alternatives to expensive business airfares, a loss of competition and a lack of available seats at a time that suits them.

12.15. ACA claimed that the Proposed Arrangements will result in a substantial lessening of competition and that if the Proposed Arrangements were allowed to proceed there would be very much less likelihood of airlines taking a risk and entering the market especially when so many airlines' profits are fragile.

12.16. AFIF noted that under the Proposed Arrangements the market power held by the Applicants on the Tasman route will be dominant. It is said to be clear from the NECG Report that a major objective for the Proposed Arrangements is to improve yield to both airlines which means increasing price and utilisation. Price increases of the order of 30 to 40 per cent are seen as not unrealistic.

12.17. BVM in New Zealand believed that the Proposed Arrangements are anti-competitive and that reduced supply along with the ability of airlines to "crank up" average fares by manipulating seat availability will see effective airfare increases of 15 to 20 per cent within three years of the Proposed Arrangements being implemented.

12.18. A confidential submitter has suggested that the Proposed Arrangements would discourage and handicap would-be entrants, lead to less competition and result in increased fares.

12.19. GPG claimed that if the Applicants are losing money on the Tasman they will seek to remedy the situation by reducing capacity to increase yield or increasing the yield thereby forcing down demand resulting in reduced capacity.

12.20. The IINZ believed the Proposed Arrangements would have the effect of reducing capacity and increasing freight rates and entrench the Applicants in a dominant position in the trans-Tasman market to an extent that would deter future competitors from entering that market.

12.21. The NSW Govt stated that its competition concerns are largely offset by the timely emergence of Virgin Blue which has shown a clear interest in the trans-Tasman.

12.22. SACL noted that efficiency savings are not expected to be passed on to travellers through lower airfares, with fares expected to rise under the Proposed Arrangements even with the influence of an expected low-cost competitor.

12.23. TIANZ assessed that the Proposed Arrangements contain many benefits but raised concerns about the potential for market dominance within the domestic market (including trans-Tasman) and barriers to entry for new entrants.

12.24. TTF stated that it is hard to deny that the levels of market concentration (estimated at 92 per cent) and market power arising from the Proposed

Arrangements could be used in an exploitative or anti-competitive manner (without any prohibitions).

12.25. DTRS stated that it is important to make sure that there is enough competition on domestic and international routes to keep Qantas and Air NZ efficient and provide consumer choices and benefits. DTRS submitted that:

- the Proposed Arrangements will dominate the traffic carried on two of Australia's five major international routes;

- Qantas/Air NZ would carry nine out of ten passengers on the trans-Tasman route and two out of every three passengers on the USA route; and

- the joint pricing and scheduling arrangements in the Proposed Arrangements would significantly reduce competition on critical trade routes.

12.26. Virgin Blue claimed that the Proposed Arrangements enable the Applicants to limit the scale and timing of Virgin Blue's entry into the trans-Tasman and New Zealand domestic markets and limits its competitive presence.

Market concentration

12.27. In its submission, DTRS provided origin/destination statistics for the trans-Tasman route for the year ended August 2002. These statistics, which appear in Table 12.1 below, show passengers on the route from Australia with destination New Zealand and vice versa. Passengers flying trans-Tasman services en route to another destination are not included.

Table 12.1 Trans-Tasman passenger traffic by airline: year ended Sept 2002[56]

Airline	Passengers each way	Passengers each way (%)
Air NZ	1,137,153	40.6
Qantas	1,082,261	38.7
Freedom Air	311,458	11.1
Thai International	115,006	4.1
United Airlines	47,780	1.7
Garuda	32,759	1.2
Other	71,222	2.5
Total	*2,797,639*	*100.0*

12.28. The statistics show that Qantas and Air NZ (including Freedom Air) have a 90.4 per cent share of the trans-Tasman market.

[56] Source: Department of Transport and Regional Services

12.29. The Applicants, using calculations based on capacity, have claimed that they have an 85.2 per cent market share with the remaining 14.8 per cent held by fifth freedom carriers. In this context, the Commission considers that origin/destination statistics provide a better guide than capacity based statistics which do not take into account loads or through passengers. Fifth freedom carriers for example may have significant loads of through passengers resulting in full capacity not being available on the route. The market share of fifth freedom carriers using origin statistics would be in the order of five to six per cent.

12.30. The Applicants claimed that fifth freedom carriers have the ability to impose a constraint on their pricing decisions. The Commission does not consider this constraint to be significant. Apart from their small overall market share, fifth freedom carriers only have a presence on three of the twelve major trans-Tasman routes operated by the Applicants between them. Fifth freedom competition is also not necessarily reliable competition. Airlines make decisions to operate routes primarily on third and fourth freedom route performance.

Barriers to entry

12.31. The Applicants cited statements from both the Commission and the NZCC to the effect that when barriers to entry or expansion are such that entry is likely in response to an attempt to increase price or decrease quality or standards of service, there can be no market power and therefore there is unlikely to be a substantial lessening of competition.

12.32. The Applicants claimed that the history of entry and expansion activity suggests that traditionally perceived barriers to entry and expansion into trans-Tasman routes have not protected incumbents from the threat of entry or expansion. The Applicants argued that the incumbents are constrained and will continue to be constrained from exercising market power because entry or expansion is likely if they increase price or decrease quality.

12.33. The Applicants identified and responded to a comprehensive range of potential barriers to entry on the trans-Tasman route comprising:

- legal and regulatory conditions;
- access to facilities;
- access to feeder services;
- vertical relationships;
- brand loyalty;
- access to capital;
- economies of scale and scope; and
- strategic barriers to entry.

- Legal and regulatory restrictions

12.34. The Applicants claimed that legal and regulatory restrictions are not real impediments to new entrants or incumbents intending to expand into the trans-Tasman.

12.35. In the relevant markets there are a range of legal and regulatory barriers including ownership and policy barriers, and barriers relating to technical, engineering and safety matters. The significance of each of these as a barrier to entry may depend in part upon the nature of the potential entrant and the particular circumstances of entry.

12.36. The Commission notes that there is an inability of wholly foreign owned domestic carriers in Australia to enter the trans-Tasman market.

12.37. However, in the case of fifth freedom operations, just because carriers have access rights does not mean that they will exercise them. Most of the carriers the Applicants have listed as having fifth freedom rights across the Tasman, including Singapore Airlines, choose not to use them. The OECD has observed that it is overly optimistic to suggest that if one airline comes to dominate a route it is not able to exercise market power due to the threat of immediate and significant new entry:

> *"Research shows that although the number of potential entrants in a city-pair market does have a disciplining effect on prices, that effect is several times smaller than the effect of even a single actual competitor."*[57]

- Access to facilities

12.38. The Applicants claimed that obtaining access to facilities such as terminals, ground services and slots is not an impediment to entry or expansion in the trans-Tasman market. It is suggested that there are no access issues at key trans-Tasman international airports.

12.39. Virgin Blue has stated that, in order to be able to provide a competitive service on trans-Tasman (and domestic New Zealand) routes, it will require significant terminal capacity at a variety of airports throughout New Zealand and Australia at peak times and on commercially reasonable terms. It is envisaged that this will require either the construction of new facilities at various airports or the surrender of capacity by the Applicants. Virgin Blue submitted the lack of gate availability and limited check-in counters in Auckland as an example.

12.40. The Applicants have suggested that they would be prepared to enter undertakings designed to remove airport facility barriers to entry for a trans-Tasman entrant. Such undertakings have been offered in the areas of airport

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[57] OECD (2000) *Airline mergers and alliances*, OECD Directorate for Financial, Fiscal and Enterprise Affairs, Committee on Competition Law and Policy.

gates, airport counter facilities, maintenance facilities and baggage handling facilities.

12.41. The Commission acknowledges that there are potentially significant access issues which result in barriers to entry. Some of these are through facilities controlled by airports and others because of airlines by virtue of their incumbency. The level of access difficulty will vary from airport to airport depending on factors such as aircraft density, slot availability, etc.

- Access to feeder services

12.42. The Applicants briefly considered the issue of access to feeder services but dismissed its relevance to a VBA entrant because such airlines offer point to point services and do not seek connectivity with other airlines.

12.43. Virgin Blue was critical of the Applicants' stereotyping of VBAs and suggested that there are a range of operating models for airlines to achieve lower costs, some of which are being picked up by Qantas and Air NZ. Virgin Blue argued that VBAs such as Virgin Blue can, and do, operate in ways that imitate network carriers, including by:

- operating high frequency schedules;
- targeting business customers;
- seeking interlining arrangements;
- establishing networked operations offering connectivity; and
- providing additional features such as lounges and loyalty programs, although this may be on a different revenue model.

12.44. Virgin Blue stated that, as its network grows and it commences international services, the amount of feeder traffic it receives from its network will increase. It also noted that it would value any arrangements to obtain feeder traffic and that a desire to access feeder traffic from a particular route or market does not require that an airline operate in all those places. Typically, arrangements can be entered into with other airlines to obtain feeder traffic.

12.45. The Commission is of the view that access to feeder traffic is important in terms of both domestic market access to international feeder traffic and international access to domestic feeder traffic.

12.46. In the case of trans-Tasman operations the Commission considers that any new entrant which does not have access to feeder traffic at both ends of the route at competitive rates will be significantly disadvantaged relative to a competitor who does have access to such traffic.

12.47. If a new entrant does not have access to its own feeder traffic either it will be restricted to point to point passengers (for example, Sydney-Auckland) or will depend on viable prorate fares from other airlines. Such a position would limit its customer base relative to its competitors and restrict the range of destinations it can offer.

12.48. United has made a submission to the Commission in relation to the impact of the loss of feeder services in Australia with the failure of Ansett. United has shown that the loss of feeder services from Ansett has significantly impacted on United's international performance. United has also stated that Qantas, the major domestic carrier in Australia, limits its access to passengers in beyond-gateways points in Australia through prorate agreements inferior to those provided to other airlines, and through limited access to seat inventory on Qantas domestic Australian flights. United stated that while such inventory limitations are common in the marketplace, Australia's lack of an alternative domestic network renders Qantas' practices particularly harmful to competition and consumers.

12.49. In recognition of the above claims, United sought undertakings in relation to Qantas on prorate agreements, seat inventory access, through check-in services, and code display.

12.50. The Commission considers that the issues raised by United point to feeder service impediments to entry that are significant in the absence of the Proposed Arrangements and sufficiently high in the event of the Proposed Arrangements proceeding, especially at the New Zealand end, to act as a deterrent to potential new entrants in the trans-Tasman market.

12.51. The level of impediment would be significant, but not be as high, for an established operator such as Virgin Blue, which was able to develop a presence in all three relevant markets, the trans-Tasman and the two domestic markets. It would be expected that until Virgin Blue could develop an adequate network in New Zealand it would be competitively disadvantaged by lack of feeder access in New Zealand. Its ability to develop such a network, especially in the face of the Proposed Arrangements, could in turn be expected to be impacted by the behaviour of the Applicants and the availability of services through the next largest New Zealand domestic operator, Origin Pacific. Origin Pacific currently operates in a code share relationship with Qantas.

- Vertical relationships

12.52. The Applicants stated that the NECG Report concluded that vertical relationships between the airlines and providers of other services do not give rise to any competitive concerns. Virgin Blue has indicated that it needs access to ground services, equipment spares and parts, maintenance and route reprotection on reasonable terms. It stated that Air NZ is currently the only supplier of many of these services in New Zealand.

12.53. The Commission is aware of claims that factors such as maintenance and engineering have been impediments to start-up airlines in Australian domestic markets through a reluctance to engage in "parts swaps". Further, there have been claims of a reluctance to carry other airlines' distressed passengers at agreed fares which is also seen as an impediment to start-up airlines. It can see how such matters could be a substantial impediment to trans-Tasman new entrants.

- Brand loyalty

12.54. The Applicants claimed that a new entrant, especially a VBA, would not find that factors associated with brand loyalty (such as an incumbent's safety record, national flag carrier status, advertising and frequent flyer programs) give rise to a barrier to entry.

12.55. The Commission can see that an airline's established position in a market and track record can provide it with an advantage. However, many of these advantages, such as a safety record, are natural advantages rather than barriers that are addressable.

12.56. One exception could be frequent flyer programs. The OECD has stated that:[58]

> *"Airlines also enhance demand for their services through loyalty programs, such as frequent flyer programs or travel agent commission override programs, which provide incentives for travellers and travel agents to focus their bookings on a single airline. Such programs benefit larger airline networks more than smaller airline networks. These programs are especially targeted at attracting and retaining high-margin time-sensitive business travellers."*

12.57. The Applicants have stated that data on air passenger traffic indicates that passenger participation in frequent flyer programs is not so widespread that it would represent a high barrier to entry. For example, only 29 per cent of Qantas trans-Tasman passengers are members of frequent flyer programs.

12.58. The Commission notes that the OECD has stated that:[59]

> *"Although upper class and full fare paying passengers represent a minority of travellers they generate a disproportionately large share of airline profits. For many routes, the ability to compete effectively depends on capturing a share of the high-margin time-sensitive business travellers."*

12.59. On this basis, the Commission would expect that the 29 per cent of passengers referred to by the Applicants above would provide a benefit to Qantas in excess of the share of the market they represent. This consideration, taken together with the broad alliance networks Qantas and Air NZ frequent flyers could access under the Proposed Arrangements, suggests frequent flyer programs would prove an impediment to entry to the trans-Tasman market without the Proposed Arrangements and a significant barrier under the Proposed Arrangements where points and redemptions would be

[58] ibid.
[59] ibid.

interchangeable between the two airlines. While Virgin Blue is introducing a frequent flyer program, its members are disadvantaged in terms of the relative range of network redemption options available.

- Access to capital

12.60. The Applicants do not express a view on access to capital as a barrier to entry in the trans-Tasman market but take selective quotes from NZCC reports to suggest that access to capital is not a significant barrier to entry. For example, the impression is given through reference to the minimal capital possessed by Kiwi Air when it started up, that capital requirements are minimal especially if a charter or lease approach to aircraft acquisition is adopted. No mention is made of the role of capital adequacy in the subsequent failure of Kiwi Air[60] or the failures of Compass I and II[61] in Australia.

12.61. The Commission considers that there are two issues associated with access to capital as it relates to market entry: the extent of funding needed, and the ability at any time to raise that capital.

12.62. It is apparent to the Commission that sunk costs[62] associated with a new entrant airline can require a considerable amount of start up capital, particularly with a start up airline, as against an established operator. Sunk costs arising from setting up an airline on a route include items such as establishing information and booking systems, hiring and training staff, setting up schedules and terminal facilities, and undertaking advertising.

12.63. In Australia, the IASC recognises the importance of an adequate capital base for a start up airline by insisting that airlines demonstrate access to the equivalent of the costs expected to be incurred in the first three months of operation before providing international route rights.

12.64. Dr Trethaway, representing Qantas in the NZCC *Bodas* matter,[63] said that sunk costs in the aviation industry are very significant, and their magnitude would depend on the scale of entry and subsequent growth. He also said that a significant proportion of sunk costs could be incurred from operating losses sustained in the start up period pending break even load factors being reached. In the same matter, Qantas submitted that incumbents can act to increase start-up costs and sunk costs for a new entrant.

12.65. It would seem to the Commission that not only is access to capital a potential barrier to entry because of the significant size of the capital requirement, but

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[60] Kiwi Air commenced scheduled services between provincial New Zealand routes and Australian capital cities in August 1995. In September 1996, Kiwi Air went into liquidation.
[61] Compass Airlines was established in 1990 and survived until 1991. Compass II lasted from 1992 until 1993.
[62] In general terms, a sunk cost is an expenditure that, once made, cannot be recovered.
[63] 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.

that for some time to come the financial performance and position of the aviation industry is such that it is unlikely to be attractive to investors.

12.66. The Commission notes in this respect the problems that Qantas (commonly held to be one of most profitable airlines in the world at the moment) experienced in selling a bond issue at a particular point in time. It was reported in the *Australian Financial Review* that:[64]

> *"Asian investors are reported to be mildly receptive, but local fund managers are more in line with investors in the United States and are shying away from the airline sector completely."*

12.67. Under these circumstances, the Commission considers that access to capital by a start-up airline in a trans-Tasman market dominated by an alliance between two carriers who hold 90 per cent of the market would be a barrier to entry.

- Economies of scale and scope

12.68. The Applicants suggested that an incumbent in the trans-Tasman is unlikely to enjoy the substantial economies of scale and scope that exist in other markets such as the United States and Europe. The Applicants' rationale is that:

- an entrant can access the majority of passenger traffic with a small route structure; and

- network structures in Australia are more linear than in the United States and Europe as Australia has no natural hubs. Therefore, the barriers to entry in terms of an entrant being able to develop a hub are not as important in Australia, as in other countries.

12.69. The Commission is inclined to accept that economies of scale do not act against entry into the trans-Tasman market and notes that the OECD has suggested that studies have found that beyond a certain level of traffic in a city pair market, the airline industry exhibits constant returns to scale.

12.70. The same OECD study found that there are both demand and cost side economies of scope in the airline industry. Airlines with larger networks have a powerful competitive advantage, especially on routes to and from their hub airports.

12.71. The Commission does not agree that Australia has no natural hubs. A very high percentage of international airline operation is centred on Melbourne and Sydney, including trans-Tasman traffic.

12.72. To say that Sydney and Melbourne are not hubs is to ignore the access to feeder problems experienced by United and examined earlier.

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[64] *"Qantas struggles to launch bonds"*, Australian Financial Review, 10 March 2003.

12.73. An economy of scope disadvantage in Australia is probably more pertinent to a new airline than to Virgin Blue which is already in the process of establishing and expanding a network which will generate demand economies of scope.

- Strategic barriers to entry

12.74. In response to the issue of strategic barriers to entry, the possibility of selective price reductions and capacity increases that may increase initial start up costs for entrants, the Applicants cited the rapid expansion and success of Virgin Blue in the Australian domestic market.

12.75. The Commission considers that these observations are irrelevant. The success of Virgin Blue in the Australian domestic market was assisted by the failure of Ansett Australia which held around 40 per cent of the domestic market at the time it failed. There is certainly no equivalent capacity hole in the trans-Tasman market and, under the Proposed Arrangements, Virgin Blue would face the combined power of Qantas and Air NZ.

12.76. Qantas has previously submitted (in relation to the *Bodas* matter referred to above), that incumbents can act to increase start-up costs and sunk costs for a new entrant.

12.77. The Commission considers that the Applicants have the ability to increase the sunk costs of a new entrant in the trans-Tasman market. This ability would be a barrier to entry for a start-up airline with limited capital reserves. Such behaviour is likely to be more of an impediment than a barrier for an established airline moving into the market, but could certainly disrupt the entry of such a carrier.

12.78. Virgin Blue argued that a barrier to establishing a substantial scale of operations is the threat of strategic capacity and pricing conduct by Air NZ and Qantas, particularly through their low cost operations, including Freedom Air, Australian Airlines and entities within the Qantas branch with low cost structures such as Impulse and Jet Connect.

12.79. Virgin Blue argued that the Proposed Arrangements raise these barriers. Virgin Blue claimed that under the Proposed Arrangements Air NZ and Qantas will not need to compete head-to-head but will instead be able to strategically target their combined fleets, and in particular their low cost operations, to constrain the growth of Virgin Blue.

12.80. Virgin Blue claimed that Air NZ has consistently employed Freedom Air as a tactical counter against new entrant airlines. Virgin Blue argued that it was established to respond to the entry of Kiwi Air, was bolstered in capacity when Virgin Blue announced an intention to enter New Zealand, was redeployed against Qantas' entry into domestic New Zealand and is now being used to operate out of Brisbane, the home base of Virgin Blue.

12.81. Prior to the Draft Determination being issued, Virgin Blue suggested that the Proposed Arrangements should only be authorised if it, or someone else, had actually entered the market on a substantial scale.

12.82. From the Commission's perspective, the issue at hand is not whether Qantas and Air NZ aggressively compete (within the limits of the Act) against the entry of Virgin Blue or any other carrier in the trans-Tasman market. Rather, the issue is whether or not the combined power of those two airlines under the Proposed Arrangements increases the barriers to entry.

12.83. While the introduction or deployment of a low cost airline by Qantas and/or Air NZ need not necessarily be anti-competitive, the deployment of any airline capacity can potentially raise issues under the Act depending upon how price and capacity are handled.

12.84. The Commission does have a concern, however, with the potential impact of the combined resources of Air NZ and Qantas under the Proposed Arrangements. Under the Proposed Arrangements, the Alliance partners can strategically allocate their resources in such a way as to maximise the competitive pressure on Virgin Blue at the critical early stage of entry while at the same time minimising the financial risk associated to either partner, especially the risk to Air NZ whose capacity to absorb losses on the trans-Tasman route is certainly lower than that of Qantas. The Applicants have offered to facilitate Virgin Blue's entry to the market through behavioural undertakings. The Commission will examine these and other proposed undertakings later in this Determination.

12.85. Without the Proposed Arrangements, each of Qantas and Air NZ would need to develop competitive strategies which not only take account of Virgin Blue as a competitor but also of each other. Under these circumstances, Virgin Blue could expect to face an easier entry. Air NZ's ability to compete in a capacity war, without the support of Qantas, would be significantly diminished.

<u>Competitive constraints</u>

12.86. The Applicants submitted that the current level of competitive constraint from fifth freedom carriers on trans-Tasman routes operates as a sufficient constraint. In addition to the high likelihood of entry by Virgin Blue (and the threat of other new entrants in the very near future), continuing expansion by fifth freedom carriers will provide an additional significant and recognised constraint.

- Fifth freedom carriers

12.87. While the Commission believes that fifth and sixth freedom carriers can provide a source of strong and effective competition in passenger markets, as they do in the Australia-Europe market, it does not believe that fifth freedom carriers are a strong competitive constraint in the trans-Tasman market. Their aggregate market share of the New Zealand-Australia origin/destination market is quite small at around five to six per cent compared with the combined power of the Applicants' market share of around 90 per cent.

12.88. Many airlines have the bilateral right to operate the trans-Tasman market including Singapore Airlines, which the Applicants described as one of the strongest carriers in the region. Singapore Airlines is able to extend every Singapore-Australia flight to New Zealand. However, the fact remains that most of these carriers, including Singapore Airlines, have chosen not to enter the trans-Tasman market.

12.89. Fifth freedom carriers are also constrained by lack of access to feeder traffic at both ends of the trans-Tasman market and they usually only operate a limited number of city pair routes as wide bodied aircraft and airport access act as operating constraints.

12.90. The availability of fifth freedom capacity is determined by the volume of through passenger traffic. The Applicants for example described the move by Malaysia Airlines to route its five Auckland-Kuala Lumpur B747 services per week via Brisbane as resulting in increasing trans-Tasman capacity from zero to 2,010 seats. This example, however, fails to recognise that a large percentage of those seats will be taken up by Auckland-Kuala Lumpur through passengers.

12.91. Importantly, fifth freedom carriers cannot be relied upon to be a permanent part of the trans-Tasman market. Fifth freedom operators could quickly depart the market if developments occur which impact on their third and fourth freedom operations with Australia, or if Air NZ or the fifth freedom carrier commences direct services to the home port of the fifth freedom carrier. A confidential submitter suggested that if Air NZ commenced direct operations to Bangkok it is likely that Thai Airways would curtail its fifth freedom operations across the Tasman.

12.92. Also, as suggested by Virgin Blue, a fifth freedom carrier in the trans-Tasman market is not an active competitor in the sense that it does not determine its schedules and operations in response to price and capacity signals from dedicated carriers.

12.93. The Commission notes that Emirates commenced flying into New Zealand from Australia from 1 August 2003. In June 2003, Emirates announced that it would extend its current daily flights to Sydney and Melbourne to Auckland, providing seven return flights weekly from Sydney and Melbourne. Emirates also announced that, from October 2003, daily flights to Brisbane would also be extended to Auckland. Passenger capacity on each flight will be 380, with cargo capacity between 17 and 20 tonnes.[65]

12.94. Significantly, it appears that Emirates' schedules will appeal to business travellers and are consistent with "peak periods". Emirates have also

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[65] Emirates (2003), "Emirates to fly to New Zealand from August 1", *Emirates Press Release,* 9 June 2003.

announced that trans-Tasman return economy fares will start at $505 for departures from Sydney and $575 for departures from Melbourne.[66] It remains to be seen what impact Emirates will have on the trans-Tasman market and whether a wide bodied aircraft with a three class product is sustainable in the longer term, especially in the face of lower fares of the style introduced on the route by the Air NZ with its Tasman Express service. Emirates can leave the market just as quickly as it entered. It would be premature of the Commission to recognise Emirates as providing a significant long term competitive constraint to the Proposed Arrangements at this stage.

- Virgin Blue

12.95. The Applicants have suggested that Virgin Blue will provide a significant competitive constraint on its entry into the trans-Tasman market by virtue of its strong financial backing, low cost structure, focus on trunk routes and brand recognition.

12.96. Virgin Blue has stated unequivocally to the Commission that it will enter the trans-Tasman market with or without the Proposed Arrangements. The issue for the Commission, therefore, is how effective a competitive constraint Virgin Blue would be against the combined power of the Applicants under the Proposed Arrangements in comparison to the structure that would be likely to exist without the Proposed Arrangements.

12.97. Virgin Blue has stated that the timing and scale of its entry will depend on barriers to entry in the form of access to facilities and the strategic capacity and pricing conduct of Air NZ and Qantas. The Commission has examined these issues and agrees that the Applicants have an incentive and the ability to impede the entry of Virgin Blue into the trans-Tasman market.

12.98. The Applicants, through the NECG Report, have suggested that they expect Virgin Blue to enter the market if the Proposed Arrangements proceed, with five aircraft and 7,380 seats each way per week in Year 1 building to eight aircraft and 11,340 seats per week by Year 3. For its part, Virgin Blue suggested that it would not achieve the growth levels predicted by the Applicants, but instead indicated its belief that it is possible to achieve a one third market share in the trans-Tasman market over time, albeit not within the time frame this share was achieved in the Australian domestic market.

12.99. Based on the Applicants' estimation of their schedules if the Proposed Arrangements are approved and if the assumption about Virgin Blue's presence is proved correct (this is effectively a best case scenario in terms of the level of Virgin Blue's competitive constraint), the Applicants would be operating at almost six times the capacity of Virgin Blue in Year 1 and four times its capacity in Year 3.

[66] Daniels, Chris (2003), "No surprises as Emirates reveals trans-Tasman fares", *The New Zealand Herald*, http://www.nzherald.co.nz, 25 June 2003.

12.100. While such an outcome would mean that Virgin Blue had emerged as a competitive factor in the trans-Tasman market, it does not necessarily follow that Virgin Blue could be regarded as a significant competitive constraint on the Applicants.

12.101. The Commission believes that while some regulatory barriers are not high, the chances of a new entrant other than Virgin Blue going on to the trans-Tasman market, even in the absence of the Proposed Arrangements, is extremely low. The route is one that is characterised by the Applicants as highly competitive at the moment and it is suggested that both airlines are loss making. Any new entrant would come into the market facing increasing competition between Air NZ and Qantas and the further threat of Virgin Blue.

12.102. For a start up airline, non-regulatory barriers to entry are high and it is difficult to imagine how a prospective operator would raise the level of capital necessary to be a serious competitor in the current investment environment given the financial position of the aviation industry globally. The Commission notes that successful airline start-ups are not a feature of this route even in less demanding times.

12.103. Barriers to entry for an established carrier are lower than for a start-up airline, however, there is not a logical established candidate in sight. The Applicants emphasised the importance of having a presence in both the Australian and New Zealand domestic markets as a prerequisite to success in the trans-Tasman market. Virgin Blue aside, there are no domestic operators of a stature in either country such as to be considered potential entrants.

12.104. For the reasons described above the likelihood of a new entrant is even less likely under the Proposed Arrangements, when also considered in the context of strategic barriers to entry.

Submissions on anti-competitive detriment in the trans-Tasman passenger transport market provided since the Commission issued its Draft Determination

<u>The Applicants</u>

12.105. The Applicants submitted that they had provided the Commission with evidence that:

- fifth freedom carriers represent ten per cent of the capacity on the trans-Tasman and have the capacity to expand if conditions are attractive and that expansion by Virgin Blue onto Tasman routes is certain;

- economic modelling demonstrates Virgin Blue's profitability based on the forecasted scale of entry; and

- empirical studies by the US DOT have shown that low levels of entry by a VBA such as Virgin Blue have a significant effect.

12.106. The Applicants submitted that there is no basis for the Commission to discount claims by Virgin Blue that it will enter the Tasman and domestic New Zealand and will be a significant competitor to Qantas and Air NZ.

12.107. The Applicants submitted that the Commission draws inappropriate conclusions from projected capacity and market shares for Virgin Blue. The Applicants submitted that VBAs provide a significant competitive constraint for FSAs even where their relative market shares are small. The Applicants further submitted that this is consistent with experience in Europe, Australia and Canada.

12.108. The Applicants submitted that Virgin Blue's entry in the Australian domestic market has had an impact on consumers and competitors well in excess of its market share and that the Commission should not dismiss the potential Virgin Blue has to materially constrain the conduct (in particular, pricing) of the Applicants on the trans-Tasman and domestic New Zealand markets.

12.109. The Applicants submitted that, in its Draft Determination, the Commission formed an erroneous conclusion that the Proposed Arrangements are highly anti-competitive on trans-Tasman routes.

<u>Qantas</u>

12.110. Qantas made a submission to the Commission specifically addressing issues surrounding the Commission's view on barriers to entry in the trans-Tasman.

12.111. Qantas submitted that it rejects the Commission's conclusion, as expressed in its Draft Determination, that certain potential barriers to entry and expansion are substantial. Qantas submitted that analysis of entry or expansion barriers will be unfairly distorted if it is undertaken in relation to those least likely to enter, rather than with reference to a complete range of potential participants.

12.112. Qantas submitted that *"the fact that Virgin Blue has confirmed that it will be entering the trans-Tasman and domestic New Zealand routes regardless of whether the Alliance proceeds supports the conclusion that a purely theoretical analysis of entry and expansion barriers based on the status quo is of limited relevance."*

12.113. Qantas submitted that the Commission focuses its analysis on start-up airlines and does not look at the real world. Qantas submitted that the real world view of the height of barriers to entry or expansion must be judged by reference to the obstacles facing Virgin Blue if the Proposed Arrangements were authorised. Qantas submitted that these obstacles are not material.

12.114. Qantas submitted that similar barriers to entry as those argued by the Commission to exist have also been argued to exist in Europe, the United States and Canada. Qantas submitted that, nonetheless, in each case there has been successful market entry by VBAs.

12.115. With respect to frequent flyer programs, Qantas submitted that international experience indicates that frequent flyer programs do not prevent or limit market entry and expansion by VBAs.

12.116. Qantas submitted that there is an inconsistency in the Commission's arguments regarding access to feeder traffic as it appears to dismiss Qantas' arguments regarding the importance of domestic New Zealand feeder traffic in the context of network benefits, however, in relation to barriers to entry, the Commission highlights the importance of feeder traffic and notes that lack of access can limit an operator's customer base.

12.117. Qantas submitted that, with respect to Virgin Blue, it is able to pursue its own sources of international feed.

Virgin Blue

12.118. Virgin Blue submitted that its presence in the Australian domestic market has ensured that there continues to be a downward trend in discount pricing even though there have been only two principal competitors after the collapse of Ansett and Impulse. Virgin Blue acknowledged that it has had little impact on domestic business fares but with increased frequencies, an increasingly integrated network of operations and initiatives embracing flight lounges, a frequent flyer program and valet parking it expects to grow the number of business customers it carries.

12.119. Virgin Blue attributed the competitive constraint it imposes on Qantas to its low cost model which supports a business plan premised on offering low fares to generate demand in order to grow the market and ensure a large volume of passengers. Virgin Blue suggested that it will tend to offer prices significantly lower than the prices of an FSA on a route regardless of the level of competition on that route.

12.120. Virgin Blue suggested that, on this basis and with appropriate undertakings and conditions in place, it will relatively quickly achieve a scale that will be sufficient to impose an effective competitive constraint on the Applicants under the Proposed Arrangements even though the market share of the Applicants will be significantly larger than that of Virgin Blue. The undertakings referred to (examined in greater detail at 14.68 to 14.71 below), include the divesture of Freedom Air by Air NZ, the removal of capacity constraints at relevant airports and constraints on the ability of the Applicants to engage in predatory or strategic conduct.

12.121. Virgin Blue acknowledged that its growth in the Australian domestic market was strongly assisted by specific factors including the collapse of Impulse and Ansett. It is claimed that acceptance of the undertakings it proposes would assist it in achieving a similar growth in the trans–Tasman market. Virgin Blue supplied confidential data showing anticipated schedules and projected growth in market share under these circumstances.

12.122. Virgin Blue submitted that with suitable undertakings and conditions in place it can impose a significant competitive constraint on the Alliance which would greatly reduce the anti-competitive detriment identified by the Commission.

12.123. Virgin Blue was not able to advise the Commission on its rate of growth in the trans-Tasman market if the Proposed Arrangements were not to proceed and Virgin Blue did not benefit from the requested undertakings and conditions. Virgin Blue advised that the rate of allocation of aircraft to routes was heavily influenced by where they could be used most effectively. Virgin Blue would have a range of international and domestic routes to consider when deploying new aircraft acquisitions.

Gullivers Pacific Group

12.124. GPG submitted that, in relation to the Commission's views on barriers to entry in the relevant markets, it agrees with the view expressed in the Draft Determination that barriers to entry are not low, nor are they likely to be low for some time.

12.125. GPG submitted that the experiences of Compass Airlines, Kiwi International, Ansett New Zealand and Qantas New Zealand do not auger well for other airlines without the resources and facilities to compete with a combined Qantas and Air NZ under the Proposed Arrangements where it has been demonstrated in the past that airlines have struggled to cope with these strong airline brands individually.

The Commission's view of detriment in the trans-Tasman market

12.126. The Commission has been asked to consider the Proposed Arrangements on the basis of assumptions and assertions made by the Applicants not only as to their future behaviour but also as to the future behaviour of their competitors. To make an assessment of anti-competitive detriment associated with the Proposed Arrangements solely on the basis of those assumptions and assertions put forward by the Applicants would be to imply that the Commission accepted those were the only possible outcomes. The Applicants quite obviously have an incentive to portray the future in the way that enhances the acceptability of the Proposed Arrangements.

12.127. As stated in its examination of the counterfactual (see Part 11 above) the Commission does not believe that the behaviour postulated by the Applicants absent the Proposed Arrangements is the only possible, or most likely, outcome. The Commission will examine detriment against the status quo, subject to natural growth and likely market behaviour and reactions.

Current market structure

12.128. The primary competitive pressure in the trans-Tasman market comes from the Applicants (holding a joint 90 per cent market share) and, Virgin Blue aside, there is little realistic prospect of new entry by a third/fourth freedom into the market in the medium term. The Commission sees an inconsistency between arguments from the Applicants which claim low barriers to market entry while at the same time predicting the inability of an established carrier such as Air NZ to remain in the market.

12.129. The Applicants have re-affirmed the presence of fifth freedom operators on the trans-Tasman route as a significant contributor to competition on the route. However for reasons discussed earlier including low market share, lack of feeder access, limited flexibility, and restricted route access arising from the use of wide-bodied aircraft the Commission believes that fifth freedom carriers do not impose, either individually or collectively, a significant competitive constraint on the Applicants in the current environment.

12.130. The Commission is aware that Emirates is commencing daily fifth freedom operations to Auckland from Sydney, Melbourne and Brisbane in the second half of 2003 with large capacity aircraft. It remains to be seen whether such operations are sustainable before they can be taken into account and viewed as a permanent feature of competition in the trans-Tasman market.

12.131. The Commission notes that in July this year Virgin Blue obtained approval from the IASC to operate services between Australia and New Zealand, Fiji and Vanuatu. Virgin Blue indicated to the IASC that it plans to commence services from October 2003.

12.132. An important element of the Commission's assessment of the anti-competitive detriment arising from the Proposed Arrangements is the rate at which Virgin Blue enters the trans-Tasman market. The Applicants have submitted that even a low level of entry by a VBA such as Virgin Blue has a significant affect. The Commission accepts that VBAs can have an early impact on fares for certain categories of passengers but considers that factors such as route breadth and flight frequency are still relevant factors in determining the effectiveness of a VBA's competitive presence.

12.133. Virgin Blue has provided details of projected schedules and market shares under circumstances where the Proposed Arrangements proceeded and Virgin Blue's requests for undertakings and conditions were met. These schedules and shares assume the divestiture of Freedom Air to Virgin Blue. Given that Air NZ has indicated it is not prepared to cede Freedom Air to Virgin Blue, these figures do not provide a guide to the Commission.

12.134. Virgin Blue has not provided the Commission with details of the rate at which it will enter the trans-Tasman market without acquiring Freedom Air. The Commission does not believe that Virgin Blue would expand on the trans-Tasman route at the same pace as it expanded in the Australian domestic market following the failure of Ansett Australia. However, the Commission does believe that the nature of its operations is such that with time it is likely that Virgin Blue is likely to establish itself as a permanent component of the trans-Tasman market.

12.135. Virgin Blue has cited access to terminal facilities as a factor impeding its entry onto the Auckland route. While the Applicants have offered undertakings to facilitate access in this area the Commission must consider the offer of undertakings in the context of its overall assessment of the Proposed Arrangements. The Commission's view on the likely success of these undertakings in allowing for VBA entry and limiting anti-competitive effects is discussed in Part 14 below.

12.136. Given that Virgin Blue will be in the market whether or not the Proposed Arrangements proceed there is a need to examine the detriment in going from a three carrier (excluding fifth freedom carriers) to a two carrier market. While the Applicants have concentrated their submissions on the entry of Virgin Blue as a force in maintaining competition in the market and acting as a competitive constraint on the Proposed Arrangements there is another aspect to the Proposed Arrangements which is the loss of competition between two FSAs on the route.

12.137. The Proposed Arrangements will lead to a loss of competition between the only two network carriers on the route. In the first instance this will remove price and quality of service competition for passengers who require network connections either internationally, including through global market alliances, or domestically in Australia or New Zealand. Virgin Blue is essentially a point to point carrier which does not link effectively with network carriers.

12.138. While some travellers respond to the lower cost regime of VBAs there are others, especially those travelling internationally, who seek an FSA experience. Included in this category are business travellers who are highly sought after by airlines because of the fares they pay, the repeat business they generate and their substantial contribution to airline yield. The Qantas domination of the Canberra-Sydney route, a route dominated by business travel passengers, reflects this experience, even in the face of competition from Virgin Blue. Information provided by the Applicants shows that on the Auckland and Wellington routes, for example, business travel accounts for between 35 per cent and 39 per cent of travellers.

12.139. The Applicants have argued that Virgin Blue will be an effective competitor for business travellers, especially where cost is a priority. For business travellers with service priorities there will be a loss of competition on price and service between FSAs. Virgin Blue has drawn the Commission's attention to statistics[67] produced by DTRS which show that the advent of Virgin Blue has not impacted on business class or full economy fares. The importance of these passengers can be noted from the retention of a two class product across the Tasman by Qantas in its Jet Connect services even in the face of Virgin Blue's entry into the market.

12.140. Absent the Proposed Arrangements there would be increased competitive tension in the trans-Tasman market at all passenger levels following the entry of Virgin Blue with all passengers, even business passengers, benefiting from competition between three airlines. Such circumstances would provide an environment for innovation, change and efficiency. Innovative responses to competition such as the Air NZ Express service, which arose from the pressure of domestic competition from Qantas and was extended to the trans-Tasman route, would be less likely under the Proposed Arrangements.

[67] Page 6 of Virgin Blue submission of 9 May 2003.

12.141. Similarly the deployment of Freedom Air as an effective low cost response to Virgin Blue is unlikely to occur under the Proposed Arrangements. The Applicants have stated that the expansion of Freedom Air would result in the unacceptable cannibalisation of Air NZ revenue. Such a response implies that Air NZ's revenue on the trans-Tasman would be unlikely to be impacted by the entry of Virgin Blue to the extent that it would need to consider low cost competition options. This response not only reflects on the competition impacts of Virgin Blue on the Proposed Arrangements, it also suggests that under the Proposed Arrangements consumers could be denied strong competition on the Tasman between the low cost arms of the two FSAs. Such competition, undertaken fairly, would be beneficial to consumers.

12.142. Under these circumstances, the Proposed Arrangements could be expected to be highly anti-competitive on the trans-Tasman route and likely to lead to outcomes such as higher prices for various passenger groups, reduced capacity and quality of service levels, and scheduling and service outcomes that benefit the airlines rather than consumers.

12.143. Virgin Blue's entry into the trans-Tasman market can be expected to lead to competition in some fare categories for some passenger groups on some routes. However, it may be some time before Virgin Blue develops its competitive presence in the market through route coverage and frequencies.

Market as assumed by the Applicants

12.144. The assumptions made by the Applicants as to how the market would look in terms of schedules and capacity under the Proposed Arrangements and their assumptions as to the level of Virgin Blue's entry tend to inflate the market power of Virgin Blue. The Applicants have indicated that they would reduce capacity on the route relative to the counterfactual in the first year (despite natural growth of four per cent per annum in the market). Under the Applicants' assumptions, Virgin Blue enters the market with five aircraft, moving to eight in the second year. These assumptions would see Virgin Blue achieve an estimated 13 per cent market share in the first year and 19 per cent in the second. The Applicants would have market share of 77 per cent and 73 per cent respectively in those years.

Conclusion on the trans-Tasman market

12.145. In light of the Commission's position that there would be a low probability of competitive pressures from airlines other than Virgin Blue entering the market, even with the assumptions made by the Applicants, the Commission's view is that the Proposed Arrangements result (in the short to medium term) in an outcome in the trans-Tasman market which sees a substantial lessening of competition, gives the Applicants substantial market power, is highly anti-competitive and would have a detrimental impact on the public in areas such as price, service, product choice and innovation.

International passenger transport markets: North America

The relevance of the Proposed Arrangements to this market

12.146. In the submission supporting their Applications, the Applicants indicated that the Proposed Arrangements would not apply in respect of the market between Australia and North America unless and until all of the relevant parts of an alliance agreement between United and Air NZ came to an end. They indicated that there would be no impact on competition in this market until that time.

12.147. Nevertheless, the projections of schedules anticipated to be operated by the airlines under the Proposed Arrangements showed that Air NZ would cease providing services between Sydney and Los Angeles from Year 3 of the Strategic Alliance, an outcome that differed from the schedules projected to operate without the Proposed Arrangements.

12.148. On this basis, the Australia-North America route certainly featured in the Applicants' operating plans under the Proposed Arrangements. Despite this, the Applicants say very little about the route in their supporting submission except that the anti-competitive effect in this market as a result of the Proposed Arrangements is likely to be minimal, predominantly for the reason that barriers to entry on routes between the two countries are low and United is the main competitor to the Applicants in that market.

12.149. The Applicants said in their submission of 9 December 2002 that they would provide further information regarding the likely competitive effect in this market of the impact of United filing for Chapter 11 bankruptcy protection. Such material was not provided to the Commission, probably because of the withdrawal of Air NZ from the Sydney-Los Angeles route effective from 27 April 2003. This withdrawal follows the withdrawal of United from the Auckland-Los Angeles route. At this time, Air NZ transferred its capacity from the Sydney route to the Auckland route.

12.150. The Commission notes recent reports that United is likely to be released from Chapter 11 bankruptcy protection earlier than originally thought.

12.151. The press release of 10 February 2003 announcing Air NZ's withdrawal from the Sydney-Los Angeles route described it as a "suspension" of services with the airline prepared to re-enter the market if market conditions improve. Air NZ also announced it would be code sharing with United on the Sydney-Los Angeles route.

12.152. While not suggesting that it is likely to happen, the Commission considers that if United ever left the Australia-North America route, Air NZ would be one of the few airlines positioned and able to enter the market.

Market concentration

12.153. Table 12.2 below shows airline passenger market shares for direct services between Australia and North America for the year 2001/02.

Table 12.2 North America passenger traffic by airline: 2001/02[68]

Airline	Market share (%)
Air Canada	10.0
Air NZ	8.2
Qantas	51.7
United Airlines	30.0
Total	*100.0*

12.154. It is possible to travel to North America indirectly, for example, through Asia. However such options are generally unattractive to consumers as they involve stopovers and much longer flight times than direct services. United has advised that a direct flight from Sydney to Los Angeles takes around 14 hours and 30 minutes. The shortest elapsed time on an indirect flight is around 24 hours.

12.155. Table 12.2 above shows that the Applicants had a combined market share in 2001/02 of nearly 60 per cent. Air Canada offers direct services only to Hawaii and Vancouver but not to the United States' mainland.

Barriers to entry

12.156. The Commission does not agree with the Applicants' claim that, because barriers to entry are low, the anti-competitive impact of the Proposed Arrangements is minimal. The Commission is of the view that, while for third and fourth freedom operators, that is, North American and Australian designated carriers, some regulatory barriers are not high, the prospect of new carriers entering the market is extremely low.

12.157. As discussed earlier in respect of the trans-Tasman market, the prospect of a start up airline entering this (or any other) market are minimal in the current investment environment, even more so from the North America side. There are no apparent established Australian carriers who could enter the market. Virgin Blue is structured toward short haul rather than long haul routes. United has indicated in a submission that it and American Airlines are the only US carriers with a relatively strong presence on the American West Coast. United noted that American Airlines is not equipped for trans-Pacific operations as it relies on B777 aircraft for its long haul operations (even if it was inclined to compete against its **one**world partner Qantas).

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[68] Source: Department of Transport and Regional Services.

12.158. The only other prospect for competition on the route would come from fifth freedom carriers if they had rights beyond Australia. If negotiations on an "open skies" agreement between Australia and Singapore, for example, were successful this would be a step toward the possibility of Singapore Airlines being able to offer direct services between Australia and North America. It remains to be seen if such a proposition is commercially attractive for Singapore Airlines bearing in mind the recent departure from the route of a relatively low cost carrier in Air NZ.

Submissions on anti-competitive detriment in the North America passenger transport market provided since the Commission's Draft Determination

The Applicants

12.159. The Applicants submitted that, in both the factual and counterfactual, Air NZ will not operate flights between Australia and North America and that, therefore, the Proposed Arrangements have no impact on this market. The Applicants submitted that, taking into account its submission with regard to the impact of the loss of Ansett on the profitability of Air NZ's flights between Australia and North America, the Commission's position on the likelihood of Air NZ's re-entry outlined in its Draft Determination is unfounded and leads to the erroneous conclusion that the Proposed Arrangements result in significant anti-competitive detriment on the North America route.

12.160. The Applicants also submitted that it is more than likely that United will successfully restructure and be released from Chapter 11 bankruptcy protection and be a credible and formidable competitor on the Pacific.

The Commission's view of detriment in the North America market

12.161. The Proposed Arrangements, as evidenced by proposed schedules under the Alliance, see Air NZ depart the Australia-North America market. When Air NZ left the market early in 2003 (in a decision independent of the Proposed Arrangements) it said that it would re-enter the market if conditions improved. Air NZ has subsequently said it would not re-enter the market.

12.162. The Commission notes that the only two direct competitors to Qantas on the route, United and Air Canada are both experiencing financial difficulties. The Applicants have suggested that it is *"more than likely"* United will emerge from Chapter 11 a stronger competitor on the route, citing a filing with the U.S. Securities Exchange Commission on 2 May 2003. The Commission notes that on 16 May 2003 the Chairman of United described[69] the airline as *"a company that has made recent progress, but has a long way to go on our climb back to financial stability"*.

12.163. In the absence of any other carrier being likely or able to enter the market (fifth freedom carriers notwithstanding), the Proposed Arrangements would

[69] Remarks of United Chairman and Chief Executive Officer John Creighton at the United Airlines Annual Meeting, 16 May 2003.

ensure that Air NZ would not re-enter the market, regardless of conditions. Likewise, if circumstances arose where current players were forced to leave the market, the Proposed Arrangements would ensure that Air NZ, the most likely potential competitor to Qantas on services to North America, did not enter the market.

12.164. For the above reasons, the Commission has formed a view that the Proposed Arrangements have an anti-competitive detriment on the North America route.

International passenger and freight markets: Pacific Islands

Fiji

12.165. The Applicants have sought authorisation for a Cooperation Agreement with Air Pacific. The Cooperation Agreement between Qantas, Air NZ and Air Pacific allows the parties to cooperate on aspects of passenger and freight services including with respect to pricing and scheduling.

12.166. The main operations of Air Pacific that are relevant to the Commission's assessment of detriment are those between Australia and Fiji where Air Pacific is currently the only direct operator.

12.167. The Commission notes that Qantas is a 46.32 per cent shareholder in Air Pacific and code shares on Air Pacific services between Australia and Fiji. The other shareholders are Air NZ (1.97 per cent) and Air Pacific (51 per cent).

12.168. The Commission's view is that the Cooperation Agreement will not result in anti-competitive detriment in the Fiji market.

Tonga and Samoa

12.169. It is possible that the Proposed Arrangements could impact on the performance and viability of Polynesian Airlines which provides services between Australia and Tonga (directly) and Australia and Samoa (over New Zealand).

12.170. Qantas code shares on Polynesian and provides technical and operational support for the airline. The main competitor of Polynesian is Air NZ, which competes on all routes operated by Polynesian.

12.171. There is a question as to whether Qantas would continue its support for Polynesian under the Proposed Arrangements and whether Polynesian could survive without that support.

12.172. Given that the predominance of the competition between Polynesian and Air NZ occurs in markets involving New Zealand, the issue of whether the Proposed Arrangements are detrimental in terms of their impact on Polynesian Airlines and the markets in which it participates is a matter more relevant for the consideration of the NZCC.

12.173. The Commission notes, however, that there is the potential for the Proposed Arrangements to be anti-competitive as they may ultimately lead to the withdrawal of Polynesian Airlines from the Tongan and Samoan markets.

International freight transport

Anti-competitive detriment comments made by the Applicants

12.174. The Applicants submit that the following factors are relevant to the assessment of the competitive impact of the Proposed Arrangements on the relevant markets:

- market concentration;
- barriers to entry and expansion;
- competitive constraints imposed on the Applicants; and
- other indicators of market structure and conduct.

12.175. However, the Applicants' discussion of each of the above factors focused primarily on the passenger air services market, with little discussion relating specifically to the air freight services market.

12.176. The Applicants acknowledged that the Proposed Arrangements will give rise to some detriment, in the form of slightly higher prices and lower capacity in the medium term (when compared with their view of the position without the Proposed Arrangements) in a number of key markets where the Applicants are the primary providers of air passenger and air freight services. The markets are the trans-Tasman market and the Australia-North America market.

12.177. However, the Applicants submitted that the freight market is highly competitive and any anti-competitive detriment arising from the Proposed Arrangements would be ameliorated by:

- Low barriers to entry and no barriers to expansion: The Applicants are of the view that potential new entrants in the freight market face low barriers to entry and no barriers to expansion as many of the alleged barriers to entry in respect of the passenger air services market, such as marketing and advertising outlays, brand loyalty and frequent flyer programs, are low or non-existent in the freight market. The Applicants submitted that specialised freight carriers could therefore readily enter or expand, thereby defeating any attempt by the Applicants to increase prices in this market.

- The presence of numerous competitors: The Applicants submitted that any Australian or New Zealand carrier is free to establish unlimited freighter services on the trans-Tasman and further services may be provided by the many foreign carriers which have fifth freedom freighter rights on the trans-Tasman route. Australia and New Zealand have also exchanged unlimited seventh freedom cargo rights with the

United States. This allows United States' freight carriers to freely operate standalone services on the trans-Tasman and on other international routes to and from both New Zealand and Australia.

12.178. The Applicants concluded that these factors will ensure that Qantas and Air NZ will be constrained from increasing prices or reducing capacity and therefore that the Proposed Arrangements are unlikely to result in any reduction in competition in the market for freight services.

Interested party views on anti-competitive detriment

12.179. AFCQ submitted that it is vital to the continued development of air cargo and trans-Tasman trade that the industry is provided regular wide-bodied passenger services between Australia and New Zealand and vice versa. AFCQ is of the view that, based on current operation costs, revenue and traffic flows, it is generally accepted that the operation of dedicated freighter aircraft is not economically viable.

12.180. AFIF submitted that, currently, most of the air cargo transported in the trans-Tasman market is carried in aircraft pallets and other unit load devices in the belly holds of passenger aircraft. The use of unit load devices and the associated handling systems greatly improves the efficiency and speed of cargo handling at both ends of a flight and ultimately provides a beneficial effect to the consumer.

12.181. AFIF submitted that the shift towards the use of narrow-bodied aircraft will reduce overall capacity and eliminate the use of unit load devices. AFIF submitted the view that that removal of pallets and the reliance on loose handling of cargo will produce "unimaginable congestion" in airport cargo handling terminals which are already struggling to cope with demand.

12.182. AFIF considered that the present freight carriers operating wide-bodied aircraft will not be able to supplement any loss of belly hold capacity resulting from the introduction of narrow-bodied aircraft. Additionally, AFIF considered that the entry of Virgin Blue would not affect overall capacity in the air freight services market as Virgin Blue operates narrow-bodied aircraft.

12.183. IINZ is opposed to the Proposed Arrangements and submitted that they would have the effect of reducing capacity and increasing freight rates. IINZ submitted that the Proposed Arrangements would entrench Qantas and Air NZ in a dominant position in the New Zealand domestic and trans-Tasman markets, to an extent that would deter future competitors from entering those markets.

12.184. Rex submitted that it is concerned that the Proposed Arrangements will result in most freight forwarders having to purchase belly space from one provider. Rex submitted that the increased market power of the Proposed Arrangements would diminish opportunities for Rex to carry freight on its network as all trans-Tasman freight will flow onto Qantas' regional subsidiaries or regional partner airlines. Rex formed the view that the possible entry of Virgin Blue into the market may not alleviate this situation, given that it has not focused on freight carriage and its aircraft do not have significant freight capacity.

12.185. Virgin Blue and Frontier Economics submitted that the Applicants have failed to identify a likely detriment in that the Proposed Arrangements are likely to have a similar effect on freight services as they have on passenger services, namely to increase prices and reduce capacity. Frontier Economics concluded that the key factor that may lessen/reduce the detriment caused by the lessening of competition would be the prospect of entry into the market(s) by another airline, providing that entry were on a scale that would effectively replace the rivalry that the Proposed Arrangements are designed to destroy.

Market concentration

12.186. While the Applicants noted that market concentration is a relevant factor to be considered in the assessment of the likely competitive impact of the Proposed Arrangements, the Applicants did not provide in their Submission any market share data in respect of the air freight services for either the trans-Tasman or Australia-North America markets.

Table 12.3 Freight tonnage in the trans-Tasman and Australia-North America market, market share by airline: 1999-2002[70]

	Market Shares (%)*			
	1999	2000	2001	2002
To/from New Zealand				
Air NZ	46.7	45.5	41.9	37.4
Qantas Airways	37.6	32.9	31.8	35.7
Asian Express Airlines	5.6	5.7	6.5	6.9
Thai Airways International	2.2	2.9	5.8	5.6
Cargolux Airlines International	0.0	2.9	5.3	5.0
Lufthansa Cargo	0.0	0.0	0.7	2.5
United Airlines	4.5	2.1	0.9	2.4
Singapore Airlines Cargo	1.7	1.8	2.0	2.0
Garuda Indonesia	0.6	0.6	0.4	1.2
Other	1.1	5.6	4.7	1.3
Total	*100.0*	*100.0*	*100.0*	*100.0*
To/from North America				
Qantas Airways	41.2	38.6	19.6	20.5
Federal Express Corporation	12.5	14.0	17.9	20.1
United Airlines	15.1	13.4	15.4	17.0
Polar Air Cargo	15.3	13.3	13.1	10.2
Lufthansa German Airlines	0.0	0.0	1.7	7.4
United Parcel Service	3.0	3.8	5.6	7.1
Air NZ	8.7	13.6	7.1	5.8
Evergreen International Airlines	0.0	0.0	17.6	5.2
Air Canada	0.0	0.0	1.5	4.8
Gemini Air Cargo	0.0	0.0	0.0	2.0
Other	4.2	3.3	0.5	0.0
Total	*100.0*	*100.0*	*100.0*	*100.0*

* These figures are based on port of uplift or discharge, rather than on the country of origin or destination of the cargo

12.187. Table 12.3 above provides a market share analysis of implications of the Proposed Arrangements in the relevant markets using data from DTRS.

12.188. On the basis of freight tonnage carried in 2001/02, if the Proposed Arrangements are authorised, the Applicants would have a market share of the order of 73 per cent in the trans-Tasman air freight market. The Applicants' largest competitor would have a market share of the order of seven per cent. Given the substantial difference in market share of the Applicants and their competitors if the Proposed Arrangements were authorised, the Commission considers that, absent ameliorating factors, the Proposed Arrangements would confer market power on the Applicants at levels that, in the context of other factors affecting competition (discussed

[70] Source: Department of Transport and Regional Services, Bureau of Transport and Regional Economics, *Air Transport Statistics*, 2000-01 and 2001-02.

below), would enable them to exert influence on the supply and pricing and competition in trans-Tasman air freight services.

12.189. While Qantas has held the highest market share of air freight in the North America market for the past four years, its market share has decreased during this period. At the same time, the market shares of dedicated freight carriers such as Federal Express and United Parcel Service have increased. During the past four years, Air NZ has not been a significant participant in the carriage of air freight between Australia and North America and its market share has decreased. The Commission also notes that Air NZ withdrew from flying to North America on from 27 April 2003.

12.190. If the Proposed Arrangements were authorised, the Applicants would have a combined market share in the North America market of the order of 26 per cent on the basis of freight tonnage in 2001/02. The structure of the North America market, characterised by a number of competitors with significant market shares and a significant competitive presence from dedicated freight carriers (accounting for around 50 per cent of the market), suggests that its competitive dynamics would not be impacted by the Proposed Arrangements. Accordingly, the Commission intends to focus the remainder of its anti-competitive detriment analysis for air freight services on the trans-Tasman market.

<u>Barriers to entry and expansion</u>

12.191. The Applicants submitted that, generally, barriers to entry to the relevant markets, and therefore the trans-Tasman market, are low, while barriers to expansion are non-existent.

12.192. Similarly, the Applicants considered that many of the possible barriers to entry are low or non-existent in the air freight services market. The Applicants specifically mentioned that participants in the freight market do not face barriers to entry in respect of marketing and advertising outlays, brand loyalty and frequent flyer programs.

12.193. As discussed previously, the majority of air freight transported in the trans-Tasman market (around 85 per cent) is carried in the belly holds of passenger aircraft. Consequently, new entry into the passenger air services market results in an immediate increase in the belly hold space potentially available for freight carriage. It follows that, to the extent that barriers to entry constrain competition in the passenger air services market, they also constrain competition in the air freight services market.

12.194. The Commission accepts that barriers to entry and expansion may be lower for dedicated freight carriers than for their competitors who also carry passengers. However, the Commission notes that the four dedicated freight airlines operating in the trans-Tasman market have a combined market share of only around 16 per cent (see Table 9.3 above). Of the four dedicated freight airlines two (Cargolux and Lufthansa) operate the route as part of one way round the world services, one (Singapore) operates a triangular service (Singapore/Sydney/Auckland/Sydney) and only one (Asian Express) is dedicated to the trans-Tasman route. The relatively small market share of the dedicated freighters and the nature of their operations suggests that while entry may be possible, operating a freight airline dedicated to this route is not necessarily an attractive business proposition and any fall off in capacity or increase in prices on the route is unlikely to result in new entrant airlines coming onto the route. In any event, the Commission notes that, as a result of the current uncertain operating environment for airlines, new entry is unlikely.

Competitive constraints imposed on the Applicants

- Fifth and seventh freedom operators

12.195. The Applicants submitted that fifth and seventh freedom operators will impose a competitive constraint on the Applicants in respect of the trans-Tasman air freight services market.

12.196. Existing fifth freedom carriers flying regular scheduled passenger services include Thai Airways, Malaysia Airlines, Garuda Airlines, LanChile, Aerolineas Argentinas, Polynesian Airlines and Royal Tongan. Of these, only LanChile and Royal Tongan did not carry freight in the trans-Tasman market in 2001/02. While five fifth freedom carriers transported freight in the relevant market in 2001-02, the Commission notes that the combined market shares of these carriers is around 10.5 per cent, with Thai Airways accounting for just over 5.5 per cent on its own and United (which has subsequently withdrawn from the route) accounting for 2.4 per cent.

12.197. The Commission is aware that Emirates has commenced entry to the trans-Tasman route on a fifth freedom basis with wide bodied aircraft with significant cargo carrying capacity. However, as the Commission has indicated in relation to the trans-Tasman passenger market, only time will tell if Emirates can be regarded as a permanent feature of the trans-Tasman market. Any decision on the future of Emirates on the route is likely to be made on the basis of passenger operations rather than cargo operations.

12.198. As submitted by AFCQ, the fifth freedom airlines services are extensions of either European or Asian services which may have limited capacity for trans-Tasman specific cargo due to the through-load. In respect of services commencing in New Zealand, these airlines would carry European or Asian-destined cargo with a reduced opportunity to provide capacity for the carriage of New Zealand-Australia traffic. It is questionable, therefore, whether any of the fifth freedom carriers currently operating services on the trans-Tasman could provide any significant increase in capacity on their existing services.

12.199. The Applicants submitted that Australia and New Zealand have exchanged unlimited seventh freedom cargo rights with the United States which allows United States freight carriers to freely operate stand-alone services on the trans-Tasman and on other international routes to and from New Zealand and Australia. Again, the freight carriage capacity of these carriers is likely to be limited due to their through-load from international points of origin.

- Dedicated freight aircraft

12.200. The Applicants submitted that dedicated freight operators would impose a competitive constraint on their behaviour in the trans-Tasman air freight services market.

12.201. Data from the DTRS shows that in 2001/02, there were two freight-only operators in the trans-Tasman market, namely Asian Express Airlines and Cargolux Airlines International. In addition, two carriers who normally operate passenger services (although not in the trans-Tasman market) also operated dedicated freight services, namely Lufthansa German Airlines and Singapore Airlines.[71] Of the 113,000 tonnes of freight carried in the trans-Tasman market in 2001/02, around 18,500 tonnes, or 16 per cent, was carried on the dedicated freighter aircraft of these four airlines. On an individual basis, Asian Express Airlines holds the largest market share accounting for around seven per cent of the freight transported in the trans-Tasman market in 2001/02.

12.202. Given the relatively small market shares of the carriers operating dedicated freight services in the trans-Tasman market and the market structure and circumstances outlined above, the Commission considers it unlikely that any one of these four carriers is likely to constrain the competitive behaviour of the Applicants, or be able to respond effectively to any attempt by the Applicants to increase prices or reduce capacity.

- Market entry by Virgin Blue

12.203. The Applicants submitted that the possible or actual entry of Virgin Blue into the trans-Tasman market will impose a significant competitive constraint on the Applicants, although they focused their analysis on the impact of Virgin Blue's entry on the passenger air services market rather than on the air freight services market.

12.204. The Commission has previously addressed the likely impact of Virgin Blue's entry into the trans-Tasman market for passenger air services. In respect of the trans-Tasman air freight services market, the Commission is not convinced that Virgin Blue's entry will impose any constraint on the conduct of the Applicants if the Proposed Arrangements are authorised because Virgin Blue only operates narrow-bodied B737 aircraft which are unsuitable for the carriage of freight. The use of narrow-bodied aircraft is discussed further below.

<u>Other indicators of market structure and conduct</u>

- Introduction of narrow-bodied aircraft

12.205. As noted previously, the majority of air freight is transported in the belly holds of passenger aircraft. In particular, air freight is transported in the belly

[71] Department of Transport and Regional Services, Bureau of Transport and Regional Economics, *Air Transport Statistics International Airlines 2001-02.*

holds of wide-bodied passenger aircraft. Wide-bodied aircraft, such as B747s and B767s, are able to accommodate containers and carry large payloads. Narrow-bodied aircraft, such as B737s and A320s, cannot accommodate containers and do not have the same payload capability.

12.206. However, the Commission is also aware that narrow-bodied aircraft are generally better suited to short haul routes, such as those in the trans-Tasman market. These aircraft enable point to point services with rapid turn around times, resulting in a relatively high frequency of flights and a relatively low cost base.

12.207. In recognition of the relative efficiency of narrow-bodied aircraft on short haul routes, Qantas and Air NZ have already commenced the introduction of narrow-bodied B737 aircraft on some trans-Tasman routes. The Commission notes that Freedom Air only operates this aircraft type. Further, the Applicants have advised that Air NZ plans to replace wide-body B767 capacity with narrow-body A320 capacity with or without the Proposed Arrangements.

12.208. The Commission notes that any reduction in the number of wide-bodied aircraft used in the trans-Tasman market is likely to limit the quantity of air freight able to be transported in the market. This in turn, is likely to constrain the level of competition in the market. However, it would appear that market participants are moving towards the use of narrow-bodied aircraft for commercial reasons. While this likely contraction in the trans-Tasman air freight services market will occur absent the Proposed Arrangements, the Commission notes that an environment of contracting freight capacity exacerbates the anti-competitive effect of the Proposed Arrangements.

12.209. The Applicants proposed to address this reduction in capacity though the introduction of "freight only" services on wide-bodied passenger aircraft (as discussed above). The Commission has examined the cost of operating such services and does not believe that they would be viable unless there were substantial increases in freight rates. AFCQ stated that, based on current operations, revenue and traffic flows, it is generally accepted that the operation of dedicated freighter aircraft is not economically viable.

Submissions on anti-competitive detriment in the international freight transport market provided since the Commission's Draft Determination

<u>The Applicants</u>

12.210. The Applicants submitted that the effect of the Proposed Arrangements in this market depends on a comparison of the arrangements with the counterfactual for freight.

12.211. The Applicants noted that the Commission accepted in its Draft Determination that Air NZ will move to narrow-bodied aircraft and that freight capacity will diminish with or without the Proposed Arrangements and that there is unlikely to be any new entry into the freight market.

12.212. The Applicants submitted that, therefore, it is clear that Qantas will obtain all of Air NZ's share of the freight market both with and without the Proposed Arrangements and that the perceived loss of Air NZ as a competitor in the freight market will therefore have no significant anti-competitive effect.

12.213. The Applicants submitted that the Commission made an erroneous assessment of freight capacity in the counterfactual and that this has led to the Commission overstating the anti-competitive effect in the freight market.

The Commission's view on anti-competitive detriment in the freight market

12.214. The move to narrow-bodied aircraft on the trans-Tasman route by Air NZ appears to occur regardless of whether the Proposed Arrangements proceed or not. Under these circumstances, the amount of freight capacity on offer on the route from current operators looks certain to diminish, even without taking into account capacity reductions that will occur under the Proposed Arrangements. This development is likely to create an imbalance in demand over supply given the reduced unitised capacity in the market available in wide-bodied aircraft.

12.215. In this context, the extent to which the Proposed Arrangements will be anti-competitive in the trans-Tasman freight market will depend on the market share ultimately held by Air NZ. If Air NZ was lost as a competitor in the trans-Tasman freight market, regardless of the Proposed Arrangements, it could be concluded that there was no anti-competitive detriment arising in this market from the Proposed Arrangements.

12.216. However, information provided to the Commission by the Applicants as appears in Table 12.4 below shows that under the first three years of the Proposed Arrangements the Applicants would jointly hold 76.8 per cent, 75.9 per cent and 76.7 per cent respectively of the total trans-Tasman market. On the Applicants' figures the share of the total market achieved by Air NZ would be 25.7 per cent, 19.8 per cent and 18.6 per cent. On these estimates Air NZ would have the second largest market share, ahead of the combined fifth freedom operators which would have share of around 15 per cent.

Table 12.4. Postulated changes in trans-Tasman air freight capacity (tonnes/average per week/both ways)*

	Air NZ	Qantas	Others**	Total capacity
Currently	1,487	1,688	793	3,968
The future without the Proposed Arrangements				
Year 1	#	#	815	#
Year 2	#	#	873	#
Year 3	#	#	897	#
The future with the Proposed Arrangements				
Year 1	949	1,888	856	3,694
Year 2	741	2,098	902	3,741
Year 3	739	2,306	926	3,972

* As advised by Qantas and Air NZ.
** Includes fifth freedom, Virgin Blue and freighter capacity
# Information provided by the Applicants to the Commission on a confidential basis

12.217. Even if cargo capacity in wide-bodied aircraft only is examined, Air NZ remains a significant player in the market. The Alliance would hold 76.2 per cent, 75.3 per cent and 76.4 per cent of market in Years 1, 2 and 3 respectively with Air NZ's share being 22.2 per cent, 14.3 per cent and 13.4 per cent respectively.

12.218. In an environment where, without new entrant capacity coming into the market, there will be an excess of demand over supply relative to the current level of trade, and where Air NZ does have a significant market share, the Proposed Arrangements could be expected to significantly increase the market power of the Applicants to the detriment of trans-Tasman importers and exporters and result in increased freight rates and a reduction of competition on freight services.

12.219. The Commission is not satisfied that new entrant airlines or the proposal of the Applicants to introduce freight only services will reduce the Applicants' market power or the effects of it.

12.220. The Commission has formed a view that the Proposed Arrangements will lead to significant anti-competitive detriment in the air freight market leading to increased prices and reduced capacity.

Australian domestic air transport market

12.221. In their Supporting Submission, the Applicants did not regard the Australian domestic passenger market as a market affected by the Proposed Arrangements but the Commission has received a number of submissions which suggest that it is likely to be affected.

Submissions on domestic market detriment

The Department of Transport and Regional Services

12.222. DTRS has commented that because Australia's domestic aviation market is the most liberal in the world, it ensures a continuing threat of competition for Qantas from domestic or foreign owned start-ups.

12.223. DTRS considered that for this reason, it is important to ensure that potential entrants to the Australian domestic aviation market are encouraged and supported. The Proposed Arrangements remove Air NZ as a potential entrant to the domestic market if its financial recovery proceeds as planned.

Regional Express

12.224. Rex, a regional operator in Australia, claimed that it will be disadvantaged if the Proposed Arrangements proceed as Air NZ will not continue with an interline agreement with Rex. If the Proposed Arrangements proceed, any Air NZ interline traffic will be directed towards QantasLink, Rex's regional service competitor.

Submissions on anti-competitive detriment in the Australian domestic market provided since the Commission's Draft Determination

12.225. Together, the Applicants did not provide any comments on the Commission's views on anti-competitive detriment in the Australian domestic market as outlined in its Draft Determination.

Air NZ

12.226. Air NZ provided an individual submission on the Commission's view of anti-competitive detriment in the Australia domestic air transport market as expressed in its Draft Determination.

12.227. Air NZ submitted that the Commission has inconsistently applied the concept of an Australasian market and that it erred in overlooking the evidence that:

- Air NZ has never entered the domestic market in its own right and has no intention of doing so; and

- to the extent that there is pressure for a Star Alliance carrier to enter the market, the Star Alliance will have to support a new entrant into the market or direct its traffic to other domestic operators as some of its members already do.

12.228. Air NZ submitted that there is clear evidence that it would not (in any time frame relevant to the Proposed Arrangements) enter the domestic Australian market as there are high costs and risks for Air NZ to build an Australian presence and Air NZ cannot afford another high risk route.

12.229. Air NZ submitted that the Commission has failed to provide any evidence that Air NZ would enter the market in its own right.

12.230. Air NZ submitted that the Proposed Arrangements therefore have no effect on the Star Alliance's ability to achieve entry and no anti-competitive effect in the market.

12.231. Air NZ submitted that, in its Draft Determination, the Commission came to the incorrect conclusion that the Proposed Arrangements are likely to result in substantial anti-competitive detriment to the Australian domestic market.

The Commission's view on domestic market detriment

12.232. The carriage of passengers on domestic journeys linked to international travel is referred to as feeder traffic or domestic on-carriage. Such on-carriage is a significant component of the domestic market.

12.233. Currently Qantas has a share of Australia's international passenger market amounting to around 35 per cent. Its **one**world partners Cathay Pacific and BA have a joint market share of an additional seven per cent. It would be expected that **one**world traffic would interline on Qantas' domestic services. Qantas also has code share arrangements with a number of other airlines services to Australia such as Air Pacific, South African Airways, LanChile, China Eastern, Japan Airlines, Asiana, Aircalin, Air Niugini, Polynesian Airlines, Air Tahiti Nui, Eva, Air Vanuatu and Vietnam Airlines. These code share partners account for nearly 11 per cent of Australia's international traffic and would also be expected to interline with Qantas domestic services. On this basis around 53 per cent of domestic on-carriage traffic accrues automatically to Qantas.

12.234. Air NZ being a major operator in the trans-Tasman, Australia's largest international air travel market, accounts for around ten per cent of all passenger traffic into and out of Australia. If the Proposed Arrangements were to proceed this ten per cent of all international passenger traffic would additionally automatically interline with Qantas. Such a development would be to the competitive disadvantage of domestic operators such as Virgin Blue and Rex by denying them access to a significant part of the market.

12.235. Such a development would also significantly increase the market power of Qantas in the domestic market and would increase its captive share of on-carriage traffic to over 60 per cent and at the same time would create a significantly increased barrier to entry into the domestic air passenger market.

12.236. Air NZ's assertions in submissions to the Commission that it has no intention of entering the Australian domestic market are not surprising in the context of the Proposed Arrangements and the Commission acknowledges that such a development is unlikely in the short term on the basis of information before it.

12.237. The Commission notes however that the assertion made by the Applicants that Australasia is a natural market and that the economic reality is that any local carrier must participate in all of the domestic Australian, domestic New Zealand and trans-Tasman markets is not consistent with such a position.

12.238. The Commission also recognises that, while the Star Alliance is not represented in the Australian domestic market, international carriers flying to