG's Model for Year 3 under the following assumptions:

- Qantas Holidays is able to achieve only the historic rate of dual destination travel of tourists travelling to New Zealand (that is, 35 per cent rather than 50 per cent);
- the additional promotional effort (that is, other than Qantas Holidays) to non-Australasian tourists is an essential part of the Proposed Arrangements but the assumed increase in efficiency in promotion resulting from cost savings is only half the rate assumed by the Applicants (and is therefore 2.5 per cent); and

- the public benefit of Australian tourists diverted away from international travel and into domestic tourism is equal to half their forgone expenditure *and* the expenditure of each international tourist is multiplied by a factor of 1.36 to reflect the high-scenario estimate provided by NECG.

13.208. Even under these varied assumptions, the Commission found that the Proposed Arrangements represented a benefit to Australia of approximately \$6.0 million. This finding is consistent with the Commission's Draft Determination that the Applicants have not established any more than marginal benefits in terms of the overall net public benefit assessment would be likely to flow from tourism under the Proposed Arrangements.

13.209. While levels of net public benefit or detriment estimated using NECG's Model are obviously highly sensitive to assumptions that are adopted, it should be noted that the Proposed Arrangements represent risks that the Commission has not sensitivity-tested. Detriment could be expected to flow from the Proposed Arrangements if, for example, the following were to transpire:

- the value of dual destination tourists to Australia is not as high as the value of those tourists that visit Australia only. This would lower the value to Australia of the Qantas Holidays marketing effort;
- the benefit lost to Australia resulting from foreigners who, because of the higher fares and reduced capacity associated with the Proposed Arrangements, choose not to fly from New Zealand to Australia is not compensated for by foreigners who visit Australia but, due to the Proposed Arrangements, do not travel to New Zealand;
- that increased tourism may be associated with negative externalities that are not reflected in the CGE model; and
- the Applicants' marketing plans, particularly with regard to dual destination travel and the promotion of New Zealand, may not be consistent with the tourism strategies of Australian-based, government-funded tourism agencies. For example, the strategic directions identified in DITR's Green Paper emphasise the promotion of "Brand Australia" and the dispersal of the benefits of tourism throughout regional Australia. Additionally the Commission notes the recent Tourism Ministers' Council in-principle endorsement of a 'One Australia' approach to international tourism marketing.

13.210. For this reason, the Commission's sensitivity tests should be regarded as an indication of the range of likely outcomes and should not be interpreted as worst case scenarios.

## Undertakings

- 13.211. The Applicants initially proposed providing the Commission with an informal undertaking to:

*“...spend an additional A\$5.4 million in the one year following the Effective Date on costs associated with the implementation of the Qantas Holidays business plan and designed to stimulate an additional 50,000 tourists to New Zealand (including 18,000 dual destination tourists) which includes A\$1.75 million on direct sales and marketing”.*<sup>105</sup>

- 13.212. The Commission understands the undertaking offered by the Applicants to be a commitment to finance the Qantas Holidays business plan should the Proposed Arrangements be authorised. This proposed undertaking does not serve to alleviate the Commission’s broader concerns regarding the risks associated with the achievement of additional tourists under the Proposed Arrangements.
- 13.213. Following the Draft Determination, the Applicants submitted to the Commission a revised outline of undertakings that they would be willing to offer in order to assist regulatory approval of the Proposed Arrangements. In the revised outline, the Applicants offer to spend the \$1.75 million direct sales and marketing expenditure identified in the original undertaking “...in conjunction with national and state tourism bodies where that is likely to maximise tourist flow”. Further, the Applicants offer to spend a further \$5.4 million on direct sales and marketing (also “...in conjunction with national and state tourism bodies where that is likely to maximise tourist flow”) if tourism targets are not met by the end of Year 3.
- 13.214. Although the meaning of “tourism targets” would need to be clarified it appears that the Applicants are offering to spend an additional \$5.4 million if the additional 18,000 dual destination tourists do not materialise in Year 3. The Commission’s view is that this offers no guarantee that the 18,000 target will be met but rather that more money will be spent in attempting to meet that target. It follows that the greater the cost to obtain these tourists, the lesser benefit to Australia the Proposed Arrangements represent. For these reasons, the revised undertakings regarding tourism do not materially change the Commission’s assessment.

## Conclusions

- 13.215. The Commission’s view is that it is unambiguous that the higher prices and reduced capacity associated with the Proposed Arrangements imply that less tourists will travel to Australia, (and less Australians will choose to travel overseas). At the same time, considerable doubt attaches to the effectiveness of the proposed promotion activities in attracting tourists to Australia and to

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<sup>105</sup> Document lodged with the Commission dated 12 March 2003.

the valuation of the benefits that the Applicants have attributed to forecast increased international tourist flows.

- 13.216. The Commission has therefore concluded that the Applicants have not established that the impact on tourism of the Proposed Arrangements would result overall in more than a marginal public benefit to Australia.

### **Freight benefits**

#### *Claims made by the Applicants*

- 13.217. The Applicants and NECG submitted that the Proposed Arrangements will continue to provide, and in some cases improve, freight access to major markets.
- 13.218. Under the Proposed Arrangements certain routes will be supplemented by “back of the clock” flying using B767 aircraft currently overnighing in Melbourne. The additional Melbourne services will enhance links to Qantas’ time sensitive Australian network. The undertaking provided to the Commission by the Applicants incorporates a commitment to add a minimum of four weekly return trans-Tasman wide bodied ‘back-of-the-clock” services specifically for freight to commence within 12 months of implementation of the Proposed Arrangements, although this commitment is subject to market support and to material adverse changes to the financial performance of the services.
- 13.219. There may also be an option to expand freight services into Asia through the use of freighters that currently position empty to Asia although this may require the negotiation of additional rights.
- 13.220. Southbound capacity from the United States to New Zealand and Australia will continue to be provided by a substantial freighter network. The introduction of Qantas B744ER equipment will enhance available capacity.
- 13.221. NECG estimated that the Proposed Arrangements would provide an additional 247 tonnes of freight capacity per week compared to the future without the Proposed Alliance which, assuming no change in the price of freight services, amounts to an annual benefit of approximately \$4 million by Year 3 of the Proposed Arrangements.
- 13.222. The Applicants submitted that the Proposed Arrangements would also involve:
- improved scheduling, which would deliver efficiency benefits, particularly for the delivery of perishable freight;
  - the realisation of cost savings from the use of common facilities and systems; and
  - the possibility that the two airlines could operate joint freighter services.

*The views of interested parties*

- 13.223. AFIF disagreed with the Applicants' claimed public benefit of improved freight operations given the likely disruption to freight services resulting from the loss of competition on the trans-Tasman market and the introduction of narrow-bodied aircraft.
- 13.224. Danzas formed the view that the improved flight frequency and scheduling resulting from the Proposed Arrangements, particularly in respect of New Zealand airports other than Auckland, would support freight capacity and assist importers and exporters in both countries. The introduction of new routes, such as Auckland-Adelaide, will also enhance freight capacity.
- 13.225. Rex disagreed with the Applicants' submission that freight operations would be enhanced under the Proposed Arrangements. Rex submitted that the Proposed Arrangements would result in the monopolistic carriage of freight, reduced capacity in the market and increased prices.
- 13.226. The Tasmanian Government submitted that the advent of direct flights across the Tasman, in particular, the proposed Auckland-Hobart route, will provide new opportunities for the development of tourism, freight and other strategic partnerships.
- 13.227. The Tasmanian Government considered that the spare capacity likely to become available for freight, particularly in "back-of-the-clock" flying using B767 aircraft currently over-nighting in Melbourne, and as a result of the new Hobart-Auckland direct service (although weekly) will provide opportunities for local producers, especially those with time-critical produce for delivery to market. The growth in Tasmanian food production, which is expected to double by 2008, will need to be supported by increased capacity to export this production to national and international markets. The Proposed Arrangements, with increased freight opportunities out of Melbourne in particular, will assist in this market development and access.
- 13.228. Frontier Economics, engaged by Virgin Blue, was highly critical of the approach taken by NECG to analyse competition in passenger services independently of competition in air freight services. Frontier Economics considered that this asymmetry of treatment is quite inappropriate because the effects of the Proposed Arrangements on the prices and quantities of freight are likely to be similar in type to the effects of the Proposed Arrangements on the prices and quantities of passenger services.
- 13.229. Frontier Economics noted that while NECG predicted that the Proposed Arrangements would reduce capacity on passenger services (compared with the counterfactual), NECG predicted that the Proposed Arrangements would increase capacity for freight by 5.3 per cent by Year 3 as a result of "back of the clock" flying of B767 aircraft that are currently over-nighting in Melbourne, possible options to expand specialised freight services into Asia and the introduction of Qantas B744ER equipment from the USA to New Zealand and Australia.



- 13.230. Frontier Economics submitted that it is not clear why these increases in capacity are contingent on the Proposed Arrangements. Frontier Economics observed that the NECG Report did not explain why Qantas, in the absence of the Proposed Arrangements, would not utilise the aircraft currently over-nighting in Melbourne, or the empty freighters flying to Asia.

*Submissions on freight public benefits provided since the Commission's Draft Determination*

The Applicants

- 13.231. In relation to the Commission's conclusion that it is not satisfied that any public benefits will accrue from the Proposed Arrangements in relation to freight markets, the Applicants submitted that they have provided the Commission with undertakings to provide "freight only" services. The Applicants submitted that the Commission therefore has no basis for refusing to recognise the benefits flowing from these additional services.

*The Commission's view on freight*

- 13.232. The Commission notes both the Applicants' proposal, and undertaking, that under the Proposed Arrangements B767 aircraft will be used to provide additional freight only services. If the Commission accepts the Applicants' proposition that they will operate additional economically viable "freight only" services in the future with the Proposed Arrangements and given that these aircraft are currently not being used for any purpose at the time these freight only services would operate, the Commission is of the view that the Applicants are no more likely to do this if the Proposed Arrangements are authorised than if they are not. Accordingly, following application of the "future-with-and-without test", the Commission would normally assign minimal weight to this claimed benefit.
- 13.233. Having said this, the Commission does not accept the proposition that it would be economically viable for the Applicants to operate additional "freight only" services with or without the Proposed Arrangements. The Commission's reasons for this view are discussed below.
- 13.234. It is the understanding of the Commission that while these aircraft would be used to provide overnight freight only services, they would also continue providing regular passenger services during the day and, as such, it would not be economic for the Applicants to regularly reconfigure the interior of the aircraft to accommodate either passengers or freight. In other words, only the belly holds of these aircraft would be available for freight cargo because the main cabin would remain configured for passengers.
- 13.235. There is a question as to whether the Applicants would be able to recover the cost of operating freight only services at current freight rates, if only the belly holds of the aircraft were used for freight. Based on the Commission's understanding of the operating costs of the aircraft and likely revenue from dedicated freight services, it is unlikely that the proposed freight only flights would be tenable at current freight rates. Absent passengers, the choice for

airlines would be between making operating losses, increasing freight rates or ceasing the services.

- 13.236. The Applicants, in their response to the Draft Determination did not dispute the Commission's comments as to the viability of the proposed "freight only" services at current freight rates. Reference has instead been made to proposed undertakings as the basis for arguing that the Commission should recognise benefits from the "freighter only" services. The Commission notes that the undertakings allow the additional freight services to be ceased or reduced *"for any period where there is a material adverse change to the financial returns earned by the Operating Carriers on that service"*. On the basis of the Commission's undisputed assessment of the viability of the "freight only" services those services would either be withdrawn from service or there would be significant increases in freight rates.
- 13.237. In respect of the Applicants' proposal to expand freight services into Asia through the use of freighters that currently position empty to Asia, the Commission notes that this option may require the negotiation of additional rights. At the very least, the need to negotiate additional rights would delay the realisation of any benefit in terms of freight capacity and furthermore, the outcome of any such negotiation is not guaranteed. Additionally, the Commission notes that this benefit does not relate to the geographic markets subject to the Commission's assessment.
- 13.238. The third benefit of southbound capacity from the USA identified by the Applicants related only to the Australian-North America market and is not relevant to an analysis of the trans-Tasman market. The Commission notes that the introduction of Qantas B744ER equipment will occur regardless of whether the Proposed Arrangements are authorised by the Commission.
- 13.239. In respect of the other public benefits claimed by the Applicants, the Commission notes that:
- while improved scheduling may have benefits for the delivery of perishable freight, as noted by the Tasmanian Govt, the extent to which these benefits are realised is dependent upon a number of factors, including the type of aircraft used to provide the rescheduled services;
  - the benefits of the realisation of cost savings from the use of common facilities and systems are reduced if these cost savings are not passed on to consumers; and
  - while the Applicants noted the possibility that they could operate joint freighter services, no details in relation to this possibility were provided.
- 13.240. The Commission is not satisfied that any public benefits will accrue from the Proposed Arrangements in relation to relevant freight markets.

## Global competitiveness benefits

### *Claims made by the Applicants*

- 13.241. The Applicants claim that it is important for them to maintain their ability to compete in the increasingly competitive and volatile global aviation market. It is claimed that many public benefits particularly those associated with additional flying and network reach extension, would not be available at all in the event that pressure from a large northern hemisphere or regional based carrier were to erode the viability of airlines domiciled in Australasia.
- 13.242. The Applicants referred to section 90(9A) of the Act and suggested that it can be interpreted to mean that an increase in the global competitiveness of the Australian aviation industry must be taken into account as a public benefit. Section 90(9A) reads:

*“In determining what amounts to a benefit to the public [and] ... without limiting the matters that may be taken into account, the Commission must take into account all other relevant matters that relate to the international competitiveness of an Australian industry.”*

- 13.243. The Applicants further claimed that the underlying purpose for the section is described in the second reading speech in respect of section 90(9A):

*“There has been some concern that a more stringent merger test could impede firms’ abilities to achieve the necessary scale to develop export markets or to compete effectively with imported products. To allay these concerns this Bill contains amendments to the merger authorisation provisions.....”*

### *Views of interested parties*

- 13.244. DTRS stated that, while Qantas has remained financially viable, it is important that it has scope to grow and acquisition of competitors may ensure its longer term growth.
- 13.245. DTRS submitted that it is in Australia’s best interests to have at least one of the surviving airline groupings based in this region and built around a strong and efficient local carrier. Further, DTRS submitted that a partnership between Qantas and Air NZ can be seen as a first step in this direction, however the Proposed Arrangements between Qantas and Air NZ has anti-competitive elements in its current form.
- 13.246. DTRS also stated that it is important to make sure that there is enough competition on domestic and international routes to keep Qantas and Air NZ efficient and provide consumer choices and benefits.
- 13.247. SACL stated that Australia’s economic interest in the broad economic sense would be expected to benefit from having a strong flag carrier in Qantas which would be better placed to compete in a difficult world market.

- 13.248. Danzas said that in the longer term the aviation industry needs strong(er) operators. Australia already has a strong aviation operator in Qantas and New Zealand will no doubt benefit from the increased and improved position of Air NZ as a result of the Proposed Arrangements.
- 13.249. Melbourne Airport stated that it is clear that the Proposed Arrangements will deliver a future for Air NZ characterised by greater certainty than is currently the case. Similarly, the arrangements proposed present a significant commercial opportunity for Qantas. That said, however it is not believed that the successful completion of the agreement is essential for the long term viability of Qantas.
- 13.250. The Qld Govt said that its support for the Proposed Arrangements is predicated on it creating a commercially sustainable, robust and viable Australasian airline group. The Proposed Arrangements is described as crucial to the future viability and operation of Air NZ.
- 13.251. ATEC said that given the current turbulent aviation climate, Australia requires a carrier that is sustainable in the long term and that the consequence of Air NZ exiting the market would be quite adverse for Australia.
- 13.252. ACA stated that while there is no doubt that the international aviation market is tough, Qantas is one of the few airlines operating very profitably. Increased cooperation as proposed is more likely to shore up Qantas' position through blocking competitor access and reducing potential consumer benefit through alternative competitive services.
- 13.253. Rex noted that Qantas is already the most profitable full service airline in the world and recent service changes involving United will only serve to consolidate its position.
- 13.254. A number of other submitters including Consolidated Travel and the WA Govt described the need for long term viable local carriers in a difficult global trading environment.

*Submissions on global competitiveness benefits provided since the Commission's Draft Determination*

The Applicants

- 13.255. The Applicants submitted that, while the Commission acknowledges that the nature of the Proposed Arrangements would be expected to increase Qantas' global competitiveness, it has inappropriately double counted the anti-competitive detriment flowing from the Proposed Arrangements by discounting the increased global competitiveness of Qantas on the basis that competition has been removed. The Applicants submitted that the effects of this removal of competition were already modelled by NECG in its quantification of the anti-competitive detriments flowing from the Proposed Arrangements.
- 13.256. The Applicants submitted that increased viability is not the same as increased global competitiveness.

13.257. The Applicants submitted that Qantas will gain by having full access to Air NZ's domestic network and to its greater connectivity out of Auckland under the Proposed Arrangements and that the carriage of Air NZ passengers through the "Kangaroo Route" will strengthen Qantas' crucial hub at Singapore. The Applicants submitted that this is not a marginal addition to Qantas' global competitiveness and that the Commission has no basis on which to conclude that an increase in global competitiveness is not a substantial public benefit.

*The Commission's view on global competitiveness*

13.258. The Commission accepts the view that arrangements which increase the global competitiveness of Australian businesses do provide a public benefit. This is not to say however that achieving an increase in global competitiveness should not also take into account the impact of the arrangements on competition in local markets. As part of the authorisation process the Commission would normally also assess the anti-competitive detriment associated with such arrangements in all relevant markets, as it has done earlier in this assessment.

13.259. While the nature of the Proposed Arrangements would be expected to provide an increase in global competitiveness for Qantas this comes through an increase in profitability as a result of removal of competition rather than through an alignment between two companies which results in outcomes such as significant network expansion, and economies of scale and scope.

13.260. The Applicants have submitted that increased viability is not the same as increased global competitiveness. While in a strict sense one does not follow the other, that is, being viable does not make a business globally competitive, there would appear to the Commission to be synergies between viability and the ability to compete, including at global levels. Certainly airlines that are in a poor financial position with regard to their ability to generate profits and the status of their reserves would seem more restricted in their ability to compete than airlines which are operating profitably and have ample reserves.

13.261. The linkage between financial position and ability to compete would seem to be acknowledged by the Applicants at page 44 of their submission of 9 December 2002. It is stated that if Air NZ responds to Qantas increases in capacity on the NZ domestic and trans-Tasman routes, then ultimately one of the two would be forced to contract elements of its network. It is stated that:

*"In NECG's view, the airline that is ultimately forced to contract is more likely to be Air NZ given the relative financial strength of the two Parties."*

13.262. Qantas is among the most profitable airlines in the world at a time when many other airlines in markets such as Europe and North America are struggling. It benefits, and will continue to benefit for some time, from its dominance of the Australian domestic passenger market. It also has a very diverse international network which provides strategic reallocation options not available to many carriers and a substantial presence in Asia where Asian carriers are achieving

much better financial and performance outcomes than their North American and European counterparts.

- 13.263. The Commission considers that the arrangements proposed with Air NZ, a relatively small airline with a limited route network, add little to the global competitiveness of Qantas. The Applicants have submitted that Qantas will gain by having full access to Air NZ's domestic network and its greater connectivity out of Auckland. It is also suggested that the carriage of Air NZ passengers through the Kangaroo route will strengthen Qantas' crucial hub at Singapore.
- 13.264. However through the combination of its domestic presence, its arrangements with Origin Pacific on New Zealand regional routes and its trans-Tasman city pair combinations, Qantas already has access to most of the New Zealand market. The reference to the Proposed Arrangements strengthening Qantas' hub at Singapore presumably flows from Qantas services beyond Singapore picking up passengers between New Zealand and Singapore currently carried by Air NZ. Such an outcome would seem to at best only marginally strengthen Qantas' position at Singapore from the daily service from New Zealand. As at March 2003 Qantas and its JSA partner, BA, were operating a combined 76 services per week between Australia and Singapore.
- 13.265. It could be argued that Australian industry might benefit from having a viable Air NZ in the trans-Tasman market. However it is noted that many of the claimed benefits come from what is described in the NECG Report<sup>106</sup> as "the incentive of a monopoly air service operator to cover the entire market". It seems to the Commission there that is little difference whether such benefits are provided by a monopolistic alliance or a monopoly provided by a single operator such as Qantas in the event of a failure of Air NZ. This is not to say that the Commission views Air NZ as under threat of failure. As stated in its examination of the counterfactual the Commission has quite the opposite view.

### **National interest benefits**

#### *Claims made by the Applicants*

- 13.266. The Applicants claimed that their objectives and the outcome of the Proposed Arrangements would be entirely consistent with Australian Government Policy and the national interest.
- 13.267. The Applicants cited a statement made by the Deputy Prime Minister and Minister for Transport and Regional Services, the Hon John Anderson MP,<sup>107</sup> to the effect that Australia needs to ensure it has a strong flag carrier and that consumer interests are not the only factors taken into account.

#### *Views of interested parties*

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<sup>106</sup> Page 141, NECG Report.

<sup>107</sup> Jason Koutsoukis and Jane Boyle, "Anderson pushes Qantas deal", Australian Financial Review, 27 November 2002.

- 13.268. Comments by submitters as to the need for a strong national carrier have previously been acknowledged when the Commission examined global competitiveness benefits.
- 13.269. It might have been expected that if progression of the Proposed Arrangements was consistent with Government policy this position would have been made in the submission of the DTRS. As cited above DTRS saw a partnership between Qantas and Air NZ as the first step in ensuring the survival of a strong and efficient local carrier, but acknowledged that the Proposed Arrangements has anti-competitive elements in its current form.

*Submissions on national interest benefits provided since the Commission's Draft Determination*

The Applicants

- 13.270. The Applicants submitted that the viability of a carrier is not the sole criterion by which the national interest can be ascertained. The Applicants submitted that strengthening the region's major airlines' ability to compete successfully in a global market is a substantial public benefit. The Applicants submitted that all Government comments support this view.

*The Commission's view on the national interest*

- 13.271. The Commission does not consider that the Proposed Arrangements add much to Australia having a strong local carrier in the form of Qantas. In the Commission's view Qantas will remain a strong carrier regardless of whether the Proposed Arrangements proceed. On this basis, the Commission does not consider it can find a national interest benefit associated with the Proposed Arrangements.
- 13.272. DTRS stated in its submission that Australian International Policy, which is presumably Government policy, includes a statement that:

*"Australia also needs to ensure a continuation of competitive pressure on international routes to ensure reasonably priced access to our major trading partners and to avoid potential monopolies exploiting their dominant position on critical international routes, to the detriment of the national interest."*

- 13.273. The Commission takes this policy to mean that it would not be in the national interest for the Proposed Arrangements to proceed if they are likely to result in an effective monopoly on the trans-Tasman route, Australia's largest international passenger route.
- 13.274. The Applicants suggested in their response to this part of the Draft Determination that strengthening the region's major airlines ability not merely to survive but to compete successfully in a global market is a substantial public benefit. This statement would seem to address viability and global competitiveness issues examined earlier by the Commission in other public benefit claims.



- 13.275. The Commission does not find a significant national interest benefit arising from the Proposed Arrangements.

### **Summary of findings on public benefit**

- 13.276. The Commission has substantial reservations about the extent of public benefit arising from the \$337 million in cost efficiency savings claimed to accrue over five years. These doubts are based primarily on the inconsistency of the proposition of higher aircraft usage efficiency under lower levels of competition, risks of the savings being realised (including the risk of x-inefficiency), the credibility of the counterfactual and its associated wasteful capacity. In addition, any weight to be attributed to the public benefits is lessened by the fact that benefits accrue to the Applicants and their shareholders rather than consumers in an environment where there is reduced competition.
- 13.277. The Commission considers that there may be public benefits to consumers on the trans-Tasman route from scheduling changes however these benefits are likely to be minor and there is a real possibility that schedule efficiency adjustments could see services removed.
- 13.278. The Commission considers that there are substantial doubts over the viability of the proposed new direct services if they could not be introduced absent the Proposed Arrangements and given the limited frequencies proposed. The limited frequencies are likely to reduce their attractiveness not only to consumers who currently utilise indirect flights but also to consumers who would only use direct flights. It is noted that a proposed undertaking would see a commitment to the new services for one year, but would be conditional on the achievement of satisfactory load factors and yields. The Commission is not convinced that the proposed new services could be relied upon to result in public benefit of significance.
- 13.279. The Commission is not satisfied that the Proposed Arrangements will lead to increased tourism in an environment of higher prices and reduced capacity. The Commission therefore does not recognise that the Proposed Arrangements lead to any more than a marginal public benefit from increased tourism.
- 13.280. The Commission considers that if “freight only” services could be provided economically under the Proposed Arrangements, the services could also be provided absent the Proposed Arrangements. However the Commission does not consider the services viable at current freight rates. A proposed undertaking in relation to the services allows them to be ceased or reduced if there is a material adverse change to the financial returns earned by the services. On this basis the Commission believes that the proposed “freight only” services are only likely to proceed if accompanied by a significant increase in freight rates. The Commission accordingly does not find a public benefit associated with freight.
- 13.281. Given the already strong position of Qantas relative to other international airlines and taking into account the little that Air NZ brings to the Proposed

Arrangements the Commission is of the view that the Proposed Arrangements would only result in a benefit of marginally increased global competitiveness for Qantas.

- 13.282. The Commission is not satisfied that there is a national interest benefit associated with the Proposed Arrangements proceeding. On the basis of stated Government policy it is possible that the national interest could be served by the Proposed Arrangements not proceeding.
- 13.283. In summary, after taking into account all claims, considering all submissions (including those in response to the Commission's Draft Determination) and following careful analysis, the Commission does not find that the Proposed Arrangements give rise to public benefits of significance.
- 13.284. The Commission notes, as discussed at the end of Part 12, that Air NZ has suggested the possibility that it might lose the war of attrition claimed by the Applicants to occur under the counterfactual, within three years. While not agreeing with the counterfactual or the Air NZ proposition, the Commission notes that a counterfactual which sees the departure of either Qantas or Air NZ from relevant markets would see a substantial reduction in any benefits arising from the Proposed Arrangements under the NECG modelling. For example, there would be zero cost efficiency and schedule savings across the two airlines if one airline departs the market. Even though the Commission does not accept the estimates of public benefit estimated by NECG, those figures can be used to provide a guide to the impact of an airline market departure. If Air NZ departed relevant markets after Year 3 absent the Proposed Arrangements, the net benefit of the Arrangements under NECG's modelling would reduce from \$680 million to \$379 million.

## 14. Undertakings

### Background

- 14.1. The Commission's assessment of an application for authorisation generally involves the weighing of the public benefit and the anti-competitive detriment flowing from the proposed arrangements or conduct.
- 14.2. In its assessment, the Commission may have regard to undertakings offered by an applicant which:
  - reduce any anti-competitive detriment (or the potential for such detriment) resulting from the proposed arrangements or conduct; or
  - enhance any public benefit flowing from the proposed arrangements or conduct or ensure (or increase the likelihood of) the realisation of public benefits claimed to flow from the proposed arrangements or conduct.
- 14.3. Undertakings offered by parties may take various forms from simple administrative undertakings (that is, conveyed by letter or submission) to court enforceable undertakings pursuant to section 87B of the Act.
- 14.4. Section 87B of the Act allows the Commission to accept written undertakings in connection with matters where it has a power or function under the Act (other than Part X). In the current context, the Commission may accept undertakings in relation to its powers to grant or deny an application for authorisation. Undertakings offered and accepted pursuant to section 87B of the Act may be enforced by the Federal Court.
- 14.5. Undertakings may be broadly characterised as either structural or behavioural.
- 14.6. Structural undertakings address structural issues in the relevant market and are ordinarily designed to provide an ongoing basis for the operation of competitive markets. The costs of providing structural undertakings are ordinarily one-off rather than ongoing. Structural undertakings may include offers of divestiture. In an airline context this may include offers to divest of subsidiary airlines or the transfer of landing slots.
- 14.7. The Commission is more likely to accept structural undertakings as an effective mechanism for reducing anti-competitive effect than behavioural undertakings. Structural undertakings are less likely to interfere with competitive processes, provide a high degree of compliance certainty and may be complied with prior to authorisation or shortly thereafter.
- 14.8. Behavioural undertakings deal with the way in which the applicant will behave in the future and on an ongoing basis. The costs of complying with behavioural undertakings are also generally ongoing. Undertakings as to quality, pricing and capacity are more likely to be characterised as behavioural undertakings.

## **Undertakings proposed by the Applicants after the Commission's Draft Determination**

- 14.9. In their submission accompanying the Applications, the Applicants advised of their intention to negotiate a range of enforceable undertakings designed to achieve the objectives of:
- facilitating and protecting new entry on trans-Tasman routes, including (if necessary) access to terminals, ground handling services and engineering facilities;
  - ensuring the Proposed Arrangements will not take unreasonable actions relating to capacity and prices on routes where the Applicants will be the sole operators; and
  - ensuring delivery of certain of the public benefits claimed in the Applications.
- 14.10. By letter dated 24 January 2003, the Applicants further outlined the nature of undertakings which they believed addressed any competition concerns and which they believed ensured the delivery of the public benefits they claimed would flow from the Proposed Arrangements.
- 14.11. By submission dated 12 March 2003, the Applicants further detailed undertakings that the Applicants were prepared to offer. The undertakings were in very similar terms to those offered on 24 January 2003.
- 14.12. In a submission to the Commission dated 9 May 2003, the Applicants offered revised undertakings to the Commission and commented on the views expressed on undertakings by the Commission in the Draft Determination
- 14.13. The revised undertakings offered by the Applicants are summarised below. The Applicants' comments are addressed subsequently.

### *Facilities and services*

- 14.14. The Applicants submitted that the revised facilities and services undertakings address the concerns and access issues raised by Virgin Blue.
- 14.15. The Applicants submitted that these undertakings will apply to any new entrant.
- 14.16. The Applicants submitted that facilities and services will be provided on Tasman and domestic New Zealand routes (as outlined below) on the following terms:
- at a equivalent rate and on similar conditions to those offered by the Applicants at the relevant airport to other airlines with similar requirements (disregarding terms attributable to global alliance membership and reciprocity); or
  - where the facility or service is not provided by the Applicants to another airline at the relevant airport, on reasonable commercial terms.

- 14.17. The Applicants submitted that the facilities and services in this undertaking do not include facilities and services that:
- are not controlled by the Applicants;
  - are not used by the Applicants to provide services on Tasman routes or domestic New Zealand routes;
  - are required by the new entrants to operate schedules which do not distribute flights through the day and to airports on a similar basis to those provided by the Applicants;
  - would require the Applicants to alter more than 25 per cent of the Alliance's schedules on Tasman routes; or
  - are available to the new entrants on similar commercial terms from the airport or other third parties.
- 14.18. The Applicants submitted that where facilities and services were utilised by the Applicants but must be made available to a new entrant by an airport or other third party, the Applicants will use all reasonable endeavours to assist a new entrant to obtain those facilities and services on terms similar to those previously obtained by the Applicants.
- 14.19. The Applicants submitted that, where the Applicants and a new entrant disagree about the application of this undertaking or are unable to agree on terms, the dispute will be referred to an independent third party (a person appointed jointly by the Applicants and approved by the Commission).
- 14.20. This undertaking will terminate upon the first of either the expiry of the authorisation granted by the Commission or five years from the effective date of the Strategic Alliance Agreement.

#### Tasman

- 14.21. The Applicants undertake to alter Alliance schedules on Tasman routes to provide new entrants to Tasman routes access to facilities and services at Auckland, Sydney and Christchurch airports (and other airports the Commission may identify) as may be reasonably required for the new entrants (in aggregate) to establish and operate a reasonable level of services on the Tasman routes. A "reasonable level of service" is said by the Applicants to be a five aircraft schedule on Tasman routes.

#### Domestic New Zealand

- 14.22. The Applicants undertake to alter Alliance schedules on domestic New Zealand routes to provide new entrants to domestic New Zealand routes access to such facilities and services as may be reasonably required for the new entrants (in aggregate) to establish and operate a reasonable level of service on domestic New Zealand routes. For the purpose of this undertaking, a reasonable level of service will be a level up to or equivalent to the five

B737 aircraft schedule operated by Qantas in domestic New Zealand during April 2003.

*Capacity ceiling*

- 14.23. The Applicants submitted that the revised undertaking in relation to a “capacity ceiling” addresses concern expressed in the Commission’s Draft Determination that the time period originally proposed by the Applicants was insufficient to significantly reduce the barriers to entry and that the qualifications associated with the undertaking limit its effectiveness.
- 14.24. The Applicants undertake, in respect of regulated city pairs, not to increase the Applicants’ combined capacity on that city pair for 18 months following the date that the first new entrant officially announces its intention to commence operating flights.
- 14.25. The Applicants submitted that this undertaking will be terminated if:
- the new entrant does not accept bookings within three months of officially announcing its intention to commence operating flights on that city pair;
  - the new entrant does not commence scheduled flights within six months of officially announcing its intention to commence operating flights on that city pair; or
  - the new entrant ceases to operate flights on that city pair.
- 14.26. The Applicants submitted that the undertaking would not apply to:
- temporary increases in capacity for period not greater than 14 days;
  - increases in capacity announced by either of the Applicants prior to the new entrant’s official announcement of its intention to commence operating flights; or
  - the capacity added to meet the freight undertaking (discussed below).
- 14.27. The Applicants submitted that the following situations would not be treated as an increase in capacity on any city pair in respect of this undertaking:
- for Air NZ, the replacement of B737 aircraft with an equivalent number of A320 aircraft; and
  - for both Applicants, the replacement of any aircraft series with an equivalent number of aircraft of the same type.
- 14.28. The Applicants submitted that this undertaking will terminate:
- upon the first to occur of the expiry of the authorisation granted by the Commission, or five years from the effective date; or

- on any regulated city pair, upon the new entrants achieving capacity equal to 50 per cent of the Applicants' capacity on that city pair.

#### *Freedom and new entry facilitation*

##### Freedom

- 14.29. The Applicants noted that in its submission to the Commission, Virgin Blue sought the divestment of Freedom.
- 14.30. The Applicants submitted that the following proposed undertaking addresses the concerns raised by Virgin Blue.
- 14.31. The Applicants proposed that, from the date that a new entrant commenced trans-Tasman services into Brisbane, Air NZ will undertake that, within three months of being advised, Freedom will only operate trans-Tasman services into Brisbane that operate from secondary airports in New Zealand.
- 14.32. The Applicants proposed that, from the date that a new entrant commences trans-Tasman services into Melbourne, Air NZ will undertake that, within three months of being advised, Freedom will only operate trans-Tasman services into Melbourne that operate from secondary airports in New Zealand.
- 14.33. The Applicants proposed that, from the date that a new entrant commences trans-Tasman services into Sydney, Air NZ will undertake that, within three months of being advised, Freedom will only operate trans-Tasman services into Sydney that operate from secondary airports in New Zealand.
- 14.34. The Applicants submitted that, from the date a new entrant commences trans-Tasman services, Freedom will not grow its Tasman schedules by more than one aircraft each calendar year.
- 14.35. The Applicants submitted that Freedom will not operate on domestic New Zealand routes.
- 14.36. The Applicants submitted that the clauses of this undertaking will terminate:
- three years after the effective date of the Strategic Alliance Agreement; or
  - on a city pair basis upon a new entrant or new entrants achieving 50 per cent of the Alliance capacity in that city pair (with the exception of 14.34 above).

##### Market entry with critical mass

- 14.37. The Applicants also proposed to undertake to lease up to four B737-300 aircraft to new entrants for operations on Tasman and/or domestic New Zealand routes.



- 14.38. The Applicants submitted that these leases will be subject to receipt of six months notice and will be provided on the following terms:
- the aircraft will be in all economy configuration;
  - the aircraft will be leased at market rates;
  - the term of the lease would be up to three years;
  - the leases will be subject to the provision of normal financial security;
  - the lease would include aircraft maintenance provided by the Applicants; and
  - the Applicants would be willing to include in the lease technical and/or cabin crews for the period required for the new entrant to train their own staff.
- 14.39. The Applicants submitted that this undertaking will terminate three years after the effective date.

*Capacity Floor*

- 14.40. The Applicants submitted that the revised undertaking to implement a “capacity floor” will address the Commission’s concerns in relation to the limited effectiveness of the undertaking originally proposed.
- 14.41. The Applicants submitted that they will undertake, in respect of each regulated city pair, not to reduce their combined capacity on that city pair. The Applicants submitted that they will increase capacity on each regulated city pair at the same average rate as the remainder of the Tasman routes or domestic New Zealand routes.
- 14.42. The Applicants submitted that this undertaking will terminate upon the earlier of:
- the first to occur of the expiry of the authorisation granted by the Commission or five years from the effective date; or
  - another airline commencing operating flights and achieving a 20 per cent capacity share on that city pair.
- 14.43. The Applicants submitted that they may reduce capacity on a regulated city pair if, for any continuous three month period, seat factors decline to less than 70 per cent or yield declines by more than five per cent, provided they first obtain the written confirmation of the independent third party.

*Tasman price cap*

- 14.44. The Applicants submitted that they will undertake not to increase prices on regulated city pairs on the Tasman beyond airline cost base increases for market and fare segments to be agreed with the Commission.
- 14.45. The Applicants submitted that this undertaking will terminate in respect of any regulated city pair on the Tasman on the earlier of:
- the first to occur of the expiry of the authorisation granted by the Commission or five years from the effective date of the Strategic Alliance Agreement; or
  - another airline commencing operating flights on that city pair.

*New services*

- 14.46. The Applicants advised that they would be prepared to undertake to commence operating new direct services on at least four trans-Tasman city pairs within one year, as follows:
- eight weekly flights (four return services) between Auckland and Adelaide; and
  - two weekly flights (one return service) on Auckland-Hobart, Wellington-Canberra and Auckland-Canberra.
- 14.47. The Applicants advised that they would be willing to undertake to continue operating direct flights on the above city pairs for at least one year.
- 14.48. The Applicants submitted that they may reduce capacity, or cease operating on a city pair if, for any continuous three month period, seat factors decline to less than 70 per cent or yield declines by more than five per cent provided they first obtain written confirmation of the independent third party.
- 14.49. The undertaking would terminate in respect of any route upon another airline commencing operations on that route.

*Tourism*

- 14.50. The Applicants proposed to offer undertakings to spend an additional \$5.4 million in the year following the Proposed Arrangements coming into effect on costs directly associated with the implementation of the Qantas Holidays business plan and designed to stimulate an additional 50,000 tourists to New Zealand (including 18,000 dual destination tourists) which includes \$1.75 million on direct sales and marketing. This additional expenditure would be undertaken in conjunction with national and state tourism bodies where it was submitted that it was likely to maximise tourism flow.
- 14.51. The Applicants submitted that if tourism targets are not met for any reason other than force majeure by the end of year 3, the Applicants will spend another \$5.4 million on direct sales and marketing in conjunction with national and state tourism bodies.

### *Freight*

- 14.52. Finally, the Applicants proposed undertakings relating to freight capacity on trans-Tasman routes. The Applicants proposed to undertake to add four weekly return trans-Tasman wide-bodied "back-of-the-clock" services specifically for freight. Two of these services would operate to Auckland and two would operate to Christchurch. The services would commence within 12 months of the Proposed Arrangements coming into effect.
- 14.53. The Applicants could reduce capacity or cease operating the additional freight services for any period where there was a material change to the financial returns earned by the airlines on those services.

### *Monitoring of undertakings*

- 14.54. The Applicants submitted that they would undertake to provide annual audited reports to the Commission demonstrating compliance with the undertakings.
- 14.55. The Applicants submitted that, should the Commission request, they will fund an independent third party (who will act as agent of the Commission) to receive annual audited reports and monitor compliance with these undertakings, adjudicate all disputes arising in the course of implementation and report to the Commission on compliance.

### **Submissions from interested parties**

- 14.56. In making submissions, interested parties were provided with copies of the undertakings proposed by the Applicants in their letter of 24 January 2003. As discussed above, those undertakings were very similar to the slightly revised undertakings proposed by the Applicants more recently on 12 March 2003.
- 14.57. Many of the submissions focused on the particular area of interest of the interested party rather than providing a more general critique of the undertakings proposed. A summary of submissions lodged by third parties is at **Appendix A**.

### **The Applicants' response to submissions on undertakings provided before the Commission's Draft Determination**

- 14.58. By submission dated 14 March 2003, the Applicants responded to submissions from interested parties including in relation to the provision of undertakings. The response was not detailed. In summary, the Applicants submitted that:
- In relation to proposals that Freedom Air should be divested to facilitate the entry of a value based airline, the Applicants noted Virgin Blue's proposed entry onto trans-Tasman and New Zealand routes. The Applicants submitted that Virgin Blue was a well-recognised brand with established infrastructure and access to new and used

aircraft. The Applicants further submitted that Freedom Air is an integral part of Air NZ's core operations.

- With respect to the undertakings proposed by United concerning its commercial relationship with the Applicants, the Applicants submitted that the authorisation process was not the appropriate forum to progress such arrangements.
- With respect to the employment undertakings proposed by the ACTU and the AMWU, the Applicants submitted that such undertakings were not appropriate. The Applicants submitted that there would be no decrease in capacity under the Proposed Arrangements compared to the present and as such, there would be no job losses as a result of the Proposed Arrangements.

### **Submissions on undertakings provided since the Commission's Draft Determination**

#### *The Applicants*

- 14.59. In relation to the Commission's concern that the undertakings proposed by the Applicants have limited effectiveness, the Applicants submitted amended undertakings to the Commission. These undertakings are outlined above.
- 14.60. With regard to the Commission's concern that the ability of the undertakings to control behaviour under the Proposed Arrangements was limited and that there are practical difficulties associated with attempting to implement and enforce effective behavioural undertakings, the Applicants submitted that the kind of undertakings proposed by the Applicants have previously been accepted overseas and in Australia to address competition concerns in the airline industry.
- 14.61. Specific comments in relation the Commission's concerns as to each of the undertakings are outlined below.

#### Facilities

- 14.62. The Applicants submitted that the Canadian Competition Bureau has accepted a surrender of airport facilities in connection with the acquisition of Canadian Airlines Corporation by Air Canada. The Applicants submitted that, in that case, the facilities undertakings to offer to sell or make available for use gates, bridges and other facilities associated with the gate was for a period of one year from the transaction date for those airports which had not yet been transferred to an airport authority and for at least six months following transfer.

### Capacity ceiling

- 14.63. The Applicants submitted that the European Commission has obtained capacity ceiling undertakings in the following airline alliance/merger cases:
- Austrian Airlines/Lufthansa – the parties undertook not to add frequencies on a particular entrant city pair for a minimum of two years;
  - Lufthansa/SAS – the parties undertook to freeze their aggregate number of daily frequencies where an airline informs them of its intention to operate on that route. The freeze remained in place until the new entrant commenced operation on the applicable route(s); and
  - British Airways/TAT European Airlines – the parties undertook not to increase frequencies above a base level for a period of four years from the date a new entrant commences on particular routes.

### Capacity floor/Price caps

- 14.64. The Applicants submitted that undertakings to maintain service through the use of a price cap have been accepted by the Commission in the past.
- 14.65. The Applicants submitted that the Commission has accepted price caps in the following cases:
- Qantas/Impulse – where a two year price constraint was accepted;
  - Ansett/Hazelton – where a two year price constraint was accepted; and
  - Qantas/British Airways – where a three year price constraint was accepted.

### New services

- 14.66. The Applicants submitted that the Commission accepted a two year new services undertaking in its non-opposition to the acquisition of Impulse by Qantas.

### Freight

- 14.67. The Applicants submitted that the Commission imposed a condition of authorisation in relation to the Qantas/BA authorisation of the JSA in 1995.

### *Virgin Blue*

- 14.68. 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.

14.69. 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 all major airports and route re-protection; 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.

14.70. 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 – that is, 26.2 per cent of the total domestic air services market in Australia (measured on a per passenger basis) and a 32.1 per cent share of the market measured on a per passenger basis when only those routes upon which it operates services are taken into account.

14.71. Virgin Blue submitted that these undertakings would assist it achieving a significant market share in the trans-Tasman because:

- the divestiture of Freedom Air will move market share away from the Applicants under the Proposed Arrangements and provide a significant initial market share to Virgin Blue;
- the divestiture of Freedom Air to Virgin Blue will impede the ability of the Applicants to engage in predatory or strategic conduct; and
- appropriate access to facilities will allow Virgin Blue to grow at a rate that would otherwise not be achievable.

*Air NZ*

14.72. Air NZ made a further submission to the Commission in response to submissions made by Virgin Blue on appropriate undertakings should the Proposed Arrangements be authorised by the Commission.

- 14.73. Air NZ submitted that the proposed divestiture of Freedom Air by it would not significantly affect the anti-competitive detriment or public benefit associated with the Proposed Arrangements.
- 14.74. Air NZ submitted that the revised undertakings were specifically tailored to address the concerns of the Commission (as expressed in its Draft Determination) and other parties (as expressed in submissions to the Commission).
- 14.75. Air NZ submitted that the revised undertakings in relation to Freedom Air will be easily monitored and will be monitored by an independent third party at the expense of the Applicants.
- 14.76. Air NZ submitted that the revised undertakings address the Commission's concern that there may be strategic allocation of resources to maximise competitive pressure on Virgin Blue or another new entrant. Air NZ submitted that, while the divestiture of Freedom Air would also resolve that concern, such a requirement would be excessive and unjustified in a regulatory context.
- 14.77. Air NZ submitted that for the Commission to impose an undertaking or condition that Air NZ divest Freedom Air at the specific request of Virgin Blue would be tantamount to compulsory acquisition of Freedom, which would set a "dangerous regulatory precedent".
- 14.78. Air NZ submitted that Virgin Blue's entry into the domestic Australian market did not require any such assistance and did not depend on it having an established base. Air NZ submitted that, similarly, Virgin Blue's entry did not depend on the failure of Ansett.
- 14.79. Air NZ also submitted that Virgin Blue has been planning its expansion into New Zealand and the trans-Tasman for some time and that it would be likely to have business plans for its expansion which do not rely on the divestiture of Freedom. Air NZ submitted that it is clear that Virgin Blue can expand without Freedom and that divestiture is not needed to ensure its expansion on trans-Tasman and domestic New Zealand routes.
- 14.80. Air NZ submitted that Virgin Blue has established facilities, distribution channels and other ingredients for its operations that could easily be expanded and that, similarly, Virgin Blue does not need any of Freedom's aircraft in order to expand.

*Gullivers Pacific Group*

- 14.81. GPG submitted that in its view, the undertakings offered by the Applicants are insufficient to overcome the detriment associated with the Proposed Arrangements.<sup>108</sup>

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<sup>108</sup> It should be noted that GPG made its submission in relation to undertakings prior to the Applicants' revised undertakings being submitted to the Commission.