Australia are significantly and competitively disadvantaged relative to Qantas in accessing feeder trade. The Commission is of the view that there is considerable pressure for a Star Alliance carrier to enter the market. Any such entry is most likely to come from a Star Alliance carrier in concert with Air NZ or through Star Alliance support of an Air NZ entry. While Virgin Blue is involved in a code share with United, United has indicated that there are aspects of Virgin Blue's operation which are inconsistent with the requirements of an alliance of network carriers.

12.239. If the Proposed Arrangements were to proceed, the prospects of a Star Alliance initiative to achieve entry would be dramatically reduced. The Commission notes in this context that no information has been put before it which would lead it to conclude that there is room for only one FSA in the Australian domestic market, a view expressed by the Applicants.

12.240. The Commission has, therefore, formed the view that, on the basis of their enhancing the market power of Qantas, their impact on existing carriers in the market and the raising of barriers to entry into the market, the Proposed Arrangements are likely to result in substantial anti-competitive detriment to the Australian domestic air passenger market.

Sale of air travel

Anti-competitive detriment comments made by the Applicants

12.241. The Applicants described the travel distribution services market in Australia as large (4,600 agents) and with low concentration, with the top six agents accounting for nearly 70 per cent of sales by agents and the largest accounting for 23 per cent of sales.

12.242. It is indicated that under the Proposed Arrangements each airline will retain its current distribution structure but they will negotiate jointly with distribution channels including wholesalers, consolidators and retail travel agents in relation to commission, incentives and other agency terms.

12.243. The Applicants claimed that the constraints faced by the Applicants from existing competitors will not be reduced. The Applicants submitted that their retail operations will be unable to raise the prices charged for selling tickets above competitive levels because:

- consumers can access different functional levels within the market;
- there are a significant number of existing competitors in the market; and
- market concentration is low.

Submissions on the sale of air travel market

12.244. Submissions from travel agents included a number of submissions made to the NZCC by New Zealand travel agents. These submissions, however, do not transfer readily into the Australian sale of air travel market because of differences in the structure of air travel markets and the relationship between carriers and agents.

12.245. A submission from ATEC and a confidential submission make pertinent points in relation to the market for the sale of air travel.

Australian Tourism Export Council

12.246. ATEC members expressed concern at the considerable increase in market power of Qantas Holidays and Air NZ Holidays and the ability of these business units to monopolise the distribution of air and ground products in Australia and New Zealand.

12.247. Concern was also expressed as to the ability of the Alliance partners to provide airfares to their own leisure and holiday divisions and not to make the same airfares/conditions/capacity available to other wholesale distributors of Australian and New Zealand tourism products and services.

Confidential Submission

12.248. The combined share of the airlines would be approximately 75 per cent on international and 90 per cent on domestic markets. Incentives would be put in place that would provide travel agents with little or no option but to favour Qantas and Air NZ above other smaller carriers. This would further inhibit and deter potential competitors from entering the market.

The Commission's view on anti-competitive detriment in the sale of air travel market

12.249. The Commission has seen no evidence to suggest that most areas of operation of the sale of air travel market would be adversely affected by the Proposed Arrangements. The Commission does, however, have some concern that the joint setting of commissions on sales in that market could have an impact on price.

12.250. There is a convention in the sale of air travel market that airlines will not sell travel directly to the public at prices lower than the prices which travel agents can offer. This convention provides a good outcome for both Qantas and Air NZ. Travel agents know that they cannot be undercut on price by the airlines. Where airlines sell direct, their margins are increased by the extent of the nominal agent's commission (five to nine per cent). The only party that is adversely affected is the consumer who misses out on the opportunity to purchase a lower fare direct from the airline.

12.251. Travel agents in recent times have been critical of Air NZ's practice to undercut the prices given to travel agents in the New Zealand market[72] contrary to the above convention. Air NZ acknowledged this in a submission to the Commission in which it stated that it has published internet fares for domestic New Zealand travel which are discounted by more than the standard

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[72] *"Net fares: great divide"*, Traveltrade, 22 May 2002.

commission available to travel agents. Qantas has consistently reassured the Australian travel agent industry that it will not adopt such practices.

12.252. The Air NZ action is a response to a highly competitive market and is designed to get fares to the public at the lowest possible price. While Air NZ has not sold fares on this basis in Australia for the trans-Tasman market, for example, there is always the potential for this to occur. The practice is particularly suited to travel markets which are short haul, do not involve interlining (such as the trans-Tasman market) and can sell readily over the internet or through call centres.

12.253. The Commission's view is that the Proposed Arrangements will result in anti-competitive detriment through the joint setting of commission payable to travel agents by ensuring that the undercutting of agents will not occur for travel sold in Australia which falls within the coverage of the Proposed Arrangements.

Anti-competitive detriment and the NECG Report

NECG views on anti-competitive detriment

12.254. The Applicants submitted that the main source of potential anti-competitive detriment is the coordination of prices and schedules on the trans-Tasman routes. The claim is that the Proposed Arrangements will produce only slightly higher prices and lower passenger numbers than would occur without the Proposed Arrangements over the medium term.

12.255. In support of these claims, the Applicants cited the NECG Report which sets out the results of modelling and analysis undertaken by NECG. NECG's analysis uses a model of air service markets based on a form of oligopoly competition to simulate market outcomes that would arise under the Proposed Arrangements compared with continued competition without the Proposed Arrangements. This Model, which estimates prices and passenger numbers for passenger services across routes (city pairs) covered by the Alliance agreement, is discussed in more detail at **Appendix C**.

12.256. The result is an estimate of detriment, defined as "deadweight loss". Deadweight loss is the dollar value of the total net loss in potential received value that producers of air services (that is, the airlines) and consumers of air services (passengers) together incur as a result of the price increases and corresponding decline in travel associated with the Proposed Arrangements relative to the future situation without the Proposed Arrangements. As such it represents a net social loss to Australia's welfare.

12.257. NECG also canvassed the likelihood of other detriments arising from the Proposed Arrangements. In particular, NECG considered detriments relating to productive efficiency, service quality, innovation incentives (including x-inefficiency) and rent seeking behaviour, arguing that the effects of the Proposed Arrangements on productive efficiency would be negligible. These arguments are set out in more detail at **Appendix C**.

PricewaterhouseCoopers

12.258. PwC, in a report commissioned by the Applicants, concluded that nothing has come to its attention to suggest that the models are not appropriate, the inputs are not reasonable, or that the calculations in the NECG Model are not reliable.

Views of interested parties on NECG modelling

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

12.260. Professor Hazledine provided a critique of the NECG Model and its findings in relation to price, quantity and welfare outcomes. He concluded that the social costs of allowing the Proposed Arrangements would substantially outweigh the most plausible benefits, particularly for New Zealand. While he noted that the net impact on Australia varies from losses to gains in respect of different areas, he points out that all, or almost all, of the benefits accrue to Qantas.

12.261. The six parties to the Combined Submission argued that some of NECG's input assumptions are questionable. They further suggested that the deadweight losses are underestimated and that the calculation and allocation of wealth transfers between consumers and producers among New Zealand, Australia and other countries is unclear and may contain errors.

12.262. GPG submitted that the Applicants and NECG are significantly understating likely anti-competitive detriments that flow from the Proposed Arrangements.

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

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

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

The Applicants

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

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

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

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

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

The Commission's views on the NECG modelling

12.270. A more detailed discussion of the NECG's modelling of anti-competitive detriments is contained in **Appendix C**. The following is a summary of the Commission's findings.

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

12.271. The Commission's assessment is that it is possible to consider the NECG modelling of the detriments independently from the modelling of benefits, while noting that any conclusions on the modelling of detriments will have flow-on effects to the estimates of tourism benefits in particular.

12.272. The quantified detriments are primarily constrained by the Applicants' assumption that VBA entry is more likely under the Proposed Arrangements than without. The Commission does not agree with the Applicants' arguments for making this assumption and is therefore of the view that the quantified detriments are likely to be understated.

12.273. If, as a number of submissions suggested, the prices estimated by NECG under the counterfactual are higher than they should be, then NECG's estimates of passenger volumes will be correspondingly lower. The greater any understatement of passengers under the counterfactual relative to the situation with the Proposed Arrangements, the greater is the extent to which deadweight losses will be underestimated.

12.274. Professor Hazledine's key findings were that, by relaxing certain assumptions made by NECG, the net result of allowing the Proposed Arrangements would be to generate deadweight losses that substantially exceed the amount estimated by NECG. Professor Hazledine's estimates of net detriments on the domestic New Zealand and trans-Tasman routes alone range between NZ$200-$400 million per annum.

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

12.276. As a result of its analysis, the Commission has considerable reservations about NECG's quantification of anti-competitive detriments. Furthermore, if the modelling approach adopted underestimates the impact of the Proposed Arrangements on total passenger volumes, then – by virtue of the links in NECG's modelling to tourism benefits – the proposed benefits will also be overstated. The modelling of tourism benefits is discussed under the Commission's assessment of claimed public benefits.

Detriments under the Commission's counterfactual

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

12.278. In itself, however, this does not necessarily mean that the net benefits (including detriments) from the Proposed Arrangements should be discounted. Indeed, it might be expected that if the capacity differences between the future with the Proposed Arrangements and the future without are smaller, the effect on prices and outputs could also be smaller and thus the estimated deadweight loss detriment reduced. Given that NECG argued that these detriments are so much lower than total (gross) benefits, the overall estimates of net benefit could still be positive, albeit somewhat reduced.

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

12.280. The Commission also notes that NECG's analysis does not address the issue of the distribution of the estimated benefits and detriment of the Proposed Arrangements between various parties, other than making some adjustments for international wealth transfers. The question of distribution, however, can be relevant to the Commission's assessment of the Proposed Arrangements. The Commission looks to the particularities of the relevant market and for benefits that are distributed to the whole community. The following section provides a brief discussion of this issue.

Welfare distribution

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

12.282. The Commission's analysis of the Proposed Arrangements' impact is that Australian consumers are significantly worse off, while Qantas reaps the increased profits that are available to it as a result of higher prices.

12.283. Notably, the NECG modelling fails to quantify the extent to which the benefits to Qantas accrue to foreign shareholders, rather than to Australia. This means that net detriments to Australia are understated.

12.284. A further point to note is that the issues previously discussed in relation to NECG's price and quantity modelling also have implications with respect to distribution. As already noted, the Commission is concerned that deadweight losses may be underestimated if the price and quantity differences between the future with the Proposed Arrangements and the future without are understated. Additionally, however, the magnitude of the welfare transfers from consumers to producers is dependent upon the price and quantity estimates – if the differences between the two scenarios are underestimated, the size of the welfare transfers from consumers to the airlines (and their shareholders) will also be underestimated.

Conclusions

12.285. The Commission's assessment is that the NECG modelling does not provide a wholly reliable indicator of detriment arising from the Proposed Arrangements. In particular, the Commission has reservations about the accuracy of estimates of the gaps between both fare prices and volumes of passenger traffic when assessing how markets would perform under the Proposed Arrangements compared to without them. The Commission is particularly concerned at the potential for underestimation of those gaps. A consequence of such underestimation is that the deadweight loss – a measure used to determine by how much Australia is worse off under the Proposed Arrangements – may also have been underestimated. Importantly, the Proposed Arrangements would also represent a significant transfer of wealth from consumers, including Australians, to the Alliance partners, Qantas and Air NZ and their shareholders. The Commission notes that as at 1 July 2003 foreign (that is, non-Australian) persons accounted for 50.48 per cent of Qantas shares.

Summary of findings

12.286. After careful consideration of extensive submissions from the Applicants and interested parties, including responses to the Commission's Draft Determination, the Commission has formed the view that the Proposed

Arrangements between Qantas and Air NZ are highly anti-competitive and would lead to increases in fares and decreases in capacity and quality of service on routes which involve Australia and where both airlines have a presence.

12.287. The Commission does not believe that the reaching of this conclusion should be surprising given that:

- the routes involved include the trans-Tasman route which is Australia's largest international route in terms of passenger numbers;
- the Applicants currently have a trans-Tasman passenger market share in excess of 90 per cent;
- a worst case scenario (from the Applicant's perspective) would see that market share reduced to around 75 per cent after Virgin Blue enters the market; and
- the likelihood of entry by other carriers, start-up or established, other than on a fifth freedom basis is low in the short to medium term.

12.288. The Commission also believes that the Proposed Arrangements would be significantly anti-competitive in the trans-Tasman freight market. In an environment of reducing freight capacity, the Proposed Arrangements would exacerbate pressure on freight rates to the detriment of Australian exporters, importers and consumers.

12.289. The Commission also considers the Proposed Arrangements would give rise to substantial anti-competitive detriment in the Australian domestic air transport passenger market by enhancing the market power of Qantas and acting as a barrier to entry to new entrant airlines. Detriment would also flow from deterring Air NZ from re-entering the Australia-North America market, regardless of the conditions in that market. The Commission considers that the conduct would be anti-competitive in respect of the sale of air travel but not in relation to the Cooperation Agreement between Air Pacific and the Applicants.

12.290. The Commission is not satisfied that the nature of the NECG modelling and its associated projected outcomes provide any reason to resile from the view that the Proposed Arrangements would overall be highly anti-competitive.

12.291. The Commission does not agree with the counterfactual advanced by the Applicants of competition between Qantas and Air NZ based on aggressive capacity increases, especially in the face of Virgin Blue's entry into the trans-Tasman and domestic New Zealand markets. While stating this position the Commission did not express a view on whether Qantas or Air NZ would be likely to depart relevant markets under the counterfactual, except to the extent that it considered Qantas more likely to depart the New Zealand domestic market than Air NZ.

12.292. It is apparent from NECG's modelling of benefit and detriment that the airlines do not envisage the departure of either airline from relevant markets within five years (or claimed cost efficiency savings would disappear). The Chief Executive of Air NZ also told the New Zealand Commerce Commission's pre-decision conference on 18 August 2003 that it would be *"a matter of some years, probably something in the order of, I would imagine, 3, 5, 6 years, it may be sooner, it may be longer"* before the claimed war of attrition between Qantas and Air NZ would be lost.

12.293. On this basis, even if either of the airlines ultimately departed a market such as the trans-Tasman market absent the Proposed Arrangements, consumers would benefit from around five years of competition between Qantas and Air NZ in the interim.

12.294. The Commission would note that its assessment of anti-competitive detriment has been made at a time when the aviation industry and individual markets are subject to rapid change and development. The Commission recognises that if this rate of change should continue it is possible that the Commission could, on a later occasion, reach a different conclusion as to the level of anti-competitive detriment in a market such as the trans-Tasman market.

13. Commission Assessment – Public Benefits arising from the Proposed Arrangements

13.1. The Commission must be satisfied that the Proposed Arrangements result in a benefit to the public that outweighs any detriment arising from anti-competitive conduct. The Commission will also consider the extent to which the benefits claimed by the Applicants represent benefits to the public.

13.2. There must be a nexus between the claimed public benefits and the conduct for which the authorisation is sought. Consistent with the "future with-and-without test" outlined in Part 11 of this Determination, the Commission compares the public benefit and anti-competitive detriment generated by the Proposed Arrangements in the future with those likely to be generated if the authorisation is not granted. Public benefits which may accrue in the future irrespective of whether or not authorisation is granted for the Proposed Arrangements may be accorded a lower weight by the Commission than benefits that would otherwise not occur.

13.3. The Applicants submitted that there are eight primary sources of public benefits that arise from the Proposed Arrangements:

- cost efficiencies;
- scheduling efficiencies;
- new direct services;
- increased tourism to Australia;
- improved freight operations;
- increased international competitiveness of Australia's aviation industry;
- preservation of a commercially viable full service Australasian airline and network; and
- furtherance of the national interest.

13.4. The Commission will respond to each of the specific claims from the Applicants for public benefits arising from the Proposed Arrangements and responses to those claims from interested parties.

13.5. The Commission will form a view on each claimed benefit taking account of supporting material provided by the Applicants and comments made by interested parties. In forming a view, consideration will be given to the credibility of the counterfactual in the sense that it provides the benchmark from which benefits are measured. As discussed, the Commission has formed a view as to the appropriate counterfactual against which to measure the claimed public benefits. The Commission's assessment will look to claims made both as a result of the NECG modelling and by the Applicants more generally.

Cost efficiencies

Claims made by the Applicants

13.6. The largest quantified benefits in the Applicants' submission are the cost savings claimed to flow from the Proposed Arrangements. The Applicants argued that the Proposed Arrangements will give rise to two kinds of cost efficiency: the first through economies of scale and the second through more cost efficient aircraft usage and maintenance.

13.7. The Applicants claimed that scale economies will be derived through coordinating lounge maintenance, IT system maintenance, and functions such as baggage handling, check-in services and sales offices and marketing. The benefits relating to these efficiencies were not quantified by the Applicants.

13.8. The major source of cost efficiency identified is in relation to aircraft usage. By reducing duplication in departures and selecting the most efficient aircraft for particular flights, substantial cost savings are argued to flow directly from the Proposed Arrangements.

13.9. NECG estimated that these aircraft usage benefits (to Australia) amount to around $337 million over five years.[73] The NECG Report set out the method by which these estimates were derived.

13.10. NECG adopted what it describes as a "bottom-up" approach to estimating the cost savings from improved aircraft usage. Based on historic financial accounts of Qantas and Air NZ, NECG estimated the unit cost per passenger, per block hour and per departure for the various aircraft types operated by the Applicants. These unit costs were hard-coded inputs into the NECG models provided to the Commission.

13.11. Passenger volumes estimated from the NECG Cournot Model are allocated across aircraft according to the capacity shares assumed in the future under the Proposed Arrangements and under the counterfactual schedules that were submitted by the Applicants. Similarly, the number of departures is taken directly from these schedules. Information on block hours for different aircraft on different routes is based on information provided to NECG by the Applicants.

13.12. Capital costs are estimated based on the number of aircraft used under the Alliance and the counterfactual, using AVITAS valuations of aircraft, straight line depreciation and a cost of capital of 12 per cent.[74]

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[73] The original estimate was for $398 million over five years. However, NECG submitted revised estimates to the Commission on 5 March 2003. The figures quoted in this Determination refer to the more recent estimates unless otherwise stated.

[74] NECG used eight per cent in the original submission but 12 per cent in the revised models.

13.13. The difference in total costs between the future with the Proposed Arrangements and without the Proposed Arrangements is then measured. To avoid double-counting, NECG deducted the costs associated with the reduction in passenger numbers due to higher fares from the estimated cost savings. The additional costs associated with new direct flights are also removed from the total cost saving estimates.

13.14. The total cost savings estimated in this way are then allocated between Australia and New Zealand based on the profit-sharing mechanism contained in the Applicants' agreement.

13.15. In a report commissioned by the Applicants, PwC noted that, although there are a number of differences between individual cost items between 2001 and 2002, using the earlier year estimates of unit costs does not materially alter the estimated net benefits modelled by NECG. PwC concluded that the 2002 actual costs provide a reasonable basis for estimating net benefits.

Views of interested parties

Virgin Blue

13.16. Virgin Blue submitted that the cost saving benefits posited by the Applicants are unsubstantiated and can be attributed to the Applicants failing to engage in inefficient and potentially unlawful conduct. These points are drawn from a report from Frontier Economics commissioned by Virgin Blue.

13.17. Virgin Blue further noted that previous decisions by the NZCC have estimated that allowing a dominant firm in a market would lead to losses in productive efficiency of between one and ten per cent of current costs, and losses of innovative efficiency in between one and 2.5 per cent.

13.18. Frontier Economics suggested that it is noteworthy that the NECG Report concluded that no cost savings would derive from achieving economies of scale. Frontier Economics further suggested that the NECG Report is essentially arguing that Air NZ has no long term future and that the costs of adjustment can be avoided by moving straight to the Proposed Arrangements.

13.19. Frontier Economics noted that the cost savings are driven primarily from the schedules provided by the Applicants, and that the cost savings are a direct consequence of the excess capacity forecast in the counterfactual.

Professor Tim Hazledine

13.20. Professor Hazledine argued that the cost efficiencies claimed under the Proposed Arrangements are not credible. He attributed the Applicants' estimates of these benefits to their conveniently adopted counterfactual under which there exists massive excess capacity, and questions the rationale for adopting such a strategy.

13.21. He also suggested that the benefit from increased engineering and maintenance activities in New Zealand is overstated because it equates costs with benefits and, accordingly, all spending on these activities in New Zealand is translated into benefits.

Australian Council of Trade Unions

13.22. The ACTU argued that the Proposed Arrangements will lead to job losses and a diminution of skills within the industry. This is argued to be contrary to the public interest.

Australian Manufacturing Workers Union

13.23. In relation to the cost savings argued by the Applicants, the AMWU argued that in claiming cost saving benefits from engineering and maintenance NECG implicitly acknowledged that Qantas would not be choosing its lowest cost option for these services. The submission also noted that the ten per cent figure cited in the event that the Proposed Arrangements do not proceed represents a contracting back of around 33 per cent of this work currently "exported" to Air NZ.

13.24. The AMWU also noted that the NECG Report claimed as benefits to New Zealand the increased jobs and revenue from engineering and maintenance activities being transferred from Australia to New Zealand.

Combined Submission

13.25. The six parties to the Combined Submission said that it is not self-evident that the parties would engage in the wasteful competition from which the estimated cost savings flow. Secondly, it is suggested that the Applicants have not made the case as to why the Proposed Arrangements are actually required to generate better capacity utilisation by Qantas and Air NZ. Finally, this submission suggested that the cost savings are likely to be overstated as the historic cost data used by NECG does not reflect the effects of competition and changes in technology.

Gullivers Pacific Group

13.26. GPG noted earlier Commission decisions in which the lack of cost pressure on firms facing little or no competition in the market lessens the pressure on firms to minimise cost and avoid waste.

13.27. GPG also suggested that Air NZ is currently inefficient and could improve this through better management and operations.

The New South Wales Government

13.28. The NSW Govt noted that Qantas has not dealt with the potential impact on employees and facilities in NSW in any significant detail but that it does make reference to cost savings in relation to areas such as lounge maintenance, IT systems, baggage handling and check-in services.

Confidential Submission

13.29. A confidential submission made to the Commission suggested that there are viable alternatives for capturing cost savings that do not result in a loss of frequency and do not require ownership exchange. Examples cited are sharing of lounges, maintenance facilities, air bridges and check-in crew.

Submissions on the public benefits associated with cost efficiencies provided since the Commission's Draft Determination

The Applicants

13.30. The Applicants submitted that, in its Draft Determination, the Commission did not provide any compelling reason why the outcomes modelled by NECG should not be taken as the best estimate of future cost efficiencies.

13.31. The Applicants submitted that it would be naïve to interpret the OECD paper referred to by the Commission as providing strong support for the contention that the efficiency of aircraft usage is higher the greater level of competition and that the Proposed Arrangements would have an adverse impact on efficiency. The Applicants questioned the statistical and economic reliability of the OECD study, its relevance to the issue and the influence of variables other than market concentration on efficiency. The Applicants submitted that a number of considerations suggest that the OECD study was misinterpreted by the Commission.

13.32. The Applicants submitted that these considerations primarily relate to:

- scale effects found by the OECD which suggest that there are opposing influences at work when considering the Proposed Arrangements and that any adverse efficiency effect from a lessening of competition could be easily offset by the efficiency enhancing effects of larger aircraft or greater propensity to travel or other factors that are associated with scale efficiencies that would be realised by the Proposed Arrangements; and

- the OECD's conclusions about the impact of regulatory and market environment factors, which are not "clear cut".

13.33. The Applicants submitted that the Commission appears to "misunderstand" the nature of the cost savings estimated by NECG, given the Commission's comments regarding job losses. The Applicants submitted that the level of labour employed in the counterfactual compared with the factual implies nothing about the level of labour required under the Proposed Arrangements compared with today.

13.34. The Applicants also submitted that, in relation to the Commission's discussion of x-inefficiency, transfers and rent seeking expenditures that could possibly arise are not a net loss to the economy to the extent that they are reflected in incomes elsewhere in the economy. In any event, the Applicants submitted that they do not accept that there would be any meaningful managerial slackness under the Proposed Arrangements and that theoretical and empirical evidence as a whole does not provide support for a claim that weaker competitive pressures will lead to significant x-inefficiency through inducing increased managerial slackness.

13.35. The Applicants submitted that it is not plausible to conclude that x-inefficiencies would result from the Proposed Arrangements because both of the Applicants remain subject to competition on substantially all of their networks and would have a strong and continuing profit incentive to ensure that such efficiencies are achieved and persist across all their operations.

13.36. The Applicants submitted that even a monopolist will pass through a substantial proportion of cost savings on to consumers to achieve a profit maximising outcome.

Gullivers Pacific Group

13.37. GPG submitted that their own experience shows that mergers can increase productive inefficiencies by between ten and 20 per cent, particularly if brand operating practices are not modified.

13.38. GPG also submitted that research supports the Commission's findings that the efficiency of aircraft usage is higher the greater the level of competition.

The Commission's view on cost efficiencies

Improved aircraft selection

13.39. The Commission has a number of reservations regarding the cost saving benefits relating to aircraft usage, as claimed by the Applicants.

13.40. Firstly, there is empirical evidence which suggests that the efficiency of aircraft usage is higher the greater the level of competition. For example, in an extensive recent study across a range of international routes and countries, OECD economists have found that "*a competitive route market structure is of the utmost importance for improving efficiency in the use of aircrafts [sic]*".[75]

13.41. While the Applicants argued that the Commission has ignored the factors identified by the OECD which may offset the loss of efficiency due to a reduction in competition,[76] the Commission notes that NECG has previously argued that at least one of these – scale efficiencies – is not sufficiently certain to justify its quantification as a benefit of the Proposed Arrangements. Furthermore, any changes in another of these factors – the propensity to travel – should be separately captured in the NECG Model through the price and capacity elasticity variables.

13.42. In relation to the argument that airline efficiency improves as average aircraft size increases, the Commission notes that the Applicants have not in fact

[75] Gonenc, R. and Nicoletti, P., (2000), *Regulation, Market Structure and Performance in Air Passenger Transportation*, OECD Working Paper No. 254, p.23.

[76] The factors mentioned by the Applicants are "larger aircraft, greater propensity to travel or other factors that are associated with scale efficiencies".

argued that average aircraft size will increase as a consequence of the Proposed Arrangements. Rather, the claimed cost efficiencies are argued to result from reducing the duplication of departures and using the lowest cost operator where cost differences exist.

13.43. In light of the Applicants' response to the Draft Determination, the Commission has undertaken a more detailed examination of aircraft use, based on the figures provided by the Applicants and NECG. This analysis used the number and types of aircraft in use to estimate average number of seats per aircraft for Year 3 under both the Proposed Arrangements and the Applicants' counterfactual. It also separately used the flight frequency information in schedules to estimate the average number of seats per flight. While for both Qantas and Air NZ, the analysis suggests that average aircraft size is higher under the Proposed Arrangements than without, the differences are marginal, and unlikely to have a significant effect on efficiency.

13.44. The Commission's examination also highlighted some aspects of the NECG modelling which are of concern. In particular, there is no reconciliation of the frequency schedules with the estimates for the number of aircraft required to provide those scheduled services. Thus it is not clear whether the estimation of cost savings is consistent with the schedules provided.

13.45. While the OECD study finds that a regulatory environment which encourages entry and price competition is important, the Commission agrees with the Applicants that current government requirements will be unaffected by the Proposed Arrangements. The Applicants have not explained, however, why this means the other findings of the study are not relevant.

13.46. The Commission therefore remains of the view that the findings of the OECD in relation to productive efficiency are relevant. In particular, the finding that actual (as opposed to potential) competition on a route is essential for improving efficiency, [77] lends support to the case that x-inefficiency is greater the greater the degree of market concentration. As the Commission notes, the magnitude of this inefficiency could well be large in the future with the Proposed Arrangements.

13.47. Secondly, NECG's projected cost saving estimates stem directly from the Applicants' proposed counterfactual. The scenario of wasteful capacity increases (absent the Proposed Arrangements) has the obvious effect of generating higher costs than those that prevail in the event the Proposed Arrangements are authorised. Given the Commission's view that a more plausible outcome would be the status quo, subject to natural growth, the Commission is of the view that estimates of cost saving benefits associated with the Proposed Arrangements would be markedly lower than suggested by the Applicants.

[77] Gonenc, R. and Nicoletti, P., (2000), *Regulation, Market Structure and Performance in Air Passenger Transportation*, OECD Working Paper No. 254, p. 24.

13.48. Although not explicitly stated in submissions, nor quantified in the NECG Model, it can be inferred from the NECG Report that the Proposed Arrangements essentially represent a re-allocation of existing resources on the routes in question.[78] If this is indeed the case, the cost savings would effectively be zero under the counterfactual of status quo with natural growth.

13.49. The Commission also notes Air NZ's recent announcement concerning the introduction of lower-priced Tasman Express services. To some degree, this behaviour appears inconsistent with the Applicants' preferred counterfactual, which emphasised capacity expansion as a logical strategy for an FSA. Furthermore, the cost saving estimates provided by the Applicants are predicated on the Applicants' historical cost structures. To the extent therefore that the new Tasman Express service is less costly than existing services, it would appear to imply that even if the Applicants were to add the capacity projected under their preferred counterfactual, the cost of such capacity would be lower. Thus, the Applicants estimates of costs savings from the Proposed Arrangements could be overstated to this extent. A similar effect could occur if Qantas moves its Jet Connect services onto the trans-Tasman route.

13.50. In its Draft Determination, the Commission expressed concern that there may be a number of risks to the projected cost savings actually being realised in practice, notwithstanding the Applicants' claim that the governance mechanisms contained in the Strategic Alliance Agreement provide strong incentives to deliver the claimed cost efficiencies. In particular, the Draft Determination highlighted the fact that 27 per cent of the savings are labour-related (and the Applicants had claimed that no job losses would occur), and that 44 per cent of the savings relate to capital – specifically, aircraft – despite the fact that the market for second-hand aircraft is highly illiquid.

13.51. In response to the Commission's Draft Determination, the Applicants have suggested that these considerations are misplaced, since a comparison of costs under the Proposed Arrangements and the Applicants' counterfactual implies nothing about the level of resourcing required under the Proposed Arrangements compared to today.

13.52. The Commission acknowledges that the Applicants' cost saving estimates are not based on comparisons of future costs with costs currently incurred. As discussed in paragraph 13.48 above, it appears that the Proposed Arrangements essentially represent a re-allocation of existing resources on the routes in question, rather than a reduction in resources. If this is correct then the concerns expressed in the Draft Determination regarding the lack of liquidity in the market for second-hand aircraft, and the Applicants' claim that no jobs will be lost, are not relevant.

13.53. Were the Proposed Arrangements to imply some *reduction* of overall capacity from current levels, however, the above considerations would cast doubts

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[78] See, for example, pp.135-137 of the NECG report. See also p.16 of the Applicants' response to the Commission's Draft Determination.

upon the extent to which savings associated with that capacity reduction would be realised in practice.

13.54. A more general point is that any projected cost savings are likely to be accompanied by costs associated with integration of the Applicants' operations. These integration costs might include staff re-training, alignment of IT systems, and management time associated with integrating schedules, staffing needs and bookings. NECG, in its Report, recognised that integration would lead to obvious additional costs, but argued that these would be relatively insignificant, since the Applicants believe that they will still be better off under the Proposed Arrangements, and integration costs are one-off rather than recurring.

13.55. The fact that the Applicants believe they will still be better off under the Proposed Arrangements does not in itself provide any support to the claim that integration costs will be insignificant. For example, the Applicants could reap substantial ongoing benefits from higher airfares which outweigh the anticipated integration costs. By the same token, the fact that the costs are not ongoing is not sufficient evidence to conclude that they are insignificant.

13.56. The earlier discussion in Part 12 of this Determination in relation to anti-competitive detriment as modelled by NECG focuses on the estimates of allocative inefficiency. Allocative inefficiency refers to the net welfare foregone as a result of resources not being put to the best use. That is, consumers willing to pay the additional costs associated with providing air travel for them are not given the opportunity as prices do not reflect those costs.

13.57. The NECG Model does not, however, provide any estimate of any productive inefficiency that may arise as a consequence of the Proposed Arrangements. More specifically, NECG argued that the impact of the Proposed Arrangements on x-inefficiency will be negligible, suggesting that x-inefficiency is simply not a likely problem both conceptually and in practice.[79] In particular, NECG suggested that x-inefficiency is a transfer rather than economic waste per se, although it noted that rent-seeking behaviour occurring in pursuit of such transfers may generate some related economic waste. Furthermore, it is suggested that any x-inefficiency that might exist will be mitigated by the governance arrangements for the Strategic Alliance, profit maximisation incentives, and capital market discipline.

13.58. The Commission generally considers x-inefficiency to be a material issue in the context of highly concentrated market structures. Furthermore, a major proportion of the purported cost saving benefits is argued to be on those routes where the Applicants' combined capacity shares are highest, for example, the Auckland-Los Angeles and domestic New Zealand routes. While NECG's argument that the Applicants under the Proposed

[79] In the context of monopoly markets, x-inefficiency refers to waste or inefficiency resulting from the absence of competitive pressure that would ordinarily act as an incentive to minimise costs.

Arrangements would continue to face profit maximisation incentives has some merit, the risk of x-inefficiency does not appear to be discounted by such observations. While NECG argues that x-inefficiency does not represent economic waste, but merely transfers, the Commission notes that there may be detriments over and above those directly associated with the kind of rent-seeking behaviour NECG describes. That is, rent seeking behaviour may affect the relative prices of factors of production, which in turn may lead to an inefficient choice of production technology. For example, a decision as to whether to replace an old aircraft with a newer model might be influenced by the relative extent of rent-seeking by providers of maintenance services (for which the airline will have a greater need if the older aircraft is retained) and rent-seeking by providers of new aircraft.

13.59. NECG's claim that x-inefficiency is merely a transfer is thus contingent upon rent-seeking behaviour creating no additional market distortions. This is only likely to be the case under special circumstances, such as transfers being lump sum in nature or the factor demands being highly inelastic. It is far from clear that these special circumstances apply in the present case.

13.60. NECG also suggests that since governance of contracts with input suppliers is important in both the Proposed Arrangements and the counterfactual, the change in the cost of governance is likely to be small. Yet this argument overlooks the fact that since the market power of the Applicants would be substantially enhanced under the Proposed Arrangements, there is likely to be a higher level of 'rents' available to the factors of production described by NECG. Furthermore, it is theoretically possible that cost of the rent-seeking behaviour could amount to the value of any additional rents. In this respect, then, there appear to be significant risks that any cost saving benefits possible under the Proposed Arrangements are actually achieved or sustained.

13.61. With respect to the factors claimed by NECG to mitigate any losses from x-inefficiency, the Commission makes the following observations. While NECG argues that x-inefficiency is inconsistent with the assumption of profit-maximisation, proponents argue that this is indeed the point;[80] the notion of x-inefficiency is that the internal workings of firms are such that they are *not* profit maximising. That is, managers and employees of firms may have objectives that are different from, and may be inconsistent with, maximising the firm's profits. These other objectives may include utility as reflected through leisure time, salary and power; and imbalances in information between a firm's owners and managers may entrench the differences between their respective objectives. It should also be noted here that proponents of x-inefficiency theory suggest that greater market power increases the extent to which that is likely to occur.

13.62. It is also unclear whether NECG's claim that the capital market disciplines would enforce the interests of shareholders is supported by empirical

[80] See for example, Frantz, R., *X-inefficiency: Theory, Evidence and Applications,* Kluwer Academic Publishers, 1988, p. 37 and pp. 94-98.

evidence. Some studies have suggested that capital markets exhibit an 'inefficiency threshold' of over ten per cent.[81]

13.63. On the basis of such considerations, the Commission remains concerned that there is an increased risk of x-inefficiency under the Proposed Arrangements, which is likely to mitigate the extent of the cost savings claimed by the Applicants. This view is consistent with previous competition decisions in the airline industry. As Virgin Blue notes, the NZCC concluded in the *Bodas* decision[82] that allowing a dominant firm in the market would increase productive inefficiency to levels between one and ten per cent of current costs. Were similar results to prevail under the Proposed Arrangements, the cost savings projected by the Applicants and NECG would be substantially lessened, and potentially extinguished.

13.64. The potential magnitude of this inefficiency can be illustrated using the cost information provided by the Applicants. Under the revised NECG Model provided to the Commission, total cost savings estimated for Year 3 for the Proposed Arrangements are $171 million. Yet cost *increases* of the same magnitude would be implied were productive inefficiency to increase by 4.6 per cent - a figure well within the ranges suggested in the preceding paragraphs. Furthermore, since this inefficiency relates to the change in market structure, rather than the airlines' capacity decisions, it is not likely to be materially affected by the choice of counterfactual. Thus, it is a detriment distinct from the Applicants' purported cost saving benefits, and is not mitigated if those benefits are discounted.

13.65. Finally, it should again be noted that the cost saving benefits accrue to the Applicants and their shareholders. While the Commission is of the view that benefits to a particular group or segment of the community may be regarded as benefits to the public, consideration needs to be given as to whether the community has an interest in that group being benefited and whether that benefit is at the expense of others – for example, consumers through higher prices. The level of competition in a market will affect both the durability of the benefit and the likelihood and extent of that benefit being passed through to consumers. Where benefits are not passed on to consumers this may be symptomatic of a lack of competitive pressure that would otherwise cause such benefits to endure and be passed through. Such benefits are likely to be accorded a lower weight by the Commission. In the Applications before the Commission, to the extent that savings are passed on to consumers through lower prices, any benefit to consumers should already be captured in the price estimates derived elsewhere in NECG's Model. Furthermore, as noted above, a large proportion of the relevant shareholders who might benefit from cost savings are non-Australian.

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[81] *Ibid*, p. 96.

[82] The New Zealand Commerce Commission Decision No.278 in respect of a business acquisition proposal involving Air NZ, Ansett and Bodas Pty Ltd, 3 April 1996.

Economies of scale

13.66. In relation to the cost savings benefits claimed to arise through economies of scale, the Commission agrees with NECG that quantification is not appropriate given the uncertainty that the net effect of such benefits would be positive.

Engineering and maintenance

13.67. NECG stated that:

> *"...without the Alliance Qantas would seek out the most cost-effective heavy maintenance agreements available in the region. On available information it is unlikely that this process would see large parcels of heavy maintenance work being awarded by Qantas to Air New Zealand."*[83]

13.68. It follows that, if in fact the Proposed Arrangements do lead to increased outsourcing of engineering work from Qantas to Air NZ, it would result in detriment to Australia through higher costs than would otherwise be the case.

13.69. Notwithstanding the above issues, there are difficulties in accepting the estimated figure of $34 million as the appropriate measure of net benefit. The figure represents the additional revenue that would flow to Air NZ under the Proposed Arrangements. As with the estimation of tourism benefits, there are significant issues associated with translating increased export projections into estimations of welfare. It is likely that such considerations would markedly reduce any quantification of the benefits (to New Zealand) of increased outsourcing by Qantas. Correspondingly, estimates of detriment to Australia would be reduced.

Conclusions

13.70. The major source of cost efficiency identified by the Applicants pertains to aircraft usage. By reducing duplication in departures and selecting the most efficient aircraft for particular flights, substantial cost savings are argued to flow directly from the Proposed Arrangements.

13.71. The Commission has a number of reservations regarding the cost efficiency benefits claimed by the Applicants.

13.72. First, there is empirical evidence which suggests that the efficiency of aircraft usage is higher the greater the level of competition.

13.73. Second, NECG's projected cost saving estimates flow from the scenario of wasteful over-capacity in the absence of the Proposed Arrangements. Given the Commission's view that a more plausible outcome would be the status quo (subject to natural growth) the estimates of cost saving benefits would be markedly lower.

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[83] NECG, p. 161.

13.74. Third, the risk of x-inefficiency could be increased under the Proposed Arrangements.

13.75. Fourth, the benefits of any costs saved accrue to the Applicants and their shareholders (many of whom are non-Australian) at the likely expense of consumers and in the context of markets characterised, as discussed earlier, by a lessening of competition. Under these circumstances there must be considerable doubt that any cost savings experienced would result in benefits for consumers.

13.76. Finally, the Commission has concerns about how engineering and maintenance costs have been measured and accounted for by the Applicants.

13.77. Taken together, these concerns cast substantial doubt upon whether significant cost efficiencies are measurable, realisable or likely and, further, whether they represent a benefit to Australia.

Scheduling efficiency benefits

Claims made by the Applicants

13.78. The benchmark case used by NECG to assess public benefits arising from scheduling efficiencies is the status quo. That is, NECG takes no account of possible market outcomes that form the basis of the "counterfactual" scenario used to support the application. This is claimed to arise because there is no information on the pattern of schedules likely to be implemented should the Proposed Arrangements be authorised. As a result, data on the number of flights were derived from the counterfactual but the patterns of flights or schedules were assumed to remain unchanged from the current scenario.

13.79. NECG argued that, since competing airlines have incentives to schedule flights on a particular route at similar times, this inevitably leads to a close alignment between their schedules. Such policies can lead to concentration of services around the most popular time slots with significant "gaps" in schedules. While this may result in loss of business in terms of passengers who would only consider travelling during these gaps, overall it is submitted that this represents the most rational approach to winning business from the rival airline.

13.80. On the other hand, with the combined management model under the Proposed Arrangements, more complete market coverage will be achieved with less "doubling up" on schedules. NECG claimed that this type of conduct is consistent with thinking in the economic literature on product diversity with imperfect competition where a single airline operator is more likely to seek to service the market more comprehensively if unconstrained by the pressures of competition.

13.81. NECG claimed that, under the Proposed Arrangements, one of the competing services can be discontinued and the resources used to provide flights during periods which would otherwise be under serviced. The net benefits of switching capacity from popular time slots to fill "gaps" in other periods include:

- better servicing the needs of consumers who have to travel at peak times because of the absence of services at other times; and

- providing services to consumers who choose not to travel at all because of a lack of services during "gap" periods.

13.82. To quantify the benefits, the time difference was taken between passengers' preferred departure times and current scheduled departure times. NECG compared this to the equivalent time differences under the Proposed Arrangements to measure the time-savings under the new schedule. Passengers' preferred departure times were assumed to be evenly distributed from 5am to midnight. The net benefit is represented by the reduction in waiting times resulting from the new scheduling. In valuing passengers' time, NECG applied rates of $20 per hour for leisure travellers and $100 per hour for business travellers, both of which it claimed were derived in estimates generated from international benchmark studies. The data was aggregated for all expected passengers to arrive at the total annual net benefit.

13.83. NECG further claimed that improved scheduling would have other flow-on benefits for passengers as they can be expected to achieve better connections with onward services. NECG claimed that improving connectivity is particularly difficult under the present competitive scenario. Also, as the benefits flowing from enhanced connectivity are particularly difficult to measure, they have not been included in the quantifications.

PricewaterhouseCoopers

13.84. PwC was engaged by the Applicants to undertake an independent review of the analysis performed by NECG on behalf of the Applicants.[84] On the issue of scheduling efficiencies, PwC concluded that the methodology used by NECG to quantify the benefits flowing from the Proposed Arrangements was reasonable and consistent with approaches typically used in transportation planning. Further, PwC considered that the dollar valuations placed on time benefits as a result of the Proposed Arrangements were approximately consistent with the range of valuations found in international benchmarking studies.

Views of interested parties

Virgin Blue

13.85. Frontier Economics on behalf of Virgin Blue contended that the difficulty inherent in estimating public benefits means that they should be treated with

[84] PricewaterhouseCoopers, January 2003, p 28.

caution and that any figures derived as a measure should be heavily discounted.

13.86. Frontier Economics also noted that methodological problems with NECG's approach may overstate the benefits. Frontier Economics asserted that NECG's modelling of passenger services is inconsistent with the assumptions underlying the modelling used for scheduling efficiencies. The former assumes a positive capacity elasticity of demand on the basis that increased capacity in the future scenario with the Proposed Arrangements is expected to encourage demand through increased frequency and choice of schedule. On the other hand, the analysis of scheduling efficiency seems to assume that there is no net increase in scheduling choice, with additional services being provided by switching capacity from other slots.

13.87. It was also argued by Frontier Economics that in valuing time it is incorrect to assume that the difference between preferred departure times and scheduled departure times is totally "wasted" and thus it is inappropriate to apply full opportunity cost valuations to such time savings.

Professor Hazledine

13.88. A submission from Professor Hazledine also questioned the appropriateness of using full opportunity costs to value the time difference between preferred and scheduled departure times. Professor Hazledine argued that travellers do not necessarily wait idly for a plane to depart and hence such waiting time should not be seen as a total loss of welfare.

Submissions on scheduling efficiency benefits provided since the Commission's Draft Determination

The Applicants

13.89. The Applicants submitted that the views expressed in the Commission's Draft Determination relating to scheduling efficiencies are based on hypothesis and conjecture. The Applicants submitted that the Commission provided no evidence to support its preference for these hypothesised outcomes against outcomes tested and modelled by NECG. The Applicants submitted that NECG's estimation of scheduling efficiency benefits is consistent with international practice in transport economics.

13.90. The Applicants submitted that there is no evidence that suggests that the elimination of time differences between preferred and scheduled departure times does not represent a benefit to the travelling public. The Applicants submitted that NECG's valuation of the benefit accruing from the time saved by travellers is low enough to reflect that passengers may be able to usefully occupy some part of the times associated with delayed departure.

13.91. The Applicants submitted that the Commission incorrectly assumes that the coordination of schedules will prevent Air NZ and Qantas from servicing demand at peak times. The Applicants submitted that the Proposed Arrangements will make it possible to ensure that schedules are arranged so that flight schedules and customer preferences regarding departure times are aligned as closely as possible.

13.92. The Applicants further submitted that even if lower yielding services are terminated, the fact that the services being terminated had lower yields relative to those being expanded would suggest that they were valued less highly so that the re-arrangements of capacity would yield a social gain. The Applicants submitted that they do not believe that the availability of off-peak fares would diminish.

13.93. The Applicants submitted that no practical difficultly with the implementation of the schedules has been identified by the Applicants or by any third party and that it is impermissible for the Commission to discount the public benefits flowing from scheduling efficiencies on this basis.

The Commission's view on scheduling efficiencies

13.94. The Commission agrees with NECG and other submissions that refer to the difficulty inherent in estimating public benefits which are claimed to flow from the Proposed Arrangements. Nevertheless, the Commission acknowledges the attempt by NECG to quantify this important aspect of the assessment of conduct under the Proposed Arrangements.

13.95. Estimation of public benefits flowing from improved scheduling can be subject to overstatement for the reasons set out by Frontier Economics and Professor Hazledine. There appear to be three key conceptual issues important to an understanding of public benefits in respect of scheduling efficiencies. The first is the establishment of preferred departure times which are assumed to be evenly distributed throughout the day from 5am to midnight, and the concomitant closer matching of preferred departure times with scheduled departure times in the future with the Proposed Arrangements. The second is the actual dollar valuations used to estimate the opportunity cost associated with "idle" time. The third issue is the definition of the time differential between preferred and scheduled departure times as "idle" or "wasted" waiting time.

13.96. As far as the distribution of preferred departure times is concerned, the Commission does not deny that passengers' preferred departure times may be distributed over the course of the day, although clustering around certain peak periods of demand appears to be more likely than the Applicants' assumption of preferences being evenly distributed.

13.97. In its Draft Determination, the Commission found that the dollar valuations used by NECG as measures of the opportunity cost of passengers not departing at their preferred times appeared to be supported by empirical studies. In that context, the Commission noted the views expressed by PwC that there is sound evidence from industry best practice and international benchmarking studies for the approaches used to set preference departure times and the opportunity costs of waiting.

13.98. The Commission has undertaken further research into the valuation of time savings in the transport industry. The NECG Report justifies the magnitude of the valuations on the basis that they are conservative as compared to those employed in two international studies. Only one of these studies appears to be directly concerned with the value of time saved by business and leisure passengers due to increased flight frequency. "Value of time saved" studies are traditionally used in the context of evaluating transport infrastructure projects by placing a value on faster transit times and less congestion. In the vast majority of road infrastructure projects, time savings represent most of the estimated benefits, sometimes it can account for up to 80 per cent of projected benefits.[85]

13.99. When compared to similar value of time saved studies employing Australian and international data, the NECG estimates of value of time saved appears partcularly high. In 1998, the Hague Consulting Group summarised the findings of several European studies of value of time studies, whose results for employee business travel in cars varied from a low of 3.0 to 4.8 Euros per hour (1998) in one UK study to 53 (1998) Euros per hour in a German study, with many studies finding a value close to 20 Euros per hour. Estimates for value of time for car commuters varied from 3.6 Euros (1998) per hour in a Finnish study to a high of 26 Euros (1998) per hour in a German study, with many studies being close to 5 Euros per hour.[86]

13.100. In 2001, Transfund New Zealand valued any time saved by car drivers at about NZ$24 per hour for travelling to and from work, while that saved by drivers for non-work purposes was valued far lower.[87] Similarly, in 1997, Austroads established unit vehicle travel time savings for Australian urban and rural road projects at $21.80 (1995 dollars) for paid private travel, and unit vehicle travel time savings of $6.81 (1995 dollars) for unpaid private travel.[88]

13.101. The methodology of value of time studies that have been employed varies from ad hoc valuation of the value of business time at an adjusted marginal product of labour (which is proxied by the wage rate) to utility estimation using revealed or stated preference. The adjustments that are made reflect an employee's value of diverting a unit of travel time into work and the value of diverting a unit of travel time into increased leisure as well as the relative productivity of working during travel time as compared to working at the office. For time studies that estimate the value of savings in non business travel, the ad hoc procedures usually value it at a proportion of that for business travel. For instance, the Austroad study valued leisure time at 40 per cent of that for business time.

13.102. Against the results of this research, the dollar valuations adopted by NECG appear to be particularly high. While it is recognised that employees undertaking air travel may appropriately have a higher valuation than

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[85] Waters (1995), *Issues in the valuation of travel time savings for road project evaluation*, p 1.
[86] Hague Consulting Group (1998), *Review of existing evidence on time and cost elasticities and on value of travel time*, pp 79 – 83.
[87] Transfund New Zealand (2003), *Information Paper Review of the Benefit Parameters Used in Transfund New Zealand's Project Evaluation Procedures*, p 15.
[88] Austroads (1997) AP 119, *Value of Travel Time Savings*, p 12.

employees undertaking road travel, the differences between the values adopted by NECG and those found in studies in Europe and Australasia appear unusually large.

13.103. The Commission's Draft Determination noted that a degree of contention is attached to the Applicants' notion that the time difference between preferred and scheduled departure times constitutes a loss of welfare to passengers. The Commission considers that the measure of value of time savings should reflect the notion that the interval between preferred and scheduled departure times does not necessarily represent a total loss of welfare. In other words, the opportunity cost of not departing at one's preferred time should take into account positive aspects associated with a delayed departure. The existence of any positive welfare considerations would have the effect of lowering the opportunity cost of waiting.

13.104. Also, once these new schedules are established they will be known in advance by travellers. Those travellers will therefore be able to plan their response to the new schedules, if the impact of the revised schedule was deemed important enough, by rescheduling meetings or other arrangements. This could lead to little or no lost time and therefore minimal disutility to be valued.

13.105. Further, compared to business travellers that travel by road, there would appear to be greater opportunity for business travellers that fly to work at either the airport, or at the office while waiting for a plane that preferably would be scheduled to arrive earlier, than in the case of driving a car where there is greater possibility of enforced idleness. In the case of time saved due to the introduction of direct flights (discussed below) there would seem to be less enforced idleness than would be associated with driving and greater probability for travellers to divert the spent time in leisure activities (due to the proximity of shops and cafes) or business activities by working at the stopover airport, or by using the additional flight time for work or leisure.

13.106. The Commission's Draft Determination raised a further issue regarding the elimination of duplicate services and switching of capacity from a "peak" time service to fill "gaps" in service at other times, noting that it may reduce choice for some passengers who may no longer be able to travel on one of their preferred peak time services. At the time, the Commission was not in a position to evaluate the materiality of this argument. The Applicants responded that "[t]he possibility that some passengers may not prefer the schedules under the factual will be far outweighed by the benefits that flow to passengers who are currently not serviced because of schedule gaps."[89] This response acknowledges the Commission's concerns but relies on their estimation of benefit to argue that the altered scheduling would result in net benefits.

[89] Qantas Airways Limited and Air New Zealand Limited, "Submission to ACCC regarding draft determination", 9 May 2003, p.17.

13.107. The Draft Determination further noted that there may be practical constraints on the spreading of departure times away from current schedules. For example, there may be only narrow windows for travel across time zones (that is, east-west travel) as consumer preferences may be biased against, for example, a late night departure that travels across time zones. In response, the Applicants argued that no practical difficulty with the implementation of the schedules has been identified by the Applicants or by any third party.

13.108. The removal of duplicate services could be expected to improve dramatically load and yield in peak times (where typical business travel occurs). On the other hand, the spread departures could be expected to be low yield to the extent that ultimately their continuation might be questioned by the Applicants. The removal of low yielding flights under such circumstances is consistent with the Applicants' approach to scheduling under the Proposed Arrangements whereby capacity is constrained to improve yields (and profits). The Applicants' response to the Draft Determination suggests that, where a service proves unprofitable, total capacity would be reallocated over routes covered by the Proposed Arrangements rather than removed. Were it to occur, this re-allocation will, according to the Applicants, yield a social gain.

13.109. On balance, and having regard to the available evidence on methodological issues and valuation of passengers' times, the Commission considers that the valuation of public benefits from improved scheduling is likely to be an overestimate. It is also recognised that, even at the Applicants' claimed total of $11.17 million over five years, these benefits may be of limited relative significance in the broader context of the Applications.

New direct services benefits

Claims made by the Applicants

13.110. As with scheduling efficiency benefits the benchmark case used by NECG to assess public benefits arising from new direct services is the status quo.

13.111. NECG has submitted that additional direct services will be introduced under a combined management scenario. The Applicants have provided undertakings to the Commission that under the Proposed Arrangements, four new direct services will be introduced: Auckland-Adelaide, Auckland-Canberra, Auckland-Hobart and Wellington-Canberra. NECG argued that there is insufficient traffic at present in these city pairs to justify a dedicated direct service. However, these new schedules would be viable after the implementation of the Proposed Arrangements (if authorised) because of the quantity effect of aggregating traffic currently shared in these routes between Qantas and Air NZ. NECG claimed that the volume of traffic for a direct service under the Proposed Arrangements in these city pairs would be double the size of the traffic currently available to each carrier.

13.112. Apart from the quantity effects of combining existing customer bases, NECG also claimed that demand will be stimulated by the introduction of a seamless end-to-end service, the improvement in connectivity with other segments of the network and the integration of marketing activities (including sharing of frequent flyer points).

13.113. Further, the strength of the two carriers' respective home-based brand loyalty makes it difficult for either carrier to capture sufficient end-to-end traffic to warrant a dedicated service. The benefits from the Proposed Arrangements are exclusively available to the two incumbents acting as a single entity. They are neither, it seems, available to either carrier acting singly, nor, by extension of the argument, to a new entrant.

13.114. As with the arguments relating to scheduling efficiencies, NECG claimed the introduction of new services in the future with the Proposed Arrangements is consistent with outcomes in the context of a monopolist provider of a diverse range products and services operating in an imperfectly competitive environment. Under these conditions, unconstrained by the pressures of competing for market share, NECG claimed that a monopolist will increase product diversity.

13.115. NECG identified three types of benefits arising from a new direct service:

- increased levels of convenience for passengers who currently travel indirectly;
- servicing the travel needs of consumers who choose not to travel in the absence of direct flights; and
- potentially lower prices on the existing indirect flights as capacity created by lower volumes of traffic can lead to lower fares as incentives to attract additional passengers.

13.116. NECG quantified these benefits by establishing the time savings achieved by travelling on direct flights relative to the most direct indirect equivalent on each city pair targeted for new direct services. These time savings were then multiplied by the number of new direct flights per annum and the number of passengers expected to travel on those flights. Finally, a monetary valuation was determined by multiplying the total annual time benefits by the same dollar valuation used in the context of assessing scheduling benefits, that is, $20 per hour for leisure travellers and $100 per hour for business travellers. The result is a dollar measure of the total benefit accruing to passengers as a result of new direct services.

Interested party views outlined in other submissions

<u>Virgin Blue</u>

13.117. Frontier Economics on behalf of Virgin Blue, reiterated the general point made in the context of scheduling efficiencies that the value of time for travellers is difficult to quantify and that any numbers derived should be treated with considerable caution.

13.118. Frontier Economics was also concerned with the wider applicability of the argument regarding the benefits of traffic aggregation in the future of the

Proposed Arrangements. This potential source of benefits only exists in respect of city pairs where both carriers actually provide indirect services. In cases where the available traffic on a particular city pair is not shared, it is inappropriate to reason in terms of aggregation of traffic. Frontier Economics argued that if it is viable for only one carrier to operate a direct service, then it is unlikely that another carrier will commence to do so as well. NECG cited the Auckland-Adelaide route, one of the city pairs for which a new direct service is envisaged under the Proposed Arrangements, where Air NZ does not operate a service at all and where the aggregation argument falls down. In this case, there would be no aggregation.

13.119. Frontier Economics concluded that given the limited benefits potentially available from new direct services in the future with the Proposed Arrangements, these should not be considered in the final analysis of public benefits which may emanate from the Proposed Arrangements.

Professor Hazledine

13.120. Professor Hazledine expressed concern that various elements of the approach used by the Applicants to quantify the benefits of new direct flights may exaggerate the dollar valuations assigned to them. For example, he asserted that the additional transit time involved in indirect flights is not totally wasted time. The dollar values used to quantify the opportunity costs of the extra flight time involved in indirect travel, should be discounted to account for the many useful activities that a passenger can undertake while in transit.

13.121. Professor Hazledine also contended that the full savings should be imputed only in respect of those passengers who travel in the city pairs currently serviced with indirect flights rather than all passengers who are expected to travel in the new direct services. Also, the valuation of benefits should be applied in respect of passengers whose preferred flight times and patterns matches the new scheduled direct flights.

13.122. Finally, Professor Hazledine argued that the base case for the purposes of calculating benefits should be between the current most direct indirect flight rather than the average of all present indirect flights, as suggested by Qantas and Air NZ.

PricewaterhouseCoopers

13.123. As with the issue of scheduling efficiencies, the independent review[90] by PwC of the NECG analysis led PwC to conclude that the methodology used by NECG to quantify the benefits of new direct services was founded in sound practice in transportation economics. The dollar valuations placed on time savings were also found reasonable given international evidence.

[90] PricewaterhouseCoopers (2003), Submission to the ACCC, January 2003, p28.

Submissions on new direct services benefits provided since the Commission's Draft Determination

The Applicants

13.124. The Applicants submitted that it is not open to the Commission to conclude that new direct services will not recover economic costs on the basis that neither applicant operates these services at the moment. The Applicants submitted that they had provided evidence that the introduction of a direct flight not currently profitable for either applicant to operate could be profitable under the Proposed Arrangements.

13.125. The Applicants submitted that it is erroneous to conclude that the provision of new services would not represent a substantial public benefit.

SA Govt

13.126. The SA Govt submitted that it has sought the implementation of direct flights between Adelaide and New Zealand for some time and that Qantas or Air NZ are best placed to provide these services.

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

Gullivers Pacific Group

13.128. GPG submitted that in their experience in the travel industry, the new services proposed by the Applicants are not valued by customers. GPG also submitted that on-time departures are more likely to be a feature of competitive markets than monopolistic markets.

The Commission's view on new direct services

13.129. Clearly, the availability of additional flights directly linking city pairs currently serviced indirectly, makes users of those services better off. The Commission notes that the dollar valuations of time savings generated by the new direct flights appear conservative having regard to valuations noted by NECG from international benchmark studies. This should mitigate somewhat the effects of NECG not taking account of passengers' preferences for travel times in respect of the new direct services. Again, the Commission notes the comments by PwC from its review of the methodology used by NECG and of evidence from other international studies.

13.130. Professor Hazledine submitted that the benefits from new direct services should be estimated only in respect of passengers who currently use the indirect flights, rather than, as NECG proposed, all passengers expected to use the new direct flights. The Commission considers that the new direct flights represent an improved level of service for both current travellers and consumers who would be willing to travel but choose not to in the absence of direct flights. As such, the Commission concurs with this aspect of the NECG approach. It is less clear, however, whether the appropriate measure of opportunity cost of indirect travel for new travellers should be the same as for consumers who currently take indirect flights. Indeed, the net public benefit to Australia of new travellers using the new direct services may be quite marginal. Therefore, while the NECG valuation of benefits for existing indirect travellers appears reasonable, the valuation for new travellers appears to be high.

13.131. In estimating the value of benefits in its Model, NECG has used for comparison purposes the total time spent travelling on "...the most direct services currently available".[91] Examples of the services used are set out at Table 20 (p.146) of the NECG Report. While the table lists the flight times (that is, the time between departure and arrival for each leg of the journey), the time spent in transit between flights has been added to the flight time in NECG's comparison. In the case of the Auckland-Canberra example, the total journey time for comparison purposes is 350 minutes, which is compared to the 160 minute direct flight. The time spent in "stopover" in this example is one hour, thirty five minutes. During that time it appears from the schedules on the Qantas web-site that up to two Sydney-to-Canberra flights depart (at 8.15am and at 8.45am). Given the probability that passengers with a high valuation of time savings will have tickets with flexible conditions, there seems to be a possibility that this stopover time could be reduced.

13.132. In acknowledging the benefits of additional flights to users who directly benefit from them, it is appropriate to also explore wider issues surrounding such a decision. For example, the Commission considers that it is relevant to consider the efficiency with which the new services are provided and whether the new services would recover their full economic costs. In essence, the issue is whether the costs of providing the new direct flights are covered by the benefits accruing to passengers who use them.

13.133. The fact that these services are not provided already suggests that they may not be viable as an extension of the current product range. In the event that, in the future with the Proposed Arrangements, the additional flights cannot be operated efficiently - that is, revenues will not permit recovery of full economic costs but are continued because of the undertakings provided to the Commission - the Applicants may have to subsidise these services from profits generated in other parts of their business. Under these circumstances, the services may not be sustained beyond the period covered by any undertaking. The Commission recognises the explanation that Air NZ provided regarding how a currently unprofitable direct route may become viable under the conditions of the Proposed Arrangements. The Commission was provided with a confidential, proprietary model used to forecast demand based on the quality of service provided, where a significant input to quality was whether a flight was direct or indirect. The Commission concluded that although, using Air NZ's assumptions, the Proposed Arrangements would make the initiation of direct flights more probable, it also understood that modelling demand for proposed routes involved a certain level of estimation and assumption that entails risk. Further, it was not obvious how impacts on

[91] NECG Report, p.145.

indirect flights were incorporated into the analysis, nor what the reaction of any potential competitor might be.

13.134. If the commercial benefits from capturing the entire end-to-end traffic in certain city pairs are compelling, then this would seem to reinforce the argument for vigorous competition rather than for an anti-competitive arrangement. The Applicants have only provided arguments for the fact that, given the minimum efficient scale of operations, the relevant traffic is too small to justify vigorous competition between the two carriers. While the benefits to direct users of the new services are not doubted, there is a broader issue in terms of whether the enhanced product diversity is socially desirable.

13.135. To the extent that the new direct services would be the subject of an undertaking to the Commission, any social costs involved in their provision would be locked in for the duration of the undertaking. Further, the commitment to continue to provide the services could constitute a barrier to entry if it precluded a more efficient carrier from providing those services. In a revised Outline of Undertakings,[92] the Applicants set out that they were willing to commit to continuing flights on the new routes for one year, although this was subject to the maintenance of certain load factors and yield levels. The Commission notes that the qualifying terms for load factor and yield provide some comfort that those services that prove to be uneconomic will not be continued.

13.136. The Commission also notes that the proposed new services are to operate only very limited frequencies. Three of the services, for example, Auckland-Hobart, Auckland-Canberra and Wellington-Canberra, are proposed to operate only one return flight per week. Such limited frequencies raise severe doubts about the ability of passengers to complete their travel without engaging in some form of indirect travel, thereby marginalising:

- the claimed increases in levels of convenience for passengers who must currently travel indirectly;
- the claimed extent to which the new flights service the needs of consumers who choose not to travel in the absence of direct flights; and
- the claimed potential for lower prices on indirect flights as a result of lower loads.

13.137. In light of statements made elsewhere by the Applicants, there is also reason to question the sustainability of the new services. Qantas states that its New Zealand domestic routes are not profitable on a stand-alone basis and it must increase its capacity in order to provide frequency for higher yield passengers.

13.138. The Commission considers that there is significant uncertainty associated with the business case for the new direct services and therefore a question,

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[92] Refer to submission from applicants titled "Outline of Undertakings" dated 9 May 2003 and email message from Brett Johnson to Scott Gregson dated 29 May 2003.

even with the proposed undertakings, about whether the services will be sustained over the period modelled by the applicants. On balance, the Commission is concerned that the benefits to users have been over-estimated by the Applicants and that a risk should be attached to the ongoing provision of the additional services.

13.139. In NECG's Revised Model Results,[93] NECG estimated benefits from new direct services to range between $6 million to $7 million through Years 2 to 5 of the Proposed Arrangements. The Commission's view is that only one year (covered by the undertaking) can give rise to benefits with any certainty (noting that even this is subject to load factors and yield levels), and that, for the reasons set out above, the dollar value of such benefits is likely to be lower than NECG's estimate.

Tourism benefits

Claims by the Applicants

13.140. The Applicants submitted that benefits from increased international tourism would accrue to Australia over the five years modelled under the Proposed Arrangements.

13.141. The benefits of tourism attributable to the Proposed Arrangements are considered by the Commission in two steps. First, the number of additional foreign tourist visitors that are claimed would be generated by the Proposed Arrangements is discussed. Second, the value of the benefit to Australia of the additional expenditure expected to be made by these additional tourists is discussed.

<u>Additional tourists</u>

13.142. In terms of additional tourist numbers, the Applicants claimed that the detrimental effect of higher prices and lower capacity that flow from the anti-competitive nature of the Proposed Arrangements will be more than offset by more effective promotional and marketing efforts.

13.143. The more effective promotional effort described by the Applicants has two aspects. First, Qantas Holidays would be given the incentive to increase its effort in marketing New Zealand as a destination for international tourists. Qantas Holidays estimates this effort will, by Year 3 of the Proposed Arrangements, increase visitors to New Zealand by 50,000 passengers per annum, over and above natural market growth. In assessing the impact on Australia, Qantas Holidays estimates that 14,000 of the additional visitors to New Zealand will be Australian residents. Of the remaining 36,000 visitors, Qantas Holidays claims that 50 per cent will also travel to Australia, resulting in an additional 18,000 visitors.

13.144. Secondly, NECG claimed that the Proposed Arrangements allow the Applicants to redirect marketing effort away from the competition for market

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[93] NECG, Revised NECG Model, 5 March 2003, Schedule 1.

share towards growing the total Australasian market. This effect is estimated to represent an increase in promotion efficiency of five per cent, which represents a net increase of approximately 20,400 foreign[94] tourists to Australia per annum.

13.145. NECG has used its Cournot Model to estimate the reduced number of passengers that would fly under the Proposed Arrangements due to the higher fares and reduced capacity. Over the five years modelled, there is a total of 45,307 tourists lost to Australia.[95] However, NECG claimed that this is an overestimate as quality of service is to increase under the Proposed Arrangements. It is assumed that Australian-resident passengers who do not fly to New Zealand because of the impact of the Proposed Arrangements instead contribute to the Australian economy as Australian tourists or through increased domestic expenditure. This is regarded as a benefit of the future with the Proposed Arrangements over the future without.

13.146. Overall, NECG claimed that the Proposed Arrangements would result in 27,600 additional tourists to Australia in Year 3. The 18,000 tourists from dual destination marketing would be supplemented by 20,400 tourists from enhanced promotion. There is also a negative impact on total tourism numbers to be taken into account as 10,800 tourists decline to travel because of fare and product changes.

13.147. The Applicants have offered the Commission an informal undertaking to increase substantially advertising on expenditure programs and new product offerings designed to increase tourism to Australia and New Zealand.

13.148. TFI was engaged by Qantas and Air NZ to assess the reasonableness of the forecast increase in tourists resulting from the additional promotional effort by Qantas Holidays. Using three different approaches to test the Qantas Holidays claims, TFI found both the forecast additional 50,000 visitors to New Zealand and consequential 18,000 visitors to Australia to be reasonable estimates. In so doing, TFI also found it reasonable that Qantas Holidays would achieve a rate of (non-Australian) dual destination tourists (at 50 per cent of total tourists) greater than that currently observed (35 per cent).

The views of interested parties

13.149. The tourism benefits claimed by the Applicants were subject to a broad range of responses from various interested parties.

13.150. ATC urged recognition of the complexity of the tourism product and noted that airline services are a derived demand which are bundled with other tourism services. ATC raised a number of concerns regarding the Applicants' analysis of the impact on Australia of inbound tourism under the Proposed Arrangements. It noted that inbound tourists are constrained by leave time and holiday budgets. This suggests that an increase in the rate of dual-

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[94] For the sake of this discussion, "foreign" will be used to mean people who are not Australian nor New Zealand residents.
[95] Refer NECG Report p.156.

destination tourism may not be of value to Australia and may imply an overestimate of the benefits claimed by the Applicants.

13.151. ATEC gave the Proposed Arrangements cautious support subject to a number of concerns. The concerns included that relatively less emphasis would be placed on the promotion of Australia relative to New Zealand, a negative impact on tourism in regional Australia, reduced time spent visiting Australia by dual-destination tourists, and the overall small increase (of 28,000 tourists) proposed to result from the Alliance.

13.152. DITR found the Proposed Arrangements to have marginal positive tourism benefits. Although generally supportive of the claims made by the Applicants, DITR was not convinced of the benefits ascribed to dual-destination travel and noted a number of potential limitations, including:

- a relative re-direction away from marketing Australia as a sole destination;
- that the Alliance partners may capture some of the gains resulting from a cessation of competing promotional effort; and
- replacement of flights to New Zealand via Australia with direct flights.

13.153. GPG, in considering the New Zealand inbound tourist market, questioned the reasonableness of the Proposed Arrangements achieving an additional 50,000 tourists per year when the market is already growing strongly and suggested that the Qantas Holidays' expertise in selling Australia may not be applicable to selling New Zealand. They also noted that Qantas' excess capacity on both domestic New Zealand and Trans-Tasman routes represents an incentive to promote New Zealand without the need of the Proposed Arrangements. GPG also predicted a negative effect on tourists from North America and Asia if Air NZ leaves the Star Alliance.

13.154. Professor Hazledine remarked that NECG neglected to establish the market failure that currently prevents the promotion to attract an additional 50,000 tourists to New Zealand. NECG also failed to explain why the Proposed Arrangements are the solution to any such market failure. Professor Hazledine went on to note a "major flaw" in the methodology used by NECG in that expenditure by tourists is equated with a benefit to the host country. Additionally, Professor Hazledine presented a criticism of NECG's approach to modelling the counterfactual. His analysis suggested that NECG has underestimated the number of tourists that would fly under the counterfactual because the NECG Cournot Model is not appropriately designed. It is argued that if the trans-Tasman market is modelled on the basis that it is aggressively competitive then significantly more passengers will not fly in a future with the Proposed Arrangements.

13.155. Rex questioned the value of joint promotion of Australia and New Zealand as tourist destinations, noting that even if such promotions were desirable they could be undertaken through joint advertising campaigns which are not dependent upon the Proposed Arrangements.